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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/9

9:00 a.m., January 30, 1995

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

A. D. Ouattara, Acting Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	
	M. Sirat
	P. Cailleteau, Temporary
	D. Desruelle, Temporary
J. Bergo	
L. E. Berrizbeitia	V. J. Fernández
I. Clark	
B. S. Dlamini	
	J. Shields
	R. Kannan, Temporary
J. E. Ismael	
D. Kaeser	M. C. B. Arraes, Temporary
W. Kiekens	J. Hamilius, Temporary
Y.-M. T. Koissy	H. A. Barro Chambrier
	M. Giulimondi, Temporary
	G. Schlitzer, Temporary
K. Lissakers	B. S. Newman
	T. Oya, Temporary
	S. Ishida, Temporary
	S. Rouai, Temporary
	J. Leiva, Temporary
S. Schoenberg	E. Wagenhoefer
	A. Guennewich, Temporary
A. S. Shaalan	Y. Y. Mohammed
	A. V. Mozhin
	B. M. Lvin, Temporay
	A. V. Vernikov, Temporary
E. L. Waterman	J.-H. Kang
	O. Havrylyshyn
	Wei B.

L. Van Houtven, Secretary and Counsellor
M. A. Khan, Assistant

Also Present

IBRD: D. Cotlear, Latin America and the Caribbean Regional Office; J. R. Hansen, Europe and Central Asia Regional Office; G. Tidrick, Southern Africa Regional Office. H. Du Toit, Representative of South Africa. African Department: E. A. Calamitsis, Director; A. Basu, Deputy Director; G. E. Gondwe, Deputy Director; D. T. S. Ballali, B. F. W. Bingham, P. Doyle, A. M. Farah, J. P. Gordon, H. Hino, D. E. Rehm, J. T. Reitmaier. European I Department: L. J. Lipschitz. European II Department: J. Odling-Smee, Director; E. Brau, Deputy Director; A. Gagales, J. Ha, H. R. Lorie, M. Shadman-Valavi, H. J. G. Trines. External Relations Department: A. M. Abushadi, D. R. Hawley. Fiscal Affairs Department: P. S. Heller, A. Jaeger, D. W. H. Orsmond. Legal Department: F. P. Gianviti, General Counsel; R. B. Leckow, J. M. Ogoola, F. M. Zeidan. Policy Development and Review Department: J. T. Boorman, Director; M. Allen, Deputy Director; J. P. Pujol, S. M. Schadler, J. F. van Houten, J. K. Wakeman-Linn. Research Department: J. Santaella. Treasurer's Department: H. Flinch. Western Hemisphere Department: C. M. Loser, Director; M. E. Bonangelino, Deputy Director; A. Gomez-Oliver, E. R. J. Kalter, C. G. Muniz, L. Schmitz, S. C. Sosa, J. E. Zeas. Office of the Managing Director: S. Sugisaki, Special Advisor; P.-I. Koupaki. Advisors to Executive Directors: J. M. Abbott, R. F. Cippa, S. S. Farid, J. Guzmán-Calafell, J. Jonáš, J. M. Jones, M. F. Melhem, Y. Patel, C. F. Pillath, R. Rainford, B. A. Sarr, J. R. Suárez. Assistants to Executive Directors: S. Al-Huseini, P. I. Botoucharov, A. L. Coronel, M. Dzervite, G. El-Masry, J. C. Estrella, R. Ferrillo, R. Glennerster, H. Golriz, C. M. Gonzalez, N. F. Gregory, B. Grikinyté, O. Himani, G. H. Huisman, C. Imashev, P. Jilek, T. Kanada, W. C. Keller, E. Kouprianova, K. Kpetigo, G. A. Kyriacou, K. J. Langdon, M. V. Nikitenko, Ng C. S., G. P. Ramdas, J. Roaf, M. W. Ryan, D. Saha, F. A. Schilthuis, G. Schlitzer, A. Sighvatsson, V. Trivedi, R. von Kleist, Wang X.

1. HONDURAS - 1994 ARTICLE IV CONSULTATION; ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT - AMENDMENT; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY - SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1994 Article IV consultation with Honduras and Honduras' request for the second annual arrangement and extension of the commitment period and increase in access under the enhanced structural adjustment arrangement (EBS/95/4, 1/10/95). They also had before them the authorities' letter of intent (EBS/94/233, 12/5/94; and Sup. 1, 1/11/95), a policy framework paper for the period 1994-97 (EBD/95/8, 1/12/95), and a background paper on recent economic developments in Honduras (SM/95/8, 1/19/95).

The staff representative from the Western Hemisphere Department, reporting on developments and information received since the staff report had been issued, noted, first, that net international reserves had increased by $25 million during 1994, compared with the staff estimate of a decline of $50 million. As central bank credit had been in line with the estimates, the better reserve performance reflected a larger demand for base money than previously estimated. Since end-December, the lempira had appreciated by approximately 2 percent vis-à-vis the U.S. dollar.

Second, the staff representative observed that preliminary data suggested that the fiscal deficit had declined to approximately 7 percent of GDP in 1994, compared with the estimate in the staff report of 7.5 percent of GDP. Public sector savings were broadly in line with the estimates, but capital expenditure in the public enterprises was smaller.

Third, inflation during 1994 had been marginally lower than previously estimated, the staff representative said. However, prices had risen by close to 3 percent in January 1995, mainly as a result of the lifting of the temporary price freeze and increases in transportation fares. The staff had estimated that prices would increase by around 2 percent in January.

Fourth, measures envisaged for December 1994 were in place, except for the new tax cut and the decree establishing expenditure limits, the staff representative added. The decree had been sent to the President and it was expected to be issued shortly. The authorities envisaged that congressional approval of the tax cut would be obtained in the first quarter of 1995.

Finally, approximately $4 million of external payments arrears remained outstanding with certain Paris Club creditors, owing to a reconciliation problem in one case and a delay in signing a bilateral agreement in another, the staff representative concluded. The authorities were seeking to solve those problems as soon as possible.

Mr. Berrizbeitia made the following statement:

My Honduran authorities are in broad agreement with the comprehensive and useful analysis of the Honduran economy contained in the set of papers prepared by the staff on the occasion of the 1994 Article IV consultation and request for second annual arrangement under the enhanced structural adjustment facility. They also thank the Fund management and the staff for its continuous support and advice.

Honduras' economic situation sharply deteriorated in the run-up to the presidential elections in November 1993. Real GDP continued growing at a rapid pace (6.1 percent); however, the deteriorated fiscal position affected economic agents' confidence and resulted in an acceleration of inflation to 13 percent, a loss of $90 million in net international reserves, and in a depreciation of 25 percent of the lempira in nominal terms and 11 percent in real terms.

The administration that took office in January 1994 acted promptly in order to tackle the fiscal imbalances and to restore confidence, by eliminating some subsidies and significantly reducing others, cutting public expenditure both current and capital, increasing gasoline prices and adjusting the custom valuation factor. Furthermore, in June 1994, the authorities adjusted electricity rates by 42 percent and, in an attempt to contain the depreciation of the lempira, increased reserve requirements and introduced a system of foreign exchange auctions.

Notwithstanding those actions, Honduras was struck by a drought that resulted in electricity shortages that partly affected economic activity during 1994. Real GDP declined by 1.5 percent and inflation accelerated to 29 percent during December 1994, reflecting in part expansionary policies in 1993 and corrective price increases. Although during the first half of the year reserves continued falling and the lempira depreciated rapidly, the above actions, coupled by a decline in the fiscal deficit and tight credit policies contributed to revert that trend during the second part of 1994. By the end of the year, the gain in net international reserves more than offset the losses of the first six months, and the nominal depreciation of the lempira slowed down from an annualized rate above 40 percent in June to 15 percent in December 1994.

Against this background, my Honduran authorities, after long and exhaustive discussions with the representatives of the main sectors of the economy, formulated a comprehensive medium-term economic program aimed at setting the basis for sustaining economic growth and reducing poverty. The program gives utmost importance to the achievement of macroeconomic stability and the strengthening of the structural reforms process.

The strengthening of public finances is the cornerstone of the program. The fiscal deficit originally projected at

12 percent of GDP was reduced to around 7.5 percent of GDP in 1994, and it will be further reduced to 4 percent in 1995, excluding revenue from the windfall to coffee producers. To achieve these objectives, several measures were approved last October to improve public revenues by almost 4 percentage points of GDP in 1995. These measures included the elimination of the custom valuation factor, a 1 percent tax on gross assets of firms, and an expansion in the sales tax base. Moreover, the Government increased gasoline and diesel revenue and increased domestic telephone rates. In addition, a temporary export tax and a minimum income tax on coffee producers were approved to capture part of the windfall and to reduce demand pressures. Part of these proceeds will be used to finance social expenditure and the rest will be deposited in a trust to be established in the Central Bank, as a stabilization mechanism. The Government is also committed to contain current expenditure; for this purpose, a presidential decree was issued establishing expenditure ceilings for 1995 for the Central Government and public enterprises.

Monetary policy will be conducted in a consistent manner with the fiscal stance. The main objective for 1995 is to build up net international reserves by $185 million and to reduce inflation to 12 percent. The strategy envisages a reduction of the net domestic assets of the Central Bank of about 75 percent stemming from a significant increase in deposits of the public sector. The authorities also intend to strengthen the capacity of the Central Bank to grant it greater autonomy and bolster its financial position to improve the conduct of monetary policy, relying more on indirect instruments of monetary control, to resist pressure to finance fiscal deficits, and to phase out the management of government trust funds--the staff paper provides detailed description of the authorities' intention on this matter. Furthermore, on December 1994 the authorities submitted to Congress a new draft of the Financial Sector Reform Law aimed at strengthening bank supervision and prudential controls, as well as to enhancing competition in the financial system. All these measures are also expected to contribute in the narrowing of interest rates spreads and improvement of financial intermediation.

On the external front, significant measures have been implemented since 1990 and the trade system is relatively open and liberal. The authorities remain committed to the maintenance of this system in order to facilitate the integration of Honduras to the world economy. My authorities are confident with the functioning of the current foreign exchange auction system which has helped to reduce exchange rate volatility. Nevertheless, they will closely monitor developments in the exchange market with a view to reviewing the exchange rate system if required, and they intend to move to a more permanent system within the period of the three-year arrangement under the enhanced structural adjustment facility (ESAF).

The Government is firmly resolved to accelerate the process of structural reforms with the support of the World Bank and the Inter-American Development Bank (IDB). Regarding the privatization process, it is worth mentioning that legislation was enacted last November to allow private sector participation in electricity generation and distribution. In addition, the Government is determined to privatize HONDUTEL and a specific proposal for this purpose will be submitted to the Assembly by April 1995. Other important measures are envisaged in the program for the agricultural and transportation sectors, in addition to those already mentioned in the financial sector.

Poverty alleviation is of foremost importance to the Honduran authorities. For this purpose, the authorities are determined to lower inflation and facilitate an adequate environment for economic growth. They will also strengthen the social safety net program mainly funded by concessional financing from abroad with a view to implementing projects specifically targeted to the poorest sector, through the Honduran Social Investment Fund (FHIS), and the Family Assistance Program (PRAF). Furthermore, my Honduran authorities are convinced of the need to continue improving and consolidating education and health services. The aim for 1994-97 is to increase the share of public expenditure in these areas.

The authorities are fully aware that a long-lasting improvement in the fiscal position is paramount to achieving macroeconomic stability and paving the way for sustained economic growth and intend to continue reducing the fiscal deficit. However, given the heavy burden of the external debt, the support of the financial community through adequate and timely external financing in concessional terms and debt reduction along the lines recently announced by the Paris Club, will be critical to achieving external viability. Let me add that meaningful efforts were made last year to eliminate external arrears to Paris Club creditors and to renegotiate with other non-Paris Club creditors.

With technical assistance from the Fund, the World Bank and the IDB the authorities expect to continue improving public sector management and tax collection. They also intend to request technical assistance from the Fund for improving their statistical system.

My Honduran authorities attach the highest importance to an economic program supported by the Fund as it provides a framework to restoring confidence both domestically and internationally. The program took some time to be finalized because of the size of the required adjustment and the need to obtain political consensus to help ensure its sustainability. Those efforts have started to pay off with the fiscal policy actions approved by Congress in October and with the improvement recorded in the fiscal position. On this basis, they are confident that this program will be fully implemented and request the support of the Board for the second annual arrangement under the ESAF, the increase in the amount of this arrangement and the extension of the commitment period of the three-year ESAF arrangement until July 24, 1997.

Mr. Newman made the following statement:

In view of the very sizeable erosion in Honduras's economic performance that has occurred since the ESAF was abandoned prior to the 1993 elections, it is unfortunate that it has taken so long for the new Government to restart the reform effort. However, we are pleased to see that the process of restoring macroeconomic stability and renewing the reform process has finally gotten underway in the past several months. We thus can support this second year program and the two-year extension of the commitment period. Nevertheless, a more ambitious approach seems warranted in a number of areas, especially given the fiscal and external risks to the program, the troubled state of the Honduran economy, and the clear need to make progress on the Government's very laudable goal of sharply reducing poverty in this very impoverished country.

The staff report amply documents the deterioration that has taken place over the past 18 months. I share their general assessment that far too much valuable time has been lost, but I see no reason to rehash the numerous mistakes that were made. Therefore, let me focus my remarks on two elements of the program that are not entirely satisfactory, the budget and the exchange rate system.

We fully agree with the staff and Mr. Berrizbeitia that fiscal consolidation must be the cornerstone of the program; as the staff points out, incomplete implementation is also the source of the biggest risk to the baseline scenario. Perhaps I overlooked something in the numerous papers, but I would appreciate comments from either the staff or Mr. Berrizbeitia as to possible specific contingency measures that the Government is prepared to adopt, should it become necessary.

Overall, I feel fiscal consolidation should move forward faster than suggested in the proposed program. While important progress was made in curbing the election excesses, the 1995-97 projections show central government revenue remaining flat at 18.7 percent of GDP while current expenditures edge down by only 1 percent of GDP. The improvement in the overall deficit in the out-years largely reflects reductions in capital spending and net lending following the substantial expansion in the pre-election period, and, apparently, the effects of privatizing the telephone company. Further efforts are needed to eliminate the remaining subsidies, contain the wage bill, and reduce the size of the civil service. The Government also needs to move more rapidly to restructure itself to eliminate overlapping responsibilities between agencies. On the revenue side, we have no problem with the level of revenues, per se, or the Government's disinclination to raise tax rates at this point. However, in view of the general problem of tax evasion in Honduras, it does seem that revenue yields should increase relative to GDP as a result of the planned improvements in tax administration. In this regard, I would appreciate staff comments on any efforts that might be underway to improve customs administration, especially as this topic does not appear to be covered in either the policy framework paper or the staff report.

Outside of the Central Government, reform of the government-owned utilities needs to be tackled so that the budget is not undermined and resources are freed up for private investment and private sector growth. While we support the planned review of the public sector enterprises in conjunction with the World Bank and the IDB, the Government's specific commitments to privatization seem too vague. In particular, the commitment to privatize the telecommunications company by mid-1996 does not seem ambitious enough, particularly as it alone suffered losses of 0.5 percent of GDP through the first half of 1994. Perhaps the staff could shed light on why this could not be brought forward somewhat.

I am not very comfortable with the accommodation that seems to have been reached on reform of the exchange rate system. As the staff notes, the various rigidities inherent in the current auction system make it inferior to the interbank market that was suspended in mid-1994. Implementation of a flexible exchange rate system is an appropriate structural benchmark, but what this means in practice seems open to dispute. Likewise, the commitment stated in the policy framework paper to improve the infrastructure, transparency, and supervision of the foreign exchange market strikes us as weak and unspecific. Finally, the staff's own recommendations in this regard are not as explicit as they could be. Overall, we are left with the impression that the Government and the staff have agreed to disagree, and I wonder whether that is the right road to take. We understand that interbank system in operation prior to July 1994 was itself far from perfect, as it was not well developed and market participants lacked transparency and information. However, it would be far preferable to return to, and fix, that system, and it seems the Fund should stick with the policy advice given under the first-year ESAF arrangement: commercial banks and exchange houses should conduct transactions at a freely determined rate. As long as this second-best auction system is preserved, I believe we should at least be urging more forcefully that the bands be widened and the rates adjusted more frequently to increase the role of market forces.

In conclusion, Honduras will have little margin for error under this program. In particular, the high degree of reliance on external financing from donors and creditors will require that the ESAF arrangement be implemented scrupulously, and that policies be adjusted promptly if needed to keep the program on track.

Mr. Shields made the following statement:

Last time we discussed an Article IV consultation report and Honduras' ESAF arrangement, in July 1993, the United Kingdom expressed serious misgivings about the commitment of the authorities, in an election year, to keep to the plans then presented to us. The Board gave Honduras the benefit of the doubt, but subsequent events proved that this benefit was not merited. The program went severely off track, the disbursement was not made and the Honduran economy continued to suffer accordingly.

We now find ourselves, 18 months later, again in the position of being asked to approve the second arrangement under the ESAF, again after a period of rising inflation, falling currency and depleting reserves--and again after the undertaking of a number of policy actions by the administration designed to restrict demand and restructure the economy. However, I find it difficult not to be impressed by the breadth of the steps being taken this time and by the determination now being shown by the new administration, not least in putting in place the prior actions under the current program.

In particular, I commend the action taken thus far to curb central government expenditure. As Mr Berrizbeitia's opening statement points out, along with the tax changes, a substantial fiscal adjustment has already been implemented.

Further structural reforms are also under way and I very much welcome in particular the proposal to develop a Public Sector Reform Program in conjunction with the World Bank and the IDB and--within that--the effort to address pension reform. Monetary policy is also beginning to acquire some usable instruments and to show its teeth--I am pleased that economic distortions caused by the very high levels of reserve requirements are now being reduced. It is however a little worrying that the questions of arrears to the Paris Club have still not been fully settled.

The staff report makes a number of references to the problems caused by electricity shortages in 1994, which were partly due to drought. But it perhaps makes less reference than it might to the unexpected boost received in the form of sharply higher coffee prices in the year, up from about 50 cents to $2 a pound. Meanwhile, two new taxes will be funneling part of this gain to the public sector and part of the public revenue will be saved. Use of this special facility may well be a second-best response to the unexpected rise in the coffee price, but it is less bad than many that might have been attempted. However, the staff report projects coffee prices to remain at a high level through 1995 and 1996, and notes the risk to the balance of payments from significantly lower prices. I would suggest that there is a considerable downside risk to the projections from this source.

I think the Board is right to extend the benefit of what remains considerable doubt to Honduras. In the circumstances, it is however vital that Honduras sticks precisely to the terms of the new agreement. The authorities have made clear their intention to do this. They will also need to gain agreement on debt rescheduling on very concessional terms and debt reduction.

In conclusion, I endorse the extension of the ESAF commitment period and the enlarged second drawing.

Mr. Cailleteau made the following statement:

As recalled by the staff, Honduras' economic situation has dramatically worsened in 1993; indeed, major macroeconomic imbalances re-emerged while--the report adds--long-standing problems have continued to persist. It is somewhat unfortunate that we have not had the opportunity to discuss those slippages in 1994.

Some significant and encouraging measures have been taken in 1994, but today's decision on the second annual arrangement under the ESAF and the increase in the amount of this arrangement is a bet on the future commitment of the authorities to forcefully address the public sector deficit.

While I do not have much doubt concerning the appropriate orientation for the fiscal policy and the need to revise the Central Bank Law and the financial structure of the economy along the lines of the reform presented in the letter of intent, I am not absolutely clear on foreign exchange policy--both the strategy and the instruments.

First, there is no doubt in my mind that the staff rightly points to the fiscal slippages as the main problem in Honduras. The challenge is indeed to reduce public sector deficit in the short run and to increase public saving substantially in the medium term. This task is made difficult by the fact that public debt service accounts for more than 40 percent of government expenditures. In the cuts, public investment expenditures downsizing will be required: it is worth noting that the level of public investment expenditures to GDP--13 percent--is currently rather high, at least by Latin American standards: however, what is the staff's view on the impact on future growth of a 2 percent reduction in investment planned for 1995?

The objective is to increase the rate of savings in order to increase the potential of growth and to reduce external vulnerability. On that last point, I would admit that the task is ambitious if one assumes that the adjustment will be made by an increase in savings rather than by a reduction of investment: I note that the rate of investment in Honduras is high--24 percent of GDP.

I would be interested to know the staff's view on the atypical behavior of investment and saving, the former being unusually high by regional standards, the latter being substantially smaller than the rate of most Latin American countries.

Concerning monetary and financial issues, I have no difficulties with the report. I subscribe to the objectives laid down in the letter of intent.

I see three main concerns, which are closely linked: the first is the inability of the Central Bank to correctly implement a clear mandate of price stabilization and financial sector surveillance. One cannot expect a central bank that incurs considerable operational losses--the valuation losses are estimated at about 9 percent of GDP--to reform its instruments with the necessary serenity, as one of the first concerns is certainly whether--and, if so, to what extent--the new framework will help reduce the financial burden of the Central Bank. The second concern relates to the reliance on high reserve requirements to control credit. I can understand that this factor and the lack of competition in the financial sector have led to large interest rate spreads--which, by the way, seem not to have deterred investment. I certainly acknowledge the need to scale back the degree of financial repression. With due regard to the increasing rate of dollarization of the economy, I would be interested in knowing the opinion of the staff on the impact of the measures announced on the favorable treatment offered to foreign currency deposits. The last concern is obviously the apparent weakness of the system of supervision, given the significant development of disintermediation.

The recommendations in the field of monetary and fiscal policies seem clear. What is less clear are the recommendations regarding the foreign exchange policy, both the strategy and the instruments. As regards the strategy, I confess that I have not seen many developments explaining what the authorities are trying to achieve--stability with flexibility: I failed to find any analytical explanations of that strategy in the papers--or of what the staff is actually advocating--except for some rather common sense ideas, and I think the matter deserves more elaboration. As regards the instruments--on which the discussion between staff and the authorities seems to have been focused--the arguments in favor of auctions against the interbank market have not been presented in details. There can be legitimate reasons to the shift decided by the authorities, and perhaps the financial system was not developed enough for the establishment of truly market-based exchange rates. It remains, however, that, as presented in a recent Working Paper ("Foreign Exchange Auctions and Fixings: a Review of Performance"), auction-market arrangements have rarely been sustainable in the long run. I would also appreciate more explanation on that issue.

In conclusion, given the commitment shown by the authorities, I support the proposed decisions.

The staff representative from the Western Hemisphere Department noted that the program was ambitious in the sense that it provided for a fairly large increase in public sector savings, excluding interest payments, from approximately 8 1/2 percent of GDP in 1993 to about 13 percent in 1995. In 1996, public sector savings would decline, but only because the program assumed that HONDUTEL, the telecommunications company, which currently contributed about 2 percentage points of GDP to public sector savings, would be privatized. At the same time, coffee prices were likely to remain stable in 1996, before falling in 1997. The program thus contained a considerable saving effort, along, it was true, with a decline in investment, which however had been unsustainably high in 1993/94. Both the authorities and the staff believed that a lower but more efficient level of public investment would make a similar contribution to economic growth. As indicated in the staff report, the authorities had been working with the World Bank staff to improve investment planning.

The most important contingency measure that the authorities could take in the near term, in case the revenue estimates were not realized or in the event of unexpected additional expenditure pressures, would be an increase in the sales tax from 7 percent to perhaps 10 percent, the staff representative said. The staff had been discussing that measure with the authorities, who had not yet acted because of political resistance.

Although HONDUTEL had been contributing about 2 percent of GDP annually to public sector savings, it had recently carried out a large investment project and had as a result experienced a deficit in the preceding year or so, the staff representative noted. The timetable that had been discussed for the privatization of HONDUTEL took into account--in consultation with the World Bank--the need to both establish a proper regulatory framework and avoid giving the impression that the authorities were being pressured into selling the company at prices that might not be favorable.

As to why the tax ratio would not increase, despite the envisaged improvements in tax administration, the staff representative explained that the reduction in the customs service charge and the elimination of the remaining import surcharge would result in a revenue loss of the order of 1 percentage point of GDP. Thus, it had been assumed that revenue would remain approximately constant. The authorities were considering various options to strengthen not only customs administration, but also the tax administration in general. In addition, the decision to grant a greater degree of autonomy to the internal revenue service would ensure greater independence in the selection and evaluation of personnel, and possibly a reduction in the number of employees, thereby improving quality. Preliminary consideration was also being given to contracting with a private surveillance firm, based on similar experience by Peru.

The revised projections for a coffee price of $1.75 for 1995 and $1.70 for 1996 were consistent with developments on export and futures markets, the staff representative commented. The small shortfall that would result would fortunately not have a major impact on the program.

The Central Bank had accumulated large losses in 1990-94, together with some outstanding losses on an accrual basis that would be met on a cash basis over the following 10-15 years, depending on the maturity of the obligation, the staff representative noted. On an ongoing basis, the losses of the Central Bank over the preceding two to three years had represented approximately 1/2 of 1 percentage point of GDP. Nevertheless, the Central Government should be able gradually to recapitalize those losses, beginning in the coming fiscal year, with a view to eliminating them as soon as possible.

The exchange rate issue had been discussed extensively with the authorities, the staff representative observed. The staff's initial recommendation had been that the authorities should keep the interbank system, which, notwithstanding some imperfections that the staff had been advising the authorities to correct since 1992, was working fairly well. But the large underlying financial problems tended to increase those imperfections, and the authorities had decided to move to the auction system. In their view, it was important to impart a degree of stability to the system, and to strengthen confidence in parallel with the measures that they were taking to tighten both fiscal and monetary policy. Although the new system had some restrictive elements--for example, the limit on sales of exchange--it seemed to have worked well and to have been well received by the market. The main test for the staff had been the virtual lack of spread--less than 1/2 of 1 percent--between the rate in the official market and the rate in the informal market. There had even been instances in which the informal rate had appreciated vis-à-vis the official rate. The staff had therefore accepted the system, pending a midyear review, and based on an understanding with the authorities that they would increase the flexibility of the system if developments in the informal market or in international reserves indicated the need to do so. The authorities still had not decided what type of system to implement in the future. The staff had emphasized the advantage of moving back to the interbank market; without closing their minds to that option, the authorities would like the staff to consider other options during the midterm review, including some type of crawling peg, for example, or even a fixed exchange rate system, if the fiscal position was sufficiently strong. The issue would be a matter for discussion during the midterm review.

Ms. Arraes made the following statement:

I would like to commend the Honduran authorities who took office in January 1994, as they have managed to slow the momentum of the country's deteriorating economic situation, which they inherited from the previous administration. The program now presented to the Fund builds upon the measures already taken during 1994 and shows the Government's continuous commitment to the adjustment effort. The revenue-enhancing measures, together with the expenditure reduction program, should yield a fiscal improvement equivalent to 3-4 percent of GDP. To lock in the fiscal consolidation progress, the authorities should restrain expenditure during the entire program period, especially after the coffee boom wanes. Additional efforts will have to replace the revenue derived from coffee. I agree with the staff that the privatization program should be implemented without delay.

Consolidation of public sector finances will be essential to the achievement of monetary targets, with a reduction by 75 percent of net domestic assets of the monetary authority. In fact, this will only be possible because the public sector will be a net provider of resources to the Central Bank. The stabilization bonds will also help. I would appreciate it if the staff could elaborate further on the implications of the targeted reduction of net domestic assets.

Ambitious targets, together with a rather weak institutional arrangement for monetary policy, will require special attention from the authorities. I could not agree more with the staff that the program contains several reforms to improve financial intermediation and to increase the flexibility of monetary policy. Nevertheless, to achieve successful implementation, a precondition is the institutional strengthening of the Central Bank and of the Superintendency of Banks. I would like to see this emphasized even more than it has been in the staff appraisal.

In view of the adverse effect of very high reserve requirements on resource allocation, I can support the decision to lower them, carefully. I have serious doubts about the ability of the Central Bank to engage in the use of indirect monetary policy instruments and, at the same time, manage funds for the Government. In summary, the monetary role of the Central Bank should be strengthened and the responsibility for managing government funds should be removed. I would strongly support technical assistance by MAE in this area.

Although Honduras has benefited from the recent increase in coffee prices in international markets in the medium term, the external sector continues to be fragile. Export diversification is needed. I acknowledge that nontraditional exports have been growing at the impressive rate of 20 percent in recent years and that they are projected to grow at 9 percent from here on. Competitiveness will have to be maintained. I agree with the staff that a more permanent exchange rate system could reduce uncertainty and, together with sound financial policies, support an increase in exports and provide the right incentives to capital inflows.

Finally, it is needless to emphasize the importance of structural reform for the achievement of sustained growth, and, in the case of Honduras, external viability as well. The World Bank and the Inter-American Development Bank are financing public sector, agricultural, and other reforms, and any delay in disbursements will increase the financing gap. With these remarks, I can support the proposed decision.

Mr. Hamilius made the following statement:

During 1994, Honduras faced a number of economic difficulties, which were, unfortunately, made worse in part by natural factors. Although the present Government's reaction to the policy left by its predecessor is commendable, much remains to be done, and it will be essential to restore confidence among the Honduran economic agents. That is the only way to sound and sustainable growth, which is highly necessary in Honduras, given the importance of the poverty issue. Fiscal policy will be a key element to restore such confidence, and we were glad to learn from the staff report that the authorities have agreed to carry out a strong fiscal adjustment program.

To comment on some details of fiscal policy, on the expenditure side, we learned from the staff report that teachers' salaries were increased by 20 percent, effective May 1994, and that another 20 percent increase is to be implemented this year. In the same vein, the Congress voted an additional monthly salary for the public sector employees, amounting to a total of 14 months of salary. Although we understand that the impact of these increases will be limited, we wonder whether such measures do not undermine financial discipline and social cohesion between the public and private sectors. What were the salary trends in the private sector last year? The staff's comment on this issue would be welcome.

We have also noted that the authorities intend to strengthen the operations of the Social Security Institute by making health insurance viable and improving the finances of the pension fund. Could the staff further elaborate on this and give details on the potential fiscal consequences of the Government's intentions.

More generally, it is clear that Honduras's public sector, particularly its tax administration, is very weak. It will be vital to provide the necessary technical assistance so as to maximize the effects of fiscal measures; otherwise imbalances will persist.

To conclude, immense efforts will be necessary to tackle the problem of poverty in Honduras. With seven persons out of ten living in poverty and five out of ten being very poor, we cannot but fully agree that policy efforts must be concentrated in the agricultural sector. It will be the task of the Honduran authorities, with the help of the international community, to alleviate to the best possible extent the effects of poverty; otherwise every adjustment effort might be endangered.

We support the proposed decision.

Mr. Guennewich made the following statement:

As I agree with most of what the previous speakers have said, I can be brief.

First of all, we regret the renewed slippages in policy implementation under the Fund-supported adjustment program.

We welcome that the new Government has adopted certain measures to bring the program back in the direction of the adjustment path. The cut in subsidies and the adjustment of public sector prices are first encouraging steps.

The new program appears broadly appropriate; thus, the key question will be its implementation.

On policy issues, the envisaged fiscal consolidation does not seem to be very ambitious. The ratio of revenues to GDP as a percentage of GDP remains unchanged, and the expenditure will only decrease by 1.1 percent of GDP during the program period. It is noteworthy in this regard, that expenditures for wages and salaries are expected to decrease by only 0.2 percent in 1995. Therefore we suggest a review of the 20 percent salary increase for teachers in 1995 and the additional monthly salary for public employees mandated in October 1994. Moreover we feel, that the envisaged elimination of excess employment and the rationalization of the Central Government could be accelerated.

Further on public finances, I would be interested in knowing whether the trend of declining military expenditures continues. In Table 4, the data shows declining military expenditures until 1993. The staff report does not contain information on such expenditures for the period since 1993.

Before I conclude I would express my disappointment that there is still no firm timetable for the elimination of exchange restrictions. Given the number of adjustment programs Honduras has undertaken in the past, I wonder whether the staff has demanded reforms in this area vigorously enough.

The staff representative from the Western Hemisphere Department said that a reduction in the net domestic assets of the Central Bank, which was a requirement for bringing reserves to the level envisaged, depended critically upon the realization of the envisaged fiscal outturn. The program assumed that, given the fiscal adjustment and the fairly large external assistance envisaged for 1995, there would be a decline in domestic financing of the nonfinancial public sector. Basically, therefore, the assumption was that the proceeds of World Bank loans for balance of payments support, plus part of the proceeds from the coffee tax, would be deposited in the Central Bank, thereby permitting the necessary reduction in net domestic assets. The other important components of net domestic assets were credit to banks, which was at the September level, and central bank losses of 1/2 percent of GDP. Those losses created an increase in net domestic assets as a counterpart of the domestic financing surplus of the nonfinancial public sector.

On the question of salary increases, the staff had emphasized the importance of wage restraint, both to ensure the fiscal target and to avoid giving the wrong signals to the private sector, the staff representative stated. The wage bill as a whole had declined slightly in 1994, and was targeted to decline again in 1995. The problem of concern to the staff was the composition of the wage increases, in the sense that teachers had been granted--for valid reasons or not--fairly large increases of 20 percent in 1994 and in 1995 as well. The result was to limit the authorities' room for maneuver, because of the need to keep wage increases in other sectors below inflation. Continuous monitoring on their part would be required, given the pressures on wages in the public sector; apart from teachers, other sectors in the central administration had experienced substantial declines in real wages. However, wages in the public enterprises had kept pace with inflation; in the case of enterprises like HONDUTEL, they had increased by substantially more than inflation, and the authorities were currently trying to hold down wage increases for 1995. Unfortunately, the data in certain areas was poor; also, the staff had no detailed information on wage developments in the private sector, although it had heard reports of wages having come down slightly in real terms during 1994. The staff had also cautioned the authorities about the 14-month salary increase, which covered private sector employees as well, based on the decision taken by Congress.

Pension reform was at a very early stage, the staff representative from the Western Hemisphere Department concluded. The authorities were interested in allowing for the establishment of private pension funds as part of the public sector reform, with the assistance of the World Bank and the IDB. At the current stage, the staff's main recommendation was that the authorities not act without taking fully into account the fiscal implications. The staff intended to look into the matter in greater depth and to discuss it with the authorities during the midterm review.

Mr. Berrizbeitia thanked the Executive Directors for their interesting and constructive comments, particularly those related to the fiscal contingency measures, privatization, and exchange rate issues, as well as to the need for the authorities to be persistent in the application of the policies that had been agreed upon with the Fund.

From the point of view of the authorities, the new exchange rate system had contributed substantially to reducing volatility and had generated confidence on the part of all the actors in the foreign exchange system, Mr. Berrizbeitia said. A greater number of participants had access to foreign exchange through the system, and there was virtually no gap between the exchange rate in the parallel market and that in the official market. The system therefore seemed to be providing fairly good results and, owing to its relative newness, the authorities did not wish to introduce modifications so quickly that negative expectations were generated. However, they were aware that the system was not ideal and that it would have to evolve toward a more market-oriented system in the future. Different mechanisms that could be introduced in the future were under study, as suggested by the staff, but in the meantime, the new system was producing positive results.

Since 1990, the previous administration of Honduras had been successfully implementing an economic stabilization program, which had been supported by the Fund, Mr. Berrizbeitia recalled. The program was aimed at reducing macroeconomic disequilibria while laying the groundwork for sustained economic growth and restoring financial relations with foreign creditors. Those efforts had provided the opportunity to launch a medium-term program under the Fund's concessional facility, supported by the World Bank and the IDB. Performance during the first year of the program had been positive but mixed. Real GDP had grown at a faster rate, inflation had slowed, and significant structural changes had taken place. However, there was no question that, despite those positive developments, policy implementation had slipped during the run-up to the presidential elections in 1993, resulting in a sharp deterioration of the public finances. Since early 1994, the new administration had acted promptly to reduce the fiscal deficit; however, the magnitude of the disequilibria were such that they had continued to affect the economic outturn in 1994 in spite of the important efforts of the authorities. Important positive trends had been observed in the second half of 1994, as indicated by the improvement in many of the economic indices, and particularly in the updating by the staff at the beginning of the meeting. His authorities were therefore determined to continue reducing the fiscal deficit during 1995 with a view to stabilizing the economy. The policy reforms envisaged in the program were expected to bring about an increase in domestic savings, which would in turn allow an expansion in investment and better reflect the new national consensus in favor of increased social spending.

The challenges ahead were great, as his authorities recognized, Mr. Berrizbeitia concluded. They included the need to continue to reduce macroeconomic disequilibria, to strengthen the market economy, and to deepen the process of structural reforms, as well as to pursue industrial restructuring and technological progress. The authorities were confident that their domestic efforts, coupled with continued financial support from the international community, would be critical to meeting those challenges successfully. The Government's determination to implement, both in the past year and in the years ahead, the economic policies described in his opening statement were indicative of its commitment and political willingness to continue to implement the far-reaching economic measures necessary to achieve the envisaged economic targets.

The Acting Chairman made the following summing up:

> Directors welcomed the steps taken by the new administration to reverse the thrust of policies by adopting a comprehensive medium-term economic program aimed at re-establishing the basis for sustainable economic growth. While expressing considerable disappointment about the re-emergence of major financial imbalances in the run-up to the 1993 presidential elections, Directors noted that the deterioration in the fiscal position had eroded most of the gains achieved in previous years, and had resulted in an acceleration of inflation, a sharp depreciation of the currency, the depletion of international reserves, and rising external payments arrears. However, they observed that the substantial corrective measures introduced in 1994, and the fiscal adjustment being set in place in 1995, indicated the authorities' commitment to implement strong policies in the future.
>
> Directors supported the main objectives of the program and concurred that fiscal consolidation was crucial to stabilizing the economy, increasing domestic savings, and achieving external viability over the medium term. They also underscored the need to deepen structural reforms to give the private sector a greater role and to improve economic efficiency.
>
> While observing that the key measures envisaged in the 1995 fiscal plan were in place, Directors emphasized that strict adherence to all aspects of the fiscal program would be required to achieve the authorities' objectives. In particular, it would

be crucial to ensure that expenditure limits were observed, including by resisting pressures for wage increases in the public sector.

With regard to the proposed cuts in public investment, Directors noted that the prevailing levels appeared unsustainable, and that the authorities were working with the World Bank to strengthen the investment plan.

Directors agreed with the authorities' plans to consolidate further the fiscal position in 1996-97 by rationalizing government expenditure, restructuring the public enterprises, and strengthening tax administration to reduce tax evasion. They observed that the success of the strategy required a clear commitment to implement promptly a public sector reform program aimed at reducing excess employment and privatizing certain public enterprises.

Directors observed that fiscal consolidation would facilitate implementation of credit policies consistent with the objectives of lowering inflation, restoring international reserves to adequate levels, and reducing reserve requirements. They welcomed the sterilization of part of the windfall earnings from higher coffee export prices, and supported strongly the authorities' commitment to reduce the operating losses of the Central Bank and to recapitalize that institution. They also attached high importance to the authorities' efforts to improve financial intermediation and increase the flexibility of monetary policy, and to their intention to enhance the autonomy of the Central Bank.

While emphasizing that restrained financial policies would contribute to exchange rate stability, Directors observed that Honduras' exchange market and exchange rate strategy were unclear. Directors requested the staff to clarify the relative merits of an interbank market versus an auction system in Honduras in further discussions with the authorities.

Directors commended the authorities for their determination to maintain an open and liberal trade system which, in their view, was essential to achieve export-oriented economic growth.

Directors believed that fiscal consolidation and the deepening of structural reforms would enhance Honduras' growth prospects and reduce its reliance on external financing. They observed, however, that given its large debt service obligations, the country would continue to need exceptional external assistance in coming years, including debt reduction and debt rescheduling on highly concessional terms. In their view, that underscored the importance of implementing policies that would elicit appropriate support from external creditors.

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

The Executive Board took the following decisions:

Enhanced Structural Adjustment Arrangement - Amendment

1. The Government of Honduras has requested that the commitment period of the three-year arrangement for Honduras under the enhanced structural adjustment facility (EBS/92/110, Sup. 2) be extended until July 24, 1997, and that the amount for the second annual ESAF arrangement be increased to the equivalent of SDR 20.34 million.

2. Accordingly,

(i) paragraph 1(a) of the three-year ESAF arrangement for Honduras is amended by extending the commitment period until July 24, 1997 and increasing the total amount to the equivalent of SDR 47.46 million; and

(ii) paragraph 1(b) is amended by increasing the amount for the second annual arrangement to the equivalent of SDR 20.34 million.

Decision No. 10899-(95/9), adopted
January 30, 1995

Enhanced Structural Adjustment Facility - Second Annual Arrangement

1. The Government of Honduras has requested the second annual arrangement under the enhanced structural adjustment facility.

2. The Fund has appraised the progress of Honduras in implementing economic policies and achieving the objectives under the program supported by the first annual arrangement, and notes the updated policy framework paper set forth in EBD/95/8.

3. The Fund approves the second annual arrangement set forth in EBS/95/4, Supplement 1.

Decision No. 10900-(95/9), adopted
January 30, 1995

2. REPUBLIC OF BELARUS - PURCHASE TRANSACTION - SYSTEMIC TRANSFORMATION FACILITY

The Executive Directors considered a staff paper on the Republic of Belarus' request for a second purchase under the systemic transformation facility in an amount equivalent to SDR 70.10 million (EBS/94/238, 12/9/94; Sup. 1, 12/12/94; Sup. 2, 1/26/95; and Sup. 3, 1/30/95).

The Acting Chairman noted that, as indicated in Supplement 2 to EBS/94/238, the Belarussian authorities had accepted the need to postpone a decision on a stand-by arrangement pending the receipt of financing assurances.

The staff representative from the European II Department, reporting on the status of remaining prior actions, noted first that, with respect to tax exemptions (EBS/94/238, Sup. 2, Table 1, III.3), the Council of Ministers had issued an order on January 27 to substantially reduce discretionary exemptions for taxes, in addition to the changes adopted through the 1995 budget, which had eliminated the discretionary exemption for profit and property taxes.

The issue of amendments to the privatization law granting the same property rights (Table 1, V.2 and V.3) to state farms as already granted to collective farms was scheduled for discussion at a session of the Supreme Soviet, which was being resumed that day, the staff representative said. Once approved, it would become possible for state farms to transform themselves into joint stock companies with a view to facilitating their restructuring. The staff understood, however, that the draft legislation amending the land law to grant property rights to juridical persons already approved by the Council of Ministers was still awaiting the President's signature, which was expected shortly.

As for the prior action on tariffs for household services, including rent, heating, hot water, and electricity, (Table 1, I.4), the resolution of the Council of Ministers dated January 27 instructed the Ministry of Economy to raise tariffs to cover no less than 20 percent of cost, the staff representative noted. On the same day, a resolution of the Ministry of Economy had decreed a sevenfold increase in rents, as well as a threefold increase in the tariffs for heating and hot water and for cold water and sewage, effective February 1, 1995. Tariffs for electricity had already been raised by two to four times at the beginning of January.

The authorities believed that those increases would allow cost coverage to reach the target sought of 20 percent, the staff representative said. While the staff had had little time to verify whether that was, indeed, fully the case, its present assessment was that the cost coverage resulting from those latest increases in tariffs might be somewhat lower than 20 percent.

The Board of the National Bank of Belarus had approved the monetary aggregates of the modified program for the first quarter of 1995 on January 26, 1995, the staff representative from the European II Department observed.

Despite the possibility that the prior action related to household tariffs had not been fully implemented, the staff was still prepared to recommend approval of the proposed decision for the second purchase under the systemic transformation facility (STF), the staff representative from the European II Department concluded. The staff had come to its judgment, first, in light of the very significant progress that had been made toward implementing that prior action; and, second, because any slippage did not immediately threaten the objectives of the program. Nevertheless, the staff urged the authorities to take any necessary remaining actions as soon as possible, and certainly before the Board was asked to approve the stand-by arrangement.

Mr. Kiekens made the following statement:

At our discussion of Belarus' previous Article IV consultation last July, the Board urged the new Government to signal clearly to the international community its determination to stabilize the economy and accelerate market reforms by means of a comprehensive package of measures.

During a visit to Minsk in August 1994, the Managing Director firmly encouraged the newly elected president to formulate and launch a strong program that could receive adequate financial support from the Fund and other creditors to cover the sizable balance of payments gaps expected during the coming years. The Fund staff has been extremely helpful by providing technical assistance to design the present program which should give Belarus access to the upper credit tranches of the Fund. On behalf of the Belarussian authorities, I would like to thank both the Managing Director and the staff for their valuable efforts.

The measures taken by the newly elected President and his Government since the summer of 1994, the prior actions, and the program all demonstrate that the Belarussian authorities accepted the Fund's advice and recommendations and have shown that they are prepared to act decisively to stabilize the economy, reinvigorate economic reform, reverse the economic decline and lay the foundations for long-term growth.

Belarus opted for monetary independence and made the Belarussian ruble the sole legal tender. As a result, the monetary authorities are now in a better position to implement an independent monetary policy aimed at reducing inflation. The National Bank of Belarus is committed to achieve monetary objectives consistent with reducing monthly inflation to 1 percent by the fourth quarter of 1995. The program also sets minimum levels for net and gross international reserves and limitations on the contracting of external debt.

The central bank will gradually shift from centralized credit allocation to refinancing commercial banks through credit auctions and other market mechanisms aimed at allocating, by the end of 1995, total National Bank refinancing by market means. At the same time, efforts will be made to foster greater competition among the banks and establish an interbank market. In order to ensure the implementation of an appropriate monetary policy aimed at price stability, the central bank will be strengthened and its objectives clearly defined. Banking supervision will be reinforced, the Public Savings Bank will be restructured, and external assistance will be called for to increase the professionalism of the banking sector.

The general government deficit target, which was originally set to hold the deficit to 4 percent of GDP, was tightened to 3.2 percent of GDP when it became clear that the available external financing will be less than had been expected. Domestic bank financing of the budget will be limited to 2 percent of GDP, foreign financing is estimated at 0.8 percent of GDP, and the remaining 0.4 percent will be provided by the proceeds of privatization.

Besides these strong stabilization measures aimed at containing domestic demand to a level consistent with a reduced savings/investment balance and at holding the external deficit to what can be covered by the limited external financing, the program also involves comprehensive structural reforms. Allow me to draw your attention to the fact that the Belarussian Government has already implemented an impressive set of structural reforms as prior actions. These include price liberalizations, utility tariff increases, liberalization of banking services, the elimination of tax exemptions, the establishment of a Treasury administration, the abolition of restrictions on foreign currency transactions by banks, and a reduction of the foreign currency surrender requirement.

Plans for the future include reforming the conduct of monetary policy and the status of the central bank, and the strengthening of the banking sector, as already mentioned. The Government will also launch a comprehensive program for restructuring, privatizing, or corporatizing public enterprises. The bankruptcy legislation has been revised, and the functioning of the financial markets will be enhanced to improve the allocation of resources in the economy. Subsidies are strictly limited, and the prices of rents and utilities, communal services and transportation will cover at least 80 percent of their costs by the end of 1995.

All these reforms should ensure the irreversibility of the reform process and lay the foundations for a growth-oriented market economy. As the reform process is still fragile, it is obviously of the first importance to protect and enhance its momentum by using to the full this renewed opportunity to achieve a real breakthrough in the reformation of the Belarussian economy. The present Government is both aware of the need for a rapid transition to a market system and strongly committed to this goal. What is crucial now is the ability to implement the program.

To enable Belarus to continue its drive towards the market, substantial external financial support is necessary. Despite its efforts to cope with a huge deterioration in terms of trade amounting to over 35 percent since 1992 via large compressions in the volume of imports in 1993 and 1994 and the further compression planned for 1995, Belarus still faces enormous difficulties with its balance of payments. Without adequate external support, the only way to make the program consistent would be by further restricting demand. This would seriously harm Belarus' production capacity and still further reduce the already very low living standard of the population to a level which is likely to be unsustainable.

But if Belarus is able to take advantage of the momentum brought by the present renewal of the reform process, and receives the help it needs to overcome its temporary adjustment related difficulties, popular support for the reform efforts of the Government will grow. The resulting economic and social stabilization will establish an environment conducive to private sector development and foreign investment, which, in turn, will place real recovery within Belarus' reach.

I am asking you to support this effort.

Extending his remarks, Mr. Kiekens stated that the program Belarus had submitted for the Board's consideration had been designed and accepted by the staff and management as appropriate for access to the upper credit tranches. The only reason why the Government could not request a stand-by arrangement was that there were not at the time satisfactory assurances for the financing of the projected current account deficit in 1995. The Government had considered requesting a conditional stand-by arrangement under which Belarus could receive assurances of access to Fund resources, provided the covering of the residual financing gap would be obtained within a short period after the Board's decision, say, in March 1995; only when that condition had been met would Belarus be allowed to draw on the Fund. However, the staff had indicated that it was not in a position to recommend such an unprecedented request. Although his authorities still believed that such a conditional stand-by arrangement made sense, and could be supported by strong arguments, they had decided, for political reasons, not to introduce the request. However, they would appreciate confirmation from

Board members, as well as from the staff, that the program under consideration indeed met all the requirements for access to a stand-by arrangement, except, of course, the requirement for prior coverage of the financing gap.

With respect to the fulfillment of the prior action to increase the tariffs for rent, heating, and household utilities, his authorities confirmed that the 20 percent coverage had been reached, Mr. Kiekens concluded. If any divergence with the staff should occur after the Executive Board had approved the proposed decision, his authorities were ready to adjust the measures as needed in order to fulfill the prior action.

Mr. Havrylyshyn made the following statement:

I start with a relevant quotation:

> The economic program the Government proposes for the coming year is comprehensive and appropriately ambitious, and offers the prospect of substantial changes in the right direction.... The staff believes.... Belarus deserves another chance at achieving stabilization and implementing market reforms, and the full support of the Fund in their endeavor.

So wrote the staff in its report of December 12, 1994 on Belarus' request for a stand-by arrangement, and I found myself able to easily agree that the program was adequate to meet criteria for upper credit tranche access. Now, looking at an even tighter program as described in the staff report of January 26--and a request for a second tranche of the STF--I naturally find myself even more easily able to support this program and the proposed decision. How a tighter program was achieved is rather interesting. The ubiquitous "Man from Mars" might think the usual relationship prevailed: inducement of greater external support motivated a tightening up of the program. Unfortunately, the cause and effect may have gone the other way, which leaves me ambivalent. On the one hand, I am very happy to see the Belarussian authorities willing to initiate a more ambitious program. On the other hand, I am disappointed that they are not being rewarded for this program by receiving increased support. Also, and more systemically, I am concerned about the signal such a reversal of the normal relationship sends out.

Let me make a few remarks about the program itself, which deserves praise and therefore constructive criticism.

The 1995 budget was approved by the Parliament on January 17, 1995 with an original target of a deficit of 4 percent of GDP. Nevertheless, owing to a change in the underlying assumptions--in particular inflation and shortfalls in external financing--the staff estimates that with no further policy measures the deficit might reach 6 percent of GDP. Furthermore, in light of the lower than expected availability of foreign financing, the staff estimates that budget implementation should be such that deficit is contained to 3.2 percent of GDP. The authorities concurred with this evaluation and declared their intention to "...strictly limit certain expenditures to the nominal budget appropriation approved at the beginning of 1995." Even though some discretionary expenditures have been identified as targets, we would appreciate the staff's comments on the likelihood of this effort's success, given the Government's legitimate concern about the standard of living of the poorest segments of the population and its intention to provide an adequate safety net. Could the staff describe what concrete measures may be planned.

In parallel to fiscal consolidation, monetary policy has to be tighter as well, particularly under the modified program. Financial policies are geared to reducing monthly inflation to 1 percent by the end of the year. The success of this aim significantly depends on the ability of the National Bank of Belarus to resist pressures for additional bank credits. It was, of course, disappointing to observe that the National Bank failed to sterilize the unexpected-- and welcomed--inflows of foreign exchange, which reflected an increase in the repatriation of foreign export receipts in late 1994. Despite this policy slippage, which contributed to the significant rise of monthly inflation to 40.5 percent in November and 31.3 percent in December, the National Bank is expected to pursue a tight interest rate policy, which would help establish positive real interest rates. We are pleased to observe that the authorities are committed to adhere to tight targets for the net domestic assets of the National Bank and of the banking system as well as for the base money. We would appreciate the staff's comments on whether any further increase in the repatriation of export receipts is anticipated--or was this a one-time flow, and, should it come again, how is the National Bank expected to react?

External sector liberalization efforts geared towards the market mechanism are expected to continue under the program. Some administrative measures, in conjunction with higher interest rates were expected, and indeed to an extent succeeded, to encourage repatriation of export receipts. Under the modified program, the 1995 external current account deficit is projected to be 5.7 percent of GDP compared with the earlier estimate of the original program of 9 percent, mainly owing to favorable terms of trade adjustments. As a result, the financing gap of the modified program is reduced to $310 million, compared with the $467 million estimate of the original program. Could the staff elaborate on the sharp change in the projection of the terms of trade as well as on the trade-off between transit fees forfeited and lower prices under the gas agreement with Russia.

It is understandable that the Belarussian authorities are facing some very difficult choices and we commend them for their burdensome efforts. However, it is regrettable that in the past there were slippages in policy implementation. One need only point to the fact that two important decisions on price liberalization were revoked recently, even though temporarily. In the future such policy slippages must be avoided, as they not only increase the risk involved in a program but they also harm the authorities' credibility in the long run.

I return, finally, to the broader issue of the relationship between program tightness and external financing. For Belarus, I hope the coming weeks will bring a closing of the circle; to that end I urge the Belarussian authorities to persevere with their proposed program and I urge the international community to reward them appropriately for the stronger adjustment effort. This will keep alive the crucial principle that access to more financial support acts as an incentive to greater efforts at adjustment, and avoid the systemic risk of the opposite, moral hazard signal.

Mr. Lvin made the following statement:

At the outset, this chair would like to express its full support of the proposed decision. Not only does the authorities' program before us represents a major breakthrough in Belarus' road to a market-guided economy--particularly if we take into account that it was not until end-summer 1994 that real reform policies were set up in the authorities' agenda--but also the most recent developments that have taken place in Belarus since the disappointing outcomes of the donors' meeting demonstrate the real level of the authorities' commitment to their program, which proved to be fairly high.

After all, our performance criteria are aimed at precisely evaluating the true strength of the authorities' policies, and of their adherence to the strategies chosen. The most formidable and unanticipated criterion--namely, effective implementation of the program without previously promised support--is being met rather successfully. The list of prior actions implemented so far looks very impressive by itself. Most of these measures constitute a profound systemic transformation in the area concerned, rather than a partial change of previous settings.

The authorities have decided, in response to the lack of projected foreign financing, to further tighten their financial policies and thus have demonstrated their full responsibility for the fate of the reform process. It is particularly commendable that the inflation target has remained unchanged despite obvious financing shortfalls, as well as the limit on bank financing of the budget deficit.

As this chair has no substantial disagreements with the staff assessment, and we fully agree with the observations made by Mr. Kiekens, our intervention will be limited to some issues related to the monetary policy and modification of the corresponding performance criteria.

We fully understand the authorities'--and the staff's--concern about monetary developments and their desire to control monetary aggregates as closely as possible. Nevertheless, some questions could be raised. For instance, what was the reason for ruling out the reserve requirement policy as a means to influence the multiplier and broad money? Other instruments of sterilization of excess reserves or an increase in base money caused by foreign exchange inflows may appear costly for the central bank. Moreover, these sterilization practices do require some sophistication on the part of the monetary authorities, which still might not be fully in place, as demonstrated by the unfortunate history with foreign deposit management by the central bank in the past few months. It looks as though the present 5.5 percent reserve requirements could be easily increased in order to accommodate, at least partially, the rather high excess reserves.

On the other hand, one could have some doubts about attempts to control both base money and the net domestic assets of the central bank simultaneously. It seems that the present foreign reserve position of the National Bank, even in terms of gross reserves, remains extremely strained. Relieving this pressure and accumulating some minimum reserves should become a priority of the National Bank. I fear that the target of overall base money containment, and quite plausible difficulties in contracting further the net domestic assets growth, may appear to be somewhat in contradiction to such a task.

These concerns might be reinforced by the buoyant increase in foreign currency receipts in the past months, which seem to be exceeding the staff projections somewhat. There are reasons to expect some further export expansion, caused by many factors, among them the most important being far-reaching trade and exchange liberalization on the one hand, and marked improvement in economic relations between Russia and Belarus on the other hand. Foreign direct investment also--apart from that related to the gas arrears clearing operation--in 1995 seems likely to exceed the amount of $20 million estimated by the staff, provided the program remains on track.

Finally, this chair must reiterate its best feelings toward the Belarussian authorities. Russia will do its best to alleviate the transition difficulties of Belarus, and we expect that the international community will concentrate its extremely needed assistance on the country which so heavily suffered from the

Chernobyl disaster, so willingly relinquished its nuclear status, and is implementing its encouraging reform program.

We fully concur with the thrust of Mr. Kiekens's oral statement: the stakes are too high in Belarus, and the donor community--including this institution--should not spare any effort to support the country's economic transition in a timely and cooperative fashion.

Mr. Desruelle made the following statement:

Let me start by taking up a concern that is not usually stressed by this chair, namely, the very short period between circulation of the relevant documents and the Board meeting. A substantial supplement to the initial staff report, a supplement reporting very significant changes to the program and such essential elements as the balance of payments, was distributed late on January 26, thus reducing the circulation period to essentially one business day.

There may be logical immediate causes for this state of affairs, such as the 18-month rule on consecutive STF purchases. However, overall, I believe that all parties would be better served if examination at such short notice of programs of this nature did not occur. After all, we are not responding here to a sudden crisis.

This discussion of the Belarussian program is somewhat complicated by the fact that the program should give rise to a request for a stand-by arrangement--as reflected in the agenda--while the proposed decision only relates to a second purchase under the STF. For the sake of clarity, let me differentiate between the two, the program and the decision, and focus first on the latter.

We fully support the proposed decision and I welcome the Belarussian authorities' decision to make a second attempt at transforming their economy. The first attempt, supported by a first purchase under the STF, unfortunately was not successful. I am convinced that the authorities understand that the policy course followed until the summer of 1994 was not sustainable. They have now taken a number of prior actions, albeit at times in a halting way, so as to restart the transition process. They intend to follow up these first steps as described in their letters. It is appropriate that the Fund accompanies and supports these efforts at this time with a second purchase under the STF.

As regards the request for a stand-by arrangement that may be presented to this Board fairly soon, I take note of the staff's assessment that satisfactory progress has been made in mobilizing the external financing needed to support the program. This note of optimism is welcome. A significant financing gap nevertheless remains, a gap that, for instance, is six times as large as the highest commitment of new money made at the donors' meeting of December 15. As regards specifically the EU, proposals for financial assistance to Belarus are still under consideration. Altogether, it remains to be seen whether efforts by all major creditors will permit full financing of the program in its present form or whether a further revision to the program will be needed.

As regards the program itself, I do not feel the need to make extensive comments. I have no difficulties with its general design. I, of course, have some questions on some of its details, such as the increased reliance on auction for central bank credit; but this, I am sure, will not surprise anyone here. More importantly, I would have wished to see a stronger program that would have warranted, in the views of the staff, access higher than the rather low 50 percent of quota, on an annual basis, that will later be proposed under the stand-by arrangement. But, at this time, given the program we have in front of us, I would insist that what is most important for the Belarussian authorities is to strictly adhere to it. Then, there will be time to build on its successes.

One should not hide the fact that Belarus is suffering from a credibility gap, which flows from the track record of previous governments and may have been recently rekindled by conflicting accounts of the implementation of certain prior actions. It is thus essential that the program be implemented steadily, consistently and fully.

In this respect, the information in the latest supplement raises some concerns regarding the evolution of the fiscal situation. There is the mention of upward adjustments in both revenue and expenditure in the 1995 budget, the adjustment in revenue coming on top of an already ambitious revenue target. There is, as Mr. Havrylyshyn said, the staff estimate of a 1995 deficit of the general Government more than 2 percent larger than before. There is also the potential impact of what is referred to in the supplementary letter of intent as "a fair and affordable partial compensation package involving wage increases and targeted government transfers" in compensation for increases in tariffs of household services.

Given the limited room for non-inflationary financing of the budget, it is essential that the authorities keep strict control of public finances. I would thus appreciate comments by the staff on the feasibility of an orderly reduction in real expenditures, as mentioned on page 13 of Supplement 2, and information, if any, on progress in allocating expenditure consistently with that targeted reduction.

Mr. Shields made the following statement:

Although the experience of the first purchase under the STF made by Belarus was very disappointing, we have seen a determined effort by the Government to move towards stabilization in the last half year. Despite this, the authorities failed to bring down the inflation rate to anywhere near the program target. This failure was mainly the result of a decision by the National Bank to deposit unexpectedly high foreign currency reserves with domestic banks which led to higher than anticipated credit growth. But there had been previous serious errors on the monetary side involving substitution of central bank credit for withdrawn fiscal support and wantonness on the agricultural side.

Belarus cannot afford to make mistakes of this magnitude again.

Turning to the program before us, I note that there continues to be a significant financing gap for 1995 even after allowing for the benefits of lower gas prices. I am aware of the efforts of the authorities to reduce this gap, including by reducing the fiscal deficit by 0.8 percent GDP compared with that under the previous program. And I commend the authorities for these steps.

However, it would be wrong to assume that the financing gap will be filled with additional donor support. In particular, the staff may be ambitious in its assumptions about the quantity and timing of any contribution from the EU.

I remain skeptical about both the estimation and the meaning of our standard financing gap calculations, but we have to accept that the figuring shows that the program is a risky one, and it would certainly be inappropriate to approve a stand-by arrangement in these circumstances.

However, given the steps which the authorities have taken, I believe that it is worth taking a risk on the STF purchase. The Government's prior actions demonstrate their clear commitment to the process.

On the stand-by arrangement, I believe, along with the French chair, that there may nonetheless be a case for considering higher access under the stand-by arrangement in support of a strong program. Of course, such a move could be considered to be risky, heightened as it is by the poor track record which Belarus had prior to last summer. However, if the authorities adhere strictly to the program, and the remaining issues on the financing gap can be resolved, I think the program would be a good one that could be worthy of higher access.

I note particularly that the targets for inflation are impressively ambitious with inflation planned to fall from over 30 percent a month in December 94 to 1 percent a month in December 1995. This is to be achieved by a tight monetary policy, including the withdrawal of foreign exchange deposits deposited by the National Bank with domestic banks, and the maintenance of high nominal interest rates which should ensure positive real interest rates.

Given the tough task ahead in reducing inflation, it seems sensible of the authorities to change their indicative targets on net domestic assets to performance criteria.

On the question of prior actions, I note the fact that the authorities have already completed a substantial number of tough prior actions. Belarus is a poor country and the rapid removal of food subsidies last year--albeit for a time--imposed real hardship for which the new social safety measures provided only a partial compensation. Nevertheless, the authorities must press on. The fact that even after the sharp increases in prices, the prior actions on rents, utilities, communal services and transportation still result in only 20 percent of costs being covered shows how far there is to go. I was disappointed to hear of the gaps in these prior actions but relieved that they may now be being filled. It is extremely important that the authorities do not delay their planned moves to increase prices on these services to 80 per cent as agreed under the program.

In the field of real wage adjustment, I note there is still some way to go, particularly after the recent increase in average wages.

Meanwhile, I share the concerns of staff about the lack of real reform in the agricultural sector. It has been too easy for credit to be channeled to agriculture and no genuine privatization seems to be envisaged. The survival of collective farming is only likely to impede realistic progress in agriculture.

In conclusion, I support the second tranche of the STF and consider that the program--if implemented--is of upper credit tranche standard.

Mr. Giulimondi made the following statement:

The program presented by the authorities and the staff in support of the second drawing of the STF is a commendable effort made at a critical juncture in Belarus' transformation process.

Indeed, the unsatisfactory performance under the program for the first purchase, recent economic developments, the approaching of the expiration date to complete the STF drawings, and the need to accelerate reforms in order to obtain foreign assistance are factors which call for resolute policy actions. Belarus must proceed with its stabilization policies without second thoughts if successful progress is to be made towards the restoration of economic stability and growth. Belarus' peculiar industrial structure, which is potentially large but focused on capital goods industries closely integrated in a declining productive net inside the countries of the former Soviet Union, and its scarce endowment of natural resources have proved with the passing of time that the strategy of postponing fundamental adjustment measures has become more and more unsustainable.

Continued contraction of recorded output, particularly in the industrial sector, demonstrates that the economy will inevitably have to turn to products and services which correspond to actual market demands. This can be achieved only through the promotion of a market environment encouraging private initiative, attracting foreign investment, and increasing Belarus' export capability. Top priorities to realize such a course of events are the reduction of 1994 inflation to much lower and stable levels as well as further, bold structural reforms.

Initial measures have been already undertaken. The monetary program appears to be coherent. Much of the strong acceleration of inflation in the fourth quarter of 1994 was due to policy uncertainties in handling the sterilization and allocation of foreign exchange with the domestic banking system. Now I note the commendable decision of the authorities to convert both the indicative target on base money and the indicative target on the net domestic assets of the banking system into performance criteria. This reveals a new awareness and a positive commitment to avoid similar policy incidents in the future. Again on the conduct of the monetary policy, the recent moves aimed at raising the interest rate structure are extraordinarily important if positive real interest rates are to be established and real demand for money is to be increased, curbing inflation and helping efficiently allocate resources toward productive purposes.

Turning to fiscal policy, the program assigns it the difficult task of bringing public spending under control. I understand from the staff report that the final version of the recently approved 1995 budget contains some upward adjustments both on the expenditure and the revenue sides. While additional expenditures have been posted to increase subsidies, the nature and actual feasibility of offsetting additional revenues is rather unclear, thus implying potential repercussions on the size of domestic bank financing to the Government. Moreover, the higher than anticipated inflation rate in the last two months of 1994 will certainly exert differentiated effects on nominal revenue and expenditure, increasing the former considerably less than the latter and thus contributing to widen the public deficit. Therefore, given the critical priority of reducing inflation, the already heavy burden imposed on monetary policy, and the latest unfavorable budgetary developments, it has become important that the limitation, envisaged by the authorities, of selected expenditures to the nominal budgetary appropriations is observed. However, as noted by Mr. Havrylyshyn, social safety needs make delicate the selection of the outlays to be curtailed in real terms. I would, therefore, appreciate some more detailed information on the "expenditures other than subsidies" which are generically referred to in the letter of intent.

Regarding the external sector, progressive reduction of surrender requirements and higher interest rates should encourage a greater repatriation of export proceeds, a lessening recourse to barter arrangements, and a strengthening of the thin auction markets for foreign exchange. As for official external assistance, I would like to strongly emphasize that only the clear perception that the authorities are irreversibly committed to stabilization and reforms can give way to large inflows. Policy commitment to the creation of an adequate business environment is also the only avenue conducive to sizable foreign direct investment.

Turning to the structural aspects of the program, I welcome the implementation of the remaining prior actions, announced today by the staff, and the positive attitude displayed by the authorities to further adjust the tariffs for household services, utilities, and transport. I also note the inclusion in the amended program of a new performance criterion devoted to such an adjustment of tariffs. Although this further development is evidence of the ongoing process of price liberalization, the subsidy structure in the economy is still rather pervasive and represents a major stumbling block to market reforms. Accordingly, a convincing strategy for enterprise rehabilitation and restructuring is still to be designed. As with other transforming economies, introducing and fortifying hard budget constraints for state-owned enterprises is a key factor both for macroeconomic stabilization and for output diversification and recovery. In particular, taking into account the delicate budgetary situation and the current process of shedding of tax privileges, any ad hoc tax exemptions to state enterprises must be avoided.

With these remarks I support the proposed decision and wish to encourage the Belarussian authorities as they embark upon a particularly rigorous implementation of agreed stabilization measures and reform agenda, in light of the special nature of this STF-supported program, which should be viewed as a bridge arrangement toward a stand-by arrangement at hand.

Mr. Newman made the following statement:

The package of stabilization and reform measures before us suggests a long overdue turnaround in Belarus's commitment to sound financial policies and market-oriented structural reforms. At the same time, we are reminded of Belarus's poor track record. Too often, Belarus has chosen short-term expedience to avoid the side effects of restructuring and financial discipline. Instead of averting economic deterioration, however, these measures hastened it. As a result, Belraus has experienced economic decline and the dislocation without any of the prospective benefits of real adjustment. This program is an opportunity to break out of this downward spiral. To do so, two shortfalls must be addressed: a financing gap and a credibility gap. The two are not unrelated. Overcoming the credibility gap will require steady adherence to stabilization objectives and implementation of structural reforms. This will take time. A good start has been made, however, with the prior actions and commitments agreed to under this program. The process has not been as smooth as would be desired, but we are now reasonably satisfied that various bumps and potholes on the road to reform are beginning to receive tangible attention. Thus, my authorities were able to respond favorably at the recent pledging session in December. We would urge others to do likewise. The risk of policy reversals cannot be ignored, but neither should we ignore the opportunity to reduce that risk by mobilizing timely support for re-energized reform efforts. Could the staff provide an update on the state-of-play among other donors?

The Belarussian authorities can help to move this process along. Speedy implementation of agreed-upon household tariff increases to achieve the 20 percent cost recovery targets for various services is essential and should not be delayed. We therefore welcome the staff's indication that considerable progress has been made in this respect. However, as Mr. Shields noted, that still leaves us with four fifths of the way yet to go to achieve full market pricing.

Meeting the budget deficit target of 4 percent of GDP will depend crucially on following through and maintaining price liberalization and cost recoveries. As the staff notes, it will also mean resisting calls for subsidies to offset tighter monetary conditions. The financing gap has taken some interesting twists and turns in recent weeks. Starting at $467 million, the gap roller-coasted through a December pledging session that generated some $150 million in new commitments, but also registered some near-offsetting declines in old commitments. Thus, the net reduction in the financing gap looked to be quite modest. Since that time, we understand the gap to have declined to some $160 million (net of the $150 million in new pledges). Most of the improvement is accounted for by the substantial drop in the current account deficit, largely the result of lower-than-expected Russian gas prices. The balance of the adjustment is achieved through a combination of monetary tightening and budget savings. In addition to the decline in imports, reserve accumulations also appear to be a bit less ambitious. Given the monetary overhang that developed at the end of 1994, it is appropriate that much of the burden of additional adjustment in 1995 falls on monetary policy. The elevation of growth limits on base money and domestic credit from indicative targets to performance criteria adds some reassurances. Other measures, including limits on national bank subsidies and increased refinance rates, are also encouraging. More fundamental changes are needed, however, to better establish and safeguard the central bank's commitment to price stability. Monetary goals would benefit substantially from a more independent central bank that is actually committed to price stability. Legislative action to further insulate money creation and bank supervision from special interests is alluded to in the staff paper and ought to be a top priority. I wonder, however, whether the staff could comment on the scope and prospects for changes in this regard over the next year.

Tighter credit means tighter budget constraints on enterprises. The elimination of state orders, margin controls, and price controls will help unshackle competitor producers, increase cash flow and reduce pressures on banks. As the staff paper notes, the agricultural sector has been a particular source of inflationary credit and fiscal largess. Recent price liberalization should improve producer viability, but it is clear that major restructuring is needed. Unfortunately, halfway measures are being pursued that would seem to guarantee continued inefficiencies and resulting pressure for fiscal or credit bailouts. Could the staff or the World Bank representative elaborate on World Bank plans to help reform the farming sector?

The need for restructuring is an economy-wide priority. The credibility of the fiscal and monetary targets depends importantly on accelerated action on bankruptcy procedures and privatization plans. The process is somewhat complicated by the social safety net role traditionally filled by enterprises. This only highlights the imperative of shifting the Government's role away from productive activity and toward the provision of social services. All seem to agree that more needs to be done to better target social assistance so that disadvantaged groups are better and more affordably covered. Generalized assistance ought to be phased out as rapidly as possible.

Of course, the best antidote to poverty and declining incomes is a growing economy and jobs. The Government must orient its efforts away from saving untenable jobs in uncompetitive firms to freeing up the private sector to create new, sustainable jobs in competitive enterprises. In this regard, it is troubling to note from the supplement that the end-December structural benchmark on facilitating privatization and bankruptcy and liquidation was not met. We would be interested in knowing whether the February deadline is likely to be met.

I wonder whether the staff could comment on the state of the banking system, which is presumably rather grim. Loan portfolios are likely to be questionable, proper financial accounting and controls seem to be lacking, and a variety of other problems exist. One might expect the situation to become more apparent as tighter money begins to bite on banks as well as their borrowers. Is there a sense of the scope of possible future calls on the budget to finance recapitalization or other efforts to clean up balance sheets? What sort of restructuring plans are envisaged? A number of speakers have raised the possibility of applying higher access limits in the future for the subsequent program. This would also raise the issue of higher access under the STF, which I hope we will be able to come to well before the April deadline.

Mrs. Wagenhoefer made the following statement:

Belarus's economy is in a very difficult situation. Demand pressures are very high, whereas available resources are more limited than expected a few months ago. Thus, the only alternative for Belarus is to make the program consistent with the resource constraint. This is easier said than done, given at least two major political constraints, also noted by Mr. Kiekens: first, the reform process is still fragile and second, what is crucial now is the ability to implement the program.

Against this background, one may however note a few signs of hope. For instance, export developments relating to markets other than those of the Baltic Countries, the Russian Federation, and other countries of the former Soviet Union proved to be more favorable than assessed earlier. Budgetary performance in the last quarter of 1994 was significantly better than envisaged, with some real savings in outlays.

I do also hope that the optimism expressed by Mr. Kiekens and the staff regarding the final implementation of prior actions will prove realistic.

With respect to the revised program, we are pleased by the authorities' demonstration that there was further room for maneuver. The general stabilization strategy goes in the right direction. First, it is particularly important to contain domestic demand by lowering the external current account deficit to a level that can be financed. Second, monetary policy has now to carry the major burden of the needed adjustment. Third, structural policy has to be accelerated, in particular, in the areas of privatization and enterprise financing--to cite only two areas.

So far, I have not commented on fiscal policy. I would like to ask the staff for further clarifications about the outlook of government finances. One target for 1995 is set at 4 percent of GDP, another one, "by end of 1995," is set at 3.2 percent. In addition, we are told that the deficit could be larger--by more than 2 percent of GDP.

Finally, let me say that we feel somewhat uncomfortable in view of the fact that the STF-supported program is not yet fully financed. We can, nevertheless, support the proposed decision to approve the second tranche under the STF basically for two reasons. The first is its catalytic effect: the staff paper has indicated "good prospects" for the covering of the residual financing gap. The second, is its incentive effect: we hope that this STF-drawing sends a sufficiently strong signal to the authorities to continue and to accelerate their reform efforts.

In conclusion, the authorities should keep in mind that the resource constraint is not an amount that is fixed once and for all. Ultimately, as we have seen in many countries, it is the speed of reform that is the major determinant of the resources available and not the other way around.

The staff representative from the European II Department said that nominal expenditures in the budget that would have to be contained at their initial level were, in national terms, rather significant. The supplementary letter of intent identified three items that accounted for about one third of the total amount: the material reserve, which was essentially strategic stocks of grain and other commodities; expenditures, other than subsidies, covering a variety of transfers to enterprises; and investment expenditure. Although the staff had discussed with the authorities the need to be more specific on the expenditure savings, it had agreed that they should have the necessary flexibility to decide on their composition in the budget. It should be noted that, both in 1993 and 1994, the authorities had been particularly effective in limiting expenditure whenever resources, in particular external resources, had not materialized.

A related issue on the social safety net--the compensation for price increases--was also of concern, the staff representative remarked. The authorities' attitude was one of great caution, despite their realization of the significance of protecting pensioners and unemployed workers. That objective could be met by increasing stipends by almost the full amount of the increased cost of consumption resulting from the price increases. For the large majority of the working population, there was no real reason why the budget should provide for compensation, particularly as enterprises provided both a substantial proportion of available housing and subsidized rents and other services, which to some extent amounted to a nonpecuniary fringe benefit. If enterprises ceased that subsidization, they would be able to channel the relevant savings to the work force in the form of higher nominal wages, without necessarily incurring financial difficulties.

The issue of the repatriation of export receipts had been discussed with the authorities, the staff representative continued. In large part, the receipts were not necessarily for recurring exports, but for specific, large exports of trucks to Pakistan. The external measures that had been taken had successfully encouraged a greater repatriation of export receipts in late 1994, as reflected in the assumption on the behavior of the demand for money. The staff had also taken a cautious view with respect to any reflow of capital, which had not been allowed for in the balance of payments for 1995. In that connection, the two performance criteria on net domestic assets and base money were addressed to different possible outcomes from the program. The criterion on net domestic assets was concerned with limiting any possible underperformance of the balance of payments, as had happened in 1993. The performance criterion on base money was to protect the inflation targets from an unanticipated inflow of foreign exchange, as had been seen in the latter part of 1994.

The deterioration in the terms of trade was projected to be significantly less than under the initial program, entirely reflecting the downward revision of gas import prices from $69 to $53 a ton, the staff representative pointed out. In that connection, when the staff had discussed the program with the authorities, it had had to take into account the commitment of the previous government, in May 1994, not to ask Russia to pay transit fees for gas crossing Belarus. However, the balance of payments included an assumption for a substantial amount of other kinds of transit receipts. The authorities had informed the staff that they were discussing prices with GAZPROM of $69 a ton; the reduction to $53 a ton was very welcome, with implications for reducing the terms of trade loss, and--ceteris paribus--the external current account deficit. To some extent, the contraction of aggregate demand that was necessary to adjust to less financing would be less hurtful than it would have been without the decrease in price. However, even if no transit fees were paid by Russia, Belarus still had to maintain the pipelines, at a domestic cost. The authorities intended to cover that cost by not fully passing on the relief from the lower gas import price to the enterprises that had to provide domestic funds for the maintenance of the pipelines.

The staff had not asked for an increase of the reserve requirements in the face of excess liquidity, the staff representative explained. The reserve requirements had been recently extended to cover broad money, including deposits in foreign exchange. Thus, the statutory ratio had been reduced to yield the same amount of overall reserves. High reserve requirements, which implied an implicit tax on the banks, were a fairly crude instrument of monetary control, and the staff considered that it would be more appropriate for the National Bank to tighten credit through its extension of refinancing to the banking system and to the Government than to require high reserve requirements.

The program did not call for a substantial increase in revenue, the staff representative noted. The net effect of the tax changes introduced in the 1995 budget was negative, which was why the revenue of the state budget was projected to decline from 29.5 to 29 percent of GDP. No account had been taken in the revised program of the full effect of the removal of tax exemptions, since some might remain. The increase in expenditure in the program reflected essentially the effect on the ratio of tax revenue to GDP of the larger contraction in real GDP. While the current policy scenario did imply the risk that the budget deficit would be substantially larger without revenue measures, the authorities' track record argued strongly that they would be able to contain expenditure so that the deficit would be contained at 3.2 percent of GDP.

Some progress had been made with respect to the independence of the National Bank, the staff representative commented. The credit program no longer needed to be approved by the Supreme Soviet, and the latest monetary program had been approved routinely by the Board of the National Bank.

The pressure from agricultural sector lobbying remained strong, although the National Bank was determined to reduce substantially any remaining directed credit to agriculture, the staff representative observed. Food price liberalization was a key element in permitting a reduction of the demand for directed credit, the large demand for which had arisen in the past largely from the depletion of working capital of enterprises, because of the deterioration in relative prices of their products.

The World Bank focused mainly on price liberalization, including procurement prices and the demonopolization of the agricultural sector, in particular of the distribution sector, for both inputs and output, in addition to the removal of all restrictions on exports under the Fund-supported program, the staff representative related.

The staff representative from the World Bank noted that the actions being taken by the World Bank were threefold. The rehabilitation loan and the private enterprise development loan both covered a number of policy actions along the general policy lines that had been mentioned. Together with the support of the Fund for efforts in that area, work was under way with the Belarussian authorities to implement the necessary reforms. The World Bank was also looking at such issues as privatization, changing the structure of the state farms and collective farms, and obtaining transferable land titles that could be used for mobilizing finance through mortgage-based lending.

The second major area of forthcoming action included the possibility of a structural adjustment loan to Belarus, the staff representative continued. Later that week, he would begin discussions with the authorities of Belarus on that loan. Consideration would be given to the development of agriculture, including interest rates, nondirected credits, increasing competition, and demonopolization of food processing and the retail and wholesale sectors, which would be important in providing price incentives, and giving producers the independence to respond to them.

The World Bank had been working for nearly two years on the design of an investment project in the south of Belarus--the Pripyat region--which would have strong agricultural reform implications, along with a substantial contribution to social welfare, flood protection, and the quality of life in that area, the staff representative went on. Based on experience in structural adjustment lending, an agricultural sector reform loan might be possible within the following two to three years.

The staff representative from the European II Department added that Table 3 in Supplement 2 on structural benchmarks indicated that the privatization decree awaited signature by the President, although he had since signed it. It appeared that the result would be a firming up of the privatization targets, including the targets for corporatization by end-March 1995.

The commercial banking system in Belarus was dynamic, the staff representative from the European II Department concluded. The lack of stabilization must have created a misleading picture of the health of the banking system. The two banks that called for close attention were the Agroprom Bank and, in particular, the Savings Bank, because of the extension of a considerable amount of housing loans at subsidized interest rates. The reform of those two banks would need to be assessed as part of the reviews under the program.

The Deputy Director of the Policy Development and Review Department noted that, as indicated in the recently circulated supplement to EBS/94/238, annual access under the expected stand-by arrangement was being increased--from 50 percent to 62.5 percent of quota--because of the strengthening of the program and because it was to cover only calendar year 1995, instead of 15 months. The purchase of 25 percent of quota under the systemic transformation facility would bring total support for the program to 87.5 percent of quota. The magnitude of the balance of payments adjustment effort that Belarus was making required external support well beyond what the Fund could give. The staff could only hope that it had judged the expected commitments from the European Union and others appropriately. Also, the medium-term balance of payments projections for Belarus indicated that balance of payments gaps would continue for some years, as shown in Table 7 of Supplement 2. The Fund's involvement in helping to support the Belarussian adjustment effort over several years was therefore a factor to be taken into account in determining the access level. The policy on access implied that high levels of access were appropriate in cases in which the turnaround in the balance of payments was expected to be quick, and that was not the case in Belarus.

Mr. Desruelle remarked that, as the program was already in place, it seemed to be a matter of which month to take in calculating the annual rate of access. He recalled that the Director of the European II Department had mentioned, during the donors' meeting, that Belarus's access was the highest possible, given the strength of the program, a comment that bore some relationship to Mr. Newman's point on the link between the financing gap and the credibility gap. However, the main point was that, irrespective of the strength of the program, the financing gap remained very large. Even a simplistic calculation, based on the contributions being made by the United States, to which Mr. Newman had referred, and by others, and based on reasonable ratios and the size of the economy, showed that full financing of the program would remain difficult.

Mr. Bergo made the following statement:

It is unfortunate that it so far has not been possible to secure the necessary financing for the program, especially so as the Belarussian program, in contrast to the serious slippages in the earlier program and also more recently, appeared to represent a new approach to macroeconomic stabilization and structural reform on the part of the authorities. Though there were, and are, queries with regard to the details in the program, and concerns with regard to developments in certain areas, on balance, the program seemed to qualify for a stand-by arrangement in the upper credit tranches. Even if the stand-by arrangement could not be brought to the Board because of the still lacking financing, the Belarussian authorities have most appropriately carried through most of the prior actions envisaged in the original program. Furthermore, they have recognized that, to avoid that the delays in closing the financing gap should lead the Belarussian economy off course, it was necessary to strengthen the program. I highly commend the Belarussian authorities for these actions, which are most courageous given the economic and political situation in the country, and urge them to implement it fully. It is to be hoped that, in the end, the delays in the financing will turn out to be to the advantage of Belarus as the modified program certainly is a better and more ambitious one, and the track record now established sharply increases confidence in the authorities' commitment and seriousness. But that probably only holds true if the financing assurances can soon be achieved.

It is in a way understandable, if regrettable, that slippages occur in programs in areas, e.g., where legislation has to pass through newly established democratic institutions, as is often the case with regard to structural reforms.

It is regrettable when a central bank takes actions like the National Bank did in late 1994, depositing a substantial part of the reserves stemming from foreign exchange inflows with the commercial banks. That indicates a serious lack of professionalism and judgment, which raises some doubts about the ability of the authorities to carry out appropriate monetary policies. And this will certainly be important; as the staff points out, "monetary policy will carry more of the burden of adjustment to the lesser availability of external financing." In this light, I very much welcome the authorities' decision to convert the indicative targets on net domestic assets of the banking system and the one on base money into performance criteria, and their intention to maintain positive real interest rates, thereby demonstrating that they now very much recognize the importance of not straying from the program in this area.

I can support the proposed decision and hope that we would soon be able to return to the request for a stand-by arrangement for Belarus.

Mr. Kaeser made the following statement:

I would like to begin by supporting Mr. Kiekens's view, according to which it should be possible for the Board to formally declare that a program is strong enough to be supported by an upper tranche credit arrangement while setting a delay during which the country would have to mobilize the necessary financing of the program, this financing remaining an important condition for the formal approval of the stand-by arrangement. This "two-step approach," which should remain exceptional, could help a country to mobilize the necessary financing for its program.

This idea has been put on hold for the time being, but anyhow I am not fully convinced that the case of Belarus would have been the ideal one to initiate such a "two-step approach." Such a procedure would probably call for a better track record than that of Belarus. I am ready today to approve a second purchase under the systemic transformation facility in order to alleviate the second start up of the transition process and to bring about the two positive effects referred to by Mrs. Wagenhoefer, that is, a catalytic one and an encouragement for the Belarussian authorities to go ahead in their endeavor. I prefer, however, to reserve my position on the request for a stand-by arrangement, and this mainly for two reasons.

First, I would like to see how the host of decrees recently taken as prior actions are implemented and to hear from the staff how it will monitor this implementation. Can the staff explain, for instance, when it became aware of the fact that the National Bank was not sterilizing the inflows of foreign currencies but depositing a large part of them with domestic banks?

Second, I think that the systemic part of the program is rather weak for a stand-by, especially for a country which appears to be a stronghold of collectivism. We can therefore fear that scarce resources are wasted for maintaining inefficient economic structures. For instance, the adjustment of rent, utilities, communal services, and transportation starts at a very low level after roughly 18 months under an STF-supported program. The state order system which is supposed to remain in place to cover the large needs of the state--including the buildup of reserves--should be replaced by a procurement system at market prices.

Progress in the privatization process has been very slow during the first 18 months of the STF-supported program. The structural benchmarks do not give clear indications of the size of the privatization program. I would therefore like to know if the full explanation of the Government's privatization program for 1995 and of privatization procedures has been published as announced in the letter of intent of December 9, 1995, and how far the World Bank will be involved in its implementation. Concerning the agriculture sector, like Mr. Shields, I share the concern of the staff about the direction of the Belarussian reform, which largely excludes privatization and aims at perpetuating collective farming.

After reading the staff's December report, it is clear that two sectors are of great importance for internal and external balance: the agricultural and energy sectors. These priorities do not come through in the description of the IBRD activities in Belarus given in Annex III. However, it would appear that special emphasis should be given to restructuring and rehabilitating these sectors. According to the representative of the World Bank, his institution will focus its efforts on the liberalization of prices. What is foreseen concerning the privatization of agricultural production? What will happen in the energy sector?

This being said, I firmly hope that the Board will be in a position to approve a stand-by arrangement with Belarus before the end of March, possibly with higher access if the program is improved. In the meantime, I wish the Belarussian authorities well in their endeavors.

Finally, I share Mr. Desruelle's concern about the too short circulation time of Supplement 2 to EBS/94/238.

Mr. Kang made the following statement:

I agree with other speakers that Belarus made significant progress in 1994. It is unfortunate, however, that loose monetary policy late last year led to an increase in inflation, and that not all the structural benchmarks had been achieved by the end of December. I welcome, however, the targeted reduction of price subsidies, and their elevation to performance criteria under the program.

I wish to make a comment about fiscal policy. The staff indicates that Belarus needs to cut spending by nearly 3 percent of GDP to achieve the deficit target, given the impact of higher than anticipated inflation late last year on the budget. We are worried by the lack of detail available as to how this will be achieved. Some action is outlined but the authorities will need to be ready to take further early action if necessary to achieve the budget deficit target. This is especially true given the fiscal risk from possible pressure for a further increase in the minimum wage.

With these remarks, I can support the request for purchase under the Systemic Transformation Facility for Belarus.

Mr. Oya made the following statement:

As the most important points have already been covered by previous speakers, I will be brief. I welcome the authorities' recent policy changes aimed at comprehensive reform, as evidenced by their having implemented most of the prior actions. However, in light of the fact that Belarus has in the past adopted a cautious approach to economic reform and sometimes even reversed measures to liberalize the economy, I believe the authorities should recognize that the program before us is a minimum requirement and be ready to further strengthen the content of the program in order to build up credibility in the international community.

I am concerned about the continued active role of the Government in the economy. In particular, like some previous speakers, I fully share the staff's concerns about the direction the authorities are considering taking for the reform of the agricultural sector.

Finally, I have a question for the staff on the medium-term balance of payments outlook. On page 14 of Supplement 2 of the staff paper, the staff concludes that lower balance of payments deficits are projected in the medium term. I would appreciate it if the staff could elaborate a little more on the reasons for the revision of the medium-term balance of payments, other than the reduction in the current account deficit in 1995. Specifically, I would appreciate it if the staff could explain whether it has revised its assumptions on export growth and the exchange rate since last December.

With these remarks, I support the proposed decision.

Mr. Newman commented that the short circulation period for the latest documentation was apparently related primarily to the limitation on the time between the first and second purchases under the STF. He asked whether other such cases were likely to arise in the near future, or whether the staff would consider it desirable to amend the decision on the STF to extend the 18-month period.

The Deputy Director of the Policy Development and Review Department responded that Belarus was the only case of a country concerning which the 18-month deadline for the second STF purchase was relevant. All other members that had made, or were likely to make, the first STF purchase would have to make the second STF purchase before the facility expired at the end of 1995. In all those cases, that would be less than 18 months after the first purchase.

Mr. Newman observed that that assumed no extension of the period beyond the end of 1995.

The staff representative from the European II Department stated that when the authorities had been in Washington for the December 15 meeting, and based on the available November data, the staff had alerted them to the fact that the National Bank might have been depositing foreign exchange reserves with the commercial banking system. By mid-January, when the end-December data had become available, the issue had again been brought to the authorities' attention. There seemed to be some need on the part of the National Bank to comprehend fully the overall implications of broad monetary aggregates and the way to approach financial programming. Nevertheless, considerable progress had been made, and the proposal to send a resident representative to the National Bank, perhaps in March, should ensure sufficient dialogue with the staff of the National Bank before decisions were taken.

As the President had signed the privatization decree, the program should have been made public, the staff representative said.

The assumptions in the medium-term projections were for no change in export growth beyond 1995, the staff representative remarked. The medium-term projections reflected the updating of the 1995 base. It was also assumed that the trends in import growth would remain unchanged over the medium term, which underlined the tighter medium-term scenario.

Pricing in the energy sector fully reflected the import prices paid by Belarus to Russia, which were essentially the world prices, the staff representative stated. There had been some discussion of programs aimed at increasing energy efficiency in Belarus, including a program to implement a monitoring device that was already in place for electricity. In the gas sector, there had been discussions with the Russian authorities on reforming Beltrans Gas and on joint projects between Belarus and Russia to improve efficiency in that sector.

The staff representative from the World Bank added that there was considerable concern about developments in the energy sector, which had been the subject of a fairly in-depth study. A mission in Belarus had looked closely at energy issues, including the role of the public versus the private sector. The mission had supported the Fund initiative regarding appropriate price recovery for domestic energy. In the longer term, the World Bank would look at the possibility of a municipal project which, as in other countries in the region, would focus on heating, because it affected so many people, as well as energy efficiency and energy pricing. It was too soon to say whether energy sources would be privatized.

The World Bank's private enterprise development loan was specifically focused on promoting private sector development, the staff representative said. The IFC had been involved for some time in the privatization of retail sales and wholesale operations, and in breaking up trading monopolies, cofinanced with USAID. The structural adjustment loan would focus on privatization.

The World Bank was clearly interested in privatization in the agricultural sector, the staff representative from the World Bank concluded. That was why the World Bank had supported transferable land titles, which would be privately held, and why it supported the Fund's effort in that regard.

Mr. Kiekens observed that the Board had placed a high priority on the success of Belarus' transition to a market economy. The Government of Belarus had demonstrated its determination to carry out its program and to reach that goal under difficult circumstances. When it had become clear that the amount of available external credit would fall short of what was needed to finance the projected deficit for 1995 under the program as initially designed, the Government and the central bank had not hesitated to adjust the budget and monetary policy proposals in order to reduce, to the extent possible, the projected deficit. Needless to say, those measures had created additional hardship for the population and carried a high political price. Belarus could not, however, succeed alone; it badly needed the support of the International Monetary Fund and other international financial institutions.

Although the Board had expressed strong support for Belarus' program of stabilization and reform, its session that day had been a painful one for the Government and population of Belarus, Mr. Kiekens added, because it had finally not become possible to obtain the strong support of the Fund under a stand-by arrangement. It was at the same time a disenchantment for all who believed in the institution and its irreplaceable task, because the Fund was equally unable to fulfill its purpose.

What was at stake was whether Belarus could receive the financial support it needed to correct its balance of payments imbalances without resorting to measures unduly destructive to its well-being and the prospects for future prosperity, Mr. Kiekens said. Belarus was at a crossroads. The failure to provide adequate financial support would dramatically slow the process of building the foundation for sustained economic growth, and impose additional sacrifices on an already long-suffering population. Given that the Fund and the international community were currently designing one of the largest financial support programs ever attempted, Belarus's peaceful population deserved a better effort, and better support. Belarus was truly and deeply grateful for the financial support it had already been promised by many countries, but those promises still fell short of what was needed. Therefore, he strongly encouraged creditor countries to cooperate in order to find, in parallel with the Fund, the additional resources Belarus needed to continue its ambitious and courageous efforts.

Several Board members had suggested that consideration be given to larger access for Belarus, Mr. Kiekens noted. It was a rather exceptional issue to have been raised in the Board; normally it was the member that requested access to a certain level and Board members who felt it necessary to discuss the issue. The suggestions by several Board members needed to be carefully considered when the authorities and management discussed--soon, he hoped--the amount of the stand-by program. He also joined Mr. Newman in expressing the hope that a consensus would soon be reached on increasing access under the STF. That being said, higher access was far from being a substitute for bilateral financial support. The Fund's financial resources were designed to be catalytic, and its members must therefore either agree to provide needed credit bilaterally, in cases that deserved support, or they must accept a substantial increase in Fund resources.

With respect to the credibility gap, to which several speakers had referred, he feared that a vicious circle was being drawn, Mr. Kiekens concluded. If it was because of a lack of credibility under a member's proposals that strong support could not be given to its program, it was also because of a lack of strong support that the member could not implement it. Several colleagues had recommended implementing the program steadily, consistently, and fully, which was clearly not possible if the financial support was not forthcoming. As the staff had stated in the second supplement to its paper, the program must be adjusted if financial support was not available by end-March. Therefore, he called on all creditor countries and the Fund to support the program.

The Acting Chairman remarked that, although Board procedures did not provide for a summing up of a discussion on a request for a purchase under the STF, it was clear from Directors' comments that a dilemma existed. Most Directors felt that the program was a strong one; only one Director felt that it should be made consistent with the available financing. Otherwise, most Directors had called for the international community to come forward with additional financing so as to close the remaining gap. The question was whether the program could be implemented steadily, whether it was realistic, and whether it could be strengthened. A strengthening would be difficult under present circumstances.

Concerning the financing gap and the credibility gap, the Fund needed to match the efforts of the country, which was trying to transform itself, the Acting Chairman added. The STF had been established for that purpose. Thus, a clear signal needed to be given, as Mr. Kiekens had indicated, to both creditors and the authorities, recognizing the strength of the program, which should be implemented fully.

He proposed that, with the agreement of the Executive Directors, the Managing Director should write to the authorities at the highest level, conveying the thrust of the discussion and the Board's satisfaction with the strength of the program and its encouragement to the authorities to continue to persevere in their effort, indicating that the next step, once the financing assurances were obtained, would be to bring a stand-by arrangement to the agenda, the Acting Chairman said.

Mr. Kiekens said that there was an appropriate answer for the Fund to give that would allow the authorities to build up credibility--namely, not to refuse strong support, but to provide firm access to its resources provided the program was implemented. That technique was called the phasing of access to resources. In that connection, he wished to draw the attention of Board members to the fact that the authorities had accepted an impressive set of performance criteria.

The Executive Directors Board took the following decision:

1. The Fund has received a request by the Government of Belarus for a purchase equivalent to SDR 70.10 million under the Decision on the Systemic Transformation Facility (Decision No. 10348-(93/61) STF, adopted April 23, 1993), as amended.

2. The Fund approves the purchase in accordance with the request.

Decision No. 10901-(95/9), adopted
January 30, 1995

3. SOUTH AFRICA - 1994 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1994 Article IV consultation with South Africa (SM/95/3, 1/9/95; and Cor. 1, 1/25/95). They also had before them a background paper (SM/95/9, 1/20/95).

Mr. Du Toit made the following statement:

Since the last Article IV consultation and the approval of a purchase under the compensatory and contingency financing facility for South Africa by the Board on December 22, 1993, South Africa has made the momentous transition to full democratic rule. This is, therefore, a historic occasion, and I am greatly honored to address the Board, representing the democratically elected Government of National Unity.

The advent of democracy, in itself, carries many responsibilities, among which the most important is the management of the political, social, and economic changes that will sustain the political transition. South Africa, at the same time, needs to abolish the distortions created by apartheid. My authorities, therefore, are most appreciative of the contribution that the Fund makes toward the ongoing policy dialogue in South Africa. In this regard, the insight displayed by staff members during both the staff visit and Article IV mission, as well as the illuminating and constructive 1995 staff report and the accompanying document entitled "South Africa-Selected Economic Issues," requires special mention.

Since the elections on April 27, 1994, South Africa is governed in terms of an Interim Constitution. The Interim Constitution provides for a Government of National Unity, in which political parties are represented in proportion to the number of votes that they received in the elections. The Interim Constitution is transitional, designed to remain in effect for a five-year period, during which a final constitution is to be drafted. The final constitution is being drafted by the Constitutional Assembly, comprising both the National Assembly and the Senate sitting in joint session. The Constitutional Assembly will be guided by the set of 34 Constitutional Principles contained in the Interim Constitution.

The Interim Constitution provides for three distinct tiers of Government: national, provincial, and local. Nine provincial governments have been established. The process of dismantling the former four provinces, the four semi-independent states, and the six self-governing territories, as well as the reintegration of their functions into the new provincial structure, have commenced. Although the Interim Constitution provides for the allocation of certain powers to the new provinces, the demarcation of authority between the provincial governments and the national Government is not precisely defined and will, under the guidance of the Commission on Provincial Government and the Constitutional Court, develop over time.

Local government includes the various former race-based local authorities, such as townships and municipalities. Integration at this level, to abolish existing racial structures, will finally be attained through local government elections scheduled for the end of October 1995. Currently, integration of local authorities is being promoted through the establishment of transitional local and metropolitan councils.

Nonracial democracy has irrevocably been established in South Africa and significant progress has been made toward the dismantling of any remaining apartheid structures.

As highlighted in the staff report, the modest recovery in economic activity that commenced in 1993 faltered somewhat in the first quarter of 1994, but subsequently regained momentum. The seasonally adjusted, annualized--quarter on quarter--rate of change in the real gross domestic product amounted to a negative 3.5 percent in the first quarter of 1994, followed by a positive rate of 1.5 percent and 2.5 percent in the second and third quarters, respectively. Current estimates suggest that the real gross domestic product has probably grown at a modest annual rate of approximately 2 percent in 1994. Various factors, such as uncertainty in the run-up to the elections, lower than expected growth in agricultural output, domestic and international investor uncertainty, labor unrest, and structural weaknesses in the economy, contributed to the slow upturn in economic activity during 1994. The growth recorded in the third quarter of 1994 was fairly widespread and, with the exception of the mining industry, moderate increases in economic activity were recorded in all the major economic sectors; other than agriculture, the most significant increases occurred in the transport and financial sectors. The upward momentum in aggregate real gross domestic fixed investment, which has been maintained since the second quarter of 1993, together with the buildup of inventories, should assist in underpinning the modest upswing. The improvement in capital formation was brought about by an expansion in real outlays on capital equipment by the private sector and public corporations.

Despite the relative weakness of the upturn in economic activity, the balance of payments on current account deteriorated substantially in the third quarter of 1994. The current account balance--seasonally adjusted and annualized--turned around from an average quarterly surplus of R2.5 billion in the first half of 1994, to a deficit of R4.8 billion--or 1.1 percent of GDP--in the third quarter. The deficit was mainly related to a strong rise in the value of merchandise imports and net service and transfer payments made to nonresidents. Based on preliminary trade figures for the period January 1 through December 31, 1994, the trade surplus is R6.4 billion--or 1.7 percent of GDP--lower than in 1993.

However, due to the normalization of South Africa's financial relations with the rest of the world, a dramatic turnaround took place in the capital account of the balance of payments. The substantial improvement in the capital account of the balance of payments offset the deficit on current account and resulted in an increase of R3.3 billion in net gold and foreign reserves in the third quarter of 1994. Having shown persistent net outward movements of capital, a net inflow of capital not related to reserves of no less than R5.6 billion was reached in the third quarter of 1994. A successful global bond issue of $750 million, with a five year maturity, was concluded by the South African Government in December 1994. The yield on this issue represented a spread of 193 basis points over the yield on five-year U.S. government paper, at the time of the issue, and established a sovereign benchmark for other South African borrowers. In the fourth quarter of 1994, net foreign reserves of the Reserve Bank increased by a further R2.9 billion, while gross reserves increased by R3.0 billion to a level of R11.1 billion.

As pointed out in the staff report, conducting money and exchange rate policy during the political transition has been complex. The growth in broadly defined money supply over a 12-month period increased to 16.9 percent in July 1994 before moderately declining again to 14.4 percent in November 1994. This was well above the upper guideline figure of 9 percent set by the monetary authorities. Based on the increase in the broadly defined money supply, and evidence that it was beginning to contribute to the inflationary effects of the depreciation of the rand earlier in 1994, as well as the increase in total merchandise imports, the monetary authorities increased the Bank rate by 1 percentage point, to 13 percent, on September 26, 1994. In the statement accompanying this announcement, the Reserve Bank indicated that: "this decision reflects their resolve to apply measures consistent with their responsibility to protect the value of the rand, and serves as an indication of a more restrictive monetary policy stance, necessitated by recent changes in underlying market conditions. If necessary, supplementary measures will be introduced to ensure that the current excessive rate of increase in the money supply will be curtailed."

Inflation for both consumer and producer prices measured over a 12-month period increased to 10.1 percent in September 1994. The producer price index has since declined to 9.4 percent in November 1994, while the consumer price index declined marginally to 9.9 percent in December, 1994.

Exchequer issues by the Government for the first nine months of 1994 were 9.4 percent higher, compared with the same period in the previous year, and remained well within the budgetary provisions of a 10.2 percent increase for the fiscal year as a whole. Compared with the previous year, total exchequer receipts for the first eight months of 1994 rose by 15.8 percent against a budgeted 12.9 percent. Limited increases in expenditure due to the creation of new political structures, higher interest payments, and the drought will be accommodated within the budgeted deficit of 6.6 percent of GDP. To ensure budgetary control and a smooth transition during the dismantling of former structures and the establishment of the nine new provincial governments, responsibility for functions will only be transferred once a provincial government has created the administrative capacity to deliver services. The Financial and Fiscal Commission has been established to mediate and advise on fiscal relations between the national and provincial governments. As highlighted in the staff report, the fiscal authorities have succeeded in setting very specific fiscal targets for the period ahead. These targets have been formally accepted by the Government and will continue to guide the annual budgeting process, in order to reduce government dissaving and avoid the development of a debt trap situation over the next few years. Meeting social backlogs, which have been created through distortions brought about by past policies, is central to the debate on fiscal policy. These demands are being accounted for within these explicit fiscal targets through a drastic re-prioritization of budget expenditure, the Reconstruction and Development Program's fund, and efficiency gains.

The approval of the purchase under the compensatory and contingency financing facility by the Board on December 22, 1993, marked an important step for South Africa toward full financial and economic reintegration with the rest of the world. The lifting of sanctions, accession to the Uruguay Round of the General Agreement on Tariffs and Trade, negotiation of the Generalized System of Preferences, and South Africa's recent issuance of a global bond represent further milestones in this process. Regionally, South Africa also joined the South African Development Community on August 29, 1994.

Given the dual exchange rate system and exchange control regime that exist in South Africa, it is inevitable that exchange liberalization will follow the progress made with trade liberalization. Subject to underlying fundamentals being in place, the South African authorities remain committed to the abolition of the current restrictive exchange system. The disruptive financial flows that emerging markets are currently experiencing serve to support this approach.

South Africa has demonstrated remarkable resilience and an ability to adapt to new challenges brought about by political change and economic liberalization. An undoubted asset in this process--to which there are many references in the staff report--is the ability of the authorities to attain consensus among widely divergent groups on major policy decisions. This has provided the basis for the substantial progress that South Africa has made in the implementation of credible policies to ensure fiscal and financial stability and establish confidence in the economy.

In its assessment of economic prospects, the staff report also directs attention to the structural difficulties that remain in achieving sustained economic growth capable of delivering higher standards of living and reducing unemployment. Within South Africa, wide-ranging debate is focused on these as well as labor issues concentrating on wage demands and increased productivity through training and retraining. With the establishment of the new statutory council, the National Economic Development and Labor Council--on which government, labor and business will be represented--progress toward agreement on labor issues remains a priority.

Bearing in mind that the Government only assumed power in May 1994, substantial progress has been made toward establishing credible domestic policies that enhance international reintegration, while addressing at the same time domestic distortions created by past policies. In addition, the magnificent support and goodwill extended to South Africa by the international community has allowed the authorities to lay the foundation to lead the South African economy toward unlocking its full potential. In this sense, the staff report and today's discussion will have a meaningful impact on the continuing debate on the restructuring of the South African economy.

Mr. Kiekens made the following statement:

South Africa's recent experience vividly illustrates the importance of expectations and confidence as determinants of economic performance. It also demonstrates how difficult and time consuming it can be to alter expectations once they are formed, and to regain credibility once it is lost.

South Africa's pressing social and economic problems can only be addressed in a context of strong economic growth, which in turn requires a climate favorable to savings and attractive to investment. Ironically, South Africa's economic prospects are still overshadowed by political uncertainties stemming largely from the very problems--massive unemployment, social inequity, widespread poverty--that cannot be solved without strong growth.

Since the last Article IV consultation, the authorities have made great efforts to dispel concerns about the possibility of high taxes, nationalization, and other policies that are generally unfriendly toward business, and they deserve full credit for pursuing prudent and market-friendly policies under very difficult circumstances. It would now be most unfortunate if, instead of moving--however slowly--toward eventual solutions, South Africa's urgent social problems were to become the pretext for reversing the course of policies and undoing the hard-won progress made so far.

It needs to be stressed that the current difficult situation does not provide much room for policy mistakes, nor does it offer the authorities the comfort of being able, without potentially serious consequences, to reject the use of some of the tools of macroeconomic management, of which the most important is the exchange rate.

The most pressing problem is clearly the performance of the labor market and the high rate of unemployment. In 1993, 44 percent of South Africa's labor force could find no jobs in the official sector, and the unemployment rate exceeded, by a wide margin, even the worst performers among either industrial or developing countries. Rigorous scientific analysis probably cannot help us to a complete understanding of how South Africa's labor market actually works, nor can we determine the precise contribution of all the factors leading to high unemployment. However, for the practical purposes of policymaking, the factors identified by the staff in the selected economic issues paper should offer plenty of inspiration for policy actions aimed at improving the capacity of the labor market to absorb workers and reduce unemployment. If the authorities are serious about a policy of job growth promotion, they should pay close attention to those recommendations.

Labor market and wage bargaining distortions favoring insiders are not the only obstacles to job creation efforts. Another serious threat comes from the high expectations about the speed and extent of changes toward a more equitable income distribution. It is still very important, as we stressed last year, for the Fund team to continue to educate the authorities about what options they have in this area and about the costs and benefits of particular policies. A better understanding of the real constraints and trade-offs will make for better policies and promote the growth of a consensus among different groups of society.

Removal of distortions in the labor market will not, by itself, sufficiently reduce unemployment. Given South Africa's high population growth rate, it would require economic growth well above 3 percent to reverse the recent trend, a fact that makes Scenario A of the staff's medium-term projection, which assumes that growth will not top 3 percent, rather alarming. It is striking how much an exchange rate policy promoting competitiveness can do to improve growth performance, as can be seen by comparing Scenario A with Scenario B. However, it is somewhat surprising to see export growth consistently outstripping GDP growth under Scenario A, but lagging behind GDP growth in all years except 1995 under Scenario B, where a faster exchange rate depreciation should produce real improvements in competitiveness. This definitely does not look like a "burst of export-led growth." If we also take into account the relatively low net inflows of capital in the staff's medium-term projections, it is hard to discern the positive effects of the "immense stock of international goodwill that would be reflected in access to financial resources and export markets."

Last year, pointing out the relatively high level of risk and high labor costs in South Africa, we questioned the realism of the assumption that foreign investment will play a major role in the country's economic economy. This year, when the most recent discussions with the authorities have produced "no evidence...of any incipient consensus...on the need for labor cost containment... ," these concerns still seem valid. At the same time, given the low level of domestic savings and the expectation that its stimulation by fiscal policy will be far from sufficient, it appears that a higher growth path will not be attainable without more copious inflows of foreign savings.

South Africa's recent experience with capital outflows also testifies to the importance to potential investors of confidence, a favorable business climate, and cost attractiveness. This testimony makes it hard to justify any delays in the abolition of the financial rand mechanism. The exchange rate controls applied to domestic residents stem from the authorities' concern to prevent large-scale outward diversification by pension funds and insurance companies, a risk that will continue as long as there is little confidence in South Africa's economic future. But controls are not the answer: experience teaches that without liberalization and openness to foreign competition, it is impossible to build a strong, efficient economy that will attract both domestic and foreign investors. The authorities have shown that they are capable of making wise and courageous decisions. They should continue to do so in the future. I wish them luck in this effort.

Mr. Havrylyshyn made the following statement:

Since the last review, South Africa has experienced the culmination of a relatively peaceful revolution. With a democratic and representative government and parliament in place, South Africa has finally shed the status of international pariah. The stage is set for a recovery of investment and economic growth, both of which suffered in the past decade from the international boycott, and from rising uncertainties about the outcome of political changes and the future course of economic policy. Nevertheless, many uncertainties remain, as many potential conflicts among economic objectives persist, and the Government is faced with the legitimate expectation of the underprivileged to reap promptly the fruits of apartheid's abolition. As miracle fixes will not materialize, the patience of the population will doubtless be tested in the years to come.

Policymakers face a difficult task, as they must address and reconcile three economic objectives: recovery to a high and sustainable economic growth; job creation to meet the needs and expectations of the large mass of unemployed and underemployed; and targeted assistance to the lowest income group of the population, again in response to the needs and expectations of those who suffered most from the inequities of apartheid.

The potential for conflict between the first objective and the other two is particularly acute in the short run, as the risk of too-early and too-broad efforts to raise incomes artificially or to mandate job creation can undermine longer-term recovery prospects. But a more patient medium-term strategy can reconcile these differences and result in a process of mutual reinforcement amongst these three objectives.

The lessons of past decades from around the world yield up a simple truth: job creation is highest when rapid economic growth is based on labor-intensive investments. It is evident that the South African authorities recognize this simple truth and are therefore stressing in the short run, three underlying policies to support such a strategy: fiscal and monetary prudence to regain credibility; restraint on wages to ensure higher future job creation levels; and liberalization of domestic and external markets to promote efficiency.

The problem is not with the proposed program; the problem is whether the population--especially the disadvantaged segment of the population--is sufficiently aware of the wisdom of such a strategy, and whether it will be patient with only partial fulfillment of its expectations in the short run. There are two more efforts the Government must stress to ensure sufficient support of the population. First, the third objective should be addressed as much as possible from the outset, but only as much as permitted by refocusing and reprioritizing the budget within the overall goals of the macro program. Intense efforts to achieve focused, targeted social safety net measures are called for. Second, the authorities must make efforts at transparency and openness, and explain the strategy and its rationale. They must attempt to engage the populace in the view that this strategy is by far the best choice--or indeed perhaps the only choice--and that a strategy of increasing jobs and incomes in the short run will only backfire, and will mean fewer jobs and lower incomes in the long run.

Let me turn to some details of the economic program. As stated, it is a very encouraging sign that the Government has decided to pursue the path of economic liberalism. Once it becomes evident that this path is consistently being maintained, through exertion of fiscal and monetary discipline and through further deregulation of financial, trade, and labor markets, confidence of market participants should be boosted, provided that a stable political environment prevails. This could well induce a return to investment ratios of 25-30 percent, common until the mid-1980s. Then, economic growth can take off at rates that are at least as high as in the positive scenario of medium-term projections in the staff report.

It is apparent that much still has to be done to reach this state of affairs. The staff gives an appropriate assessment of the situation and of measures to be taken, such as the need to attain clarity, consistency, and credibility in the fiscal accounts; to tighten monetary policy further; and to reduce labor costs. I wish to elaborate on a few points.

First, to induce a rate of economic growth that creates a significant amount of employment, the rate of investment will have to increase considerably. To accommodate this investment growth, the staff appears to suggest the use of more foreign savings, implying a large increase in the current account deficit. If the investment rate is expected to be at least 25 percent of GDP, the current account deficit could deteriorate by as much as 8 percent of GDP, given the present investment rate of 17 percent GDP--unless there is a rise in domestic savings. Also, it seems inadvisable to increase the external debt considerably in the face of uncertain prospects for economic growth and for desired moves in the exchange rate level. Therefore, the authorities should first make an effort to make the economic environment attractive for foreign direct investment--thus non-debt-creating--investment. Second, while awaiting a more favorable economic environment, and to prevent the buildup of undue future pressures on the external balances, it would be preferable to finance a large part of the increased investment by increased domestic savings. It should be noted that the reduction in investment of the past decade was parallelled by a reduction in domestic savings. As can be seen in table 4 of the paper on selected economic issues, this reduction in savings was the result of the reduction in government savings. To help generate higher savings early on, the fiscal deficit should be reduced far quicker than the rate that the staff approves of. This, in turn, could encourage foreign investment.

I recognize that severely cutting the budget can be difficult in a period when much is expected from the Government and when conflict-preventing policies are important. It is in this context that I return to my earlier point about more intensive efforts to rationalize budget expenditures and social programs so as to target only the neediest. I wonder if the staff could comment on how much room it sees for early results. Let me add that any additional budget deficit reduction would make room for considerable investment crowding-in effects, provided that the bulk of the reduction came from expenditure reduction as opposed to revenue augmentation. The increase in savings could in itself be a motor to generate the increase in investments.

A second point concerning the recommendations of the staff is the question of how to achieve a reduction of the labor costs, and hence provide for a higher labor-intensity of the new investments. The staff notes that, ideally, this should be done by effective productivity-enhancing training and by reducing wages. As there is a significant degree of wage rigidity, the staff judges that a depreciation of the currency should be considered, while acknowledging that this step could set off a price-wage inflation spiral. Therefore, what it comes down to is that the authorities must judge whether there is a greater chance of achieving a real depreciation by reducing wages directly or by controlling the wages at a more or less constant level following a nominal depreciation. If both steps would be expected to meet with the same amount of opposition, then it would seem preferable to seek a direct wage reduction, so as not to meddle with the exchange rate. Moreover, achieving wage flexibility at an early stage would be useful, as this is needed in the longer run anyway. A depreciation would temporarily circumvent the need for adjustments of labor market rigidities, but would retain the structural problems in the medium term.

Third, and finally, on the question of sequencing of reforms, it seems worth considering a delay in the removal of exchange controls on residents until progress is made in reducing labor costs. This would render circumstances more conducive to investment. Removing exchange controls sooner could lead to a large outflow of capital, causing a strong depreciation. While this depreciation could correct South Africa's competitiveness position, it would, as already mentioned, not adjust the labor market rigidities, nor even accommodate them, and thus would probably still leave the investment climate rather subdued in the medium term.

A "momentous transition to full democratic rule" has been made, in the words of Mr. Du Toit. The successful consensus building efforts that have made this possible now need to be applied to the economic goals that South Africa has set for itself.

Mr. Shields made the following statement:

I warmly commend the performance of the authorities in managing the economy during the difficult period of political transition. The staff report demonstrates the difficult course they have had to tread, and how well they have done it. I would also congratulate the new Government on forging a consensus around outward-oriented market-based economic policies, underpinned by fiscal prudence. As a result, the new South Africa has made excellent progress in establishing a credible macroeconomic framework. This has already proved to be a great asset: business and external confidence, far from being dented by the transition, have improved; economic stability has contributed to social and political stability.

It is encouraging that sound economic management has been rewarded by economic recovery, but slow economic growth and high levels of poverty show the urgency of addressing deep-seated structural weaknesses. Stabilization therefore needs to be supplemented by rapid but prudent structural adjustment, to enable the economy to meet the aspirations of all South Africans.

I would like to comment on fiscal and monetary policy, trade policy, balance of payments prospects, and--particularly--labor market policy.

A key requirement will be to carry through the commitment to budgetary discipline. So far, the authorities have set exactly the right tone on the budget: taking action to limit the deficit in the medium term; and making room for Reconstruction and Development Program-related commitments by reordering priorities rather than increasing spending. However, the underlying tension remains strong, and the aim to reduce the fiscal deficit to 4.5 percent of GDP by 1998/99 will not allow much in the way of slippage before raising investor uncertainty about tax rates and inflation. It will be important to build up credibility by sticking firmly to announced targets.

I note that the role of provincial and local governments is still being defined; their potential fiscal impact thus remains uncertain. I welcome the establishment of a Commission to examine these fiscal relations, and the authorities' cautious approach to transfer of responsibilities of the provinces.

I note that monetary growth was above target in 1994, and welcome the authorities' determination to take prompt measures to curtail it.

I welcome the authorities commitment to an outward-looking trade policy with access to foreign capital markets. Trade and investment policies are intertwined: foreign investment is only likely if conditions for foreign trade are favorable. I would encourage the authorities to press ahead with plans for tariff reductions, and not to be deflected by special interest groups. An outward-looking trade policy will result in real efficiency gains, providing incentives to introduce new technology and international best practice, and preventing an abuse of market power by domestic monopolies. I also urge further progress in removing the remaining import surcharges on consumer goods and in abolishing the Non-Resident Shareholders Tax.

The report's baseline medium-term projection suggests only modest further increases in the current account deficit this year, despite a substantial increase in GDP growth and a history of rapid increases in imports, under such circumstances. I wonder if this is too optimistic.

We should also not take it for granted that private finance will be available to fill the current account deficit. The success of the Government's recent U.S. bond issue and the improvement in other capital flows are very encouraging, but the Mexican crisis has added a new element of uncertainty to forecasts of private flows. I would welcome the staff's comments on whether this will increase or reduce South Africa's attractiveness to foreign investors.

I support the authorities' objective of abolishing the financial rand and ending capital account restrictions as soon as is practicable, and endorse the prudent approach proposed to this. Some further analysis of likely trends in capital flows and the implications for economic management would be helpful in preparing for this. While there is obviously a short-term risk of capital outflows, not least from pension funds, many countries that have liberalized capital account transactions have experienced strong capital inflows.

The risk remains that the balance of payments will reemerge as a constraint on growth in the medium term. To avoid this, South Africa needs to strengthen its trade account, both through the development of new export industries and through improved competitiveness of existing industries. These actions require labor market policies that will ensure competitive unit labor costs.

I felt, however, that the staff analysis of the labor market was overly influenced by conditions in the formal, unionized segment, which employs a minority of the workforce. This was reflected in the policy analysis, which suggested that the key issue is engineering a real wage reduction, either by means of an incomes policy or by currency depreciation. However, informal sector unskilled wages are well below those of the formal economy, and many are close to subsistence levels. Control of wage settlements in the formal sector could, therefore, only address part of the problem. Nominal depreciation might leave the informal sector even more exposed.

Furthermore, even the formal labor market is quite fragmented, both sectorally and in terms of skills. Many of the most internationally competitive industries are energy or natural-resource intensive. Their production-function coefficients are fairly fixed, and much of industry is extremely concentrated, dominated by four or five industrial conglomerates. In those circumstances, it is unrealistic to expect that a reduction in real wages would lead to a rapid growth in employment or a big improvement in international competitiveness.

Nor do I agree with the staff that "it is reasonable to assume that employment growth will have to rely chiefly on growth in manufacturing and tourism." Even within tradable goods, there is some scope for increased employment in mining and in other tradable services, such as transport and business services, but, as is the case elsewhere in the world, the main expansion of employment will probably come in the nontradable service sector plus, in the South African context, construction. In agriculture, I agree that there is little scope for absorbing greater numbers, but there is some scope for turning underemployed and subsistence farmers into more efficient producers. I would also draw attention to the role of existing microenterprises, and the expansion of small and medium enterprises, as a source of increased employment.

Instead, I perceive two key issues on which further staff comment would be welcome. The first is how to reduce labor market segmentation. This would help bring real wages in all parts of the economy toward market-clearing levels, and would increase the rate at which economic growth creates new jobs. Of course, this would have a negative impact on the minority of workers in unionized industries. It will be important to seek a national consensus to enable this to happen without damaging labor disputes. This would be the context in which an incomes policy might have a role.

The second key issue is how to reduce unit labor costs, both through increased investment and training, to increase labor productivity, and through restructuring industry, to achieve a lower capital/labor ratio.

I join Mr. Du Toit in expressing my appreciation for the role of the Fund during the transition period, both through its contribution to the policy dialogue and through provision of the compensatory and contingency financing facility. I hope that the Fund will continue to play a supportive role in South Africa's economic development.

Mr. Clark made the following statement:

The political economy of South Africa is clearly at a critical crossroads. With the momentous issues of political reform and the future of the polity largely settled in the April 1994 elections, the formidable problems of the economy now demand the continuing urgent attention of the authorities.

The staff report reflects the general recognition that the complex and difficult central issue that policy must address is that of increasing employment substantially over the next several years by breaking down the rigid "employed insider unemployed outsider" dualism of the labor market, while at the same time reducing persistent large fiscal deficits, improving the external balance, and maintaining a responsible stance on monetary policy. This means that for the foreseeable future there will be an extremely tight race between rapidly growing popular expectations generated by the political reforms, and the actual delivery of jobs and social betterment. If ever there was a situation where strong political leadership and sound economic management were needed, this must surely be it.

Fortunately, there is reason to hope that South Africa at the present juncture is blessed with both, and it is critical that they be applied both judiciously and with a sense of urgency. The three consecutive years of recession from 1990 to 1992 coincided with what was probably one of the periods of highest political uncertainty in the country. Though some uncertainty remains, the broad and decisive move toward a viable political modus vivendi has restored some measure of foreign and domestic confidence, and this has been accompanied by recovery, starting with a modest 1 percent growth in 1993, strengthening to 2 percent in 1994.

There are other factors that can be counted on the positive side of the balance sheet of current conditions against which financial and economic reform has to be pursued. One is the lifting of international economic sanctions. Second, as the staff report mentions, and related to the first, is an ongoing manifestation of international goodwill to the new South Africa, an asset that cannot be taken for granted and that must be maintained by the pursuit of sound economic policies and by continued statesmanship in the political leadership. This has the practical benefit of giving the country access to foreign capital markets, as witness the recent successful floating of a $750 million bond issue. This success was also undoubtedly linked to the additional assets of South Africa's strong financial system and relatively well-developed physical infrastructure.

There is also the potential development impulse inherent in the act of freeing black entrepreneurship from apartheid restrictions such as those outlined in Chapter 7 of the selected economic issues paper. I would have welcomed some clearer assessment of this potential, for the immediate and longer term future. For instance, against the background of the highly skewed distribution of credit illustrated at page 130 of the selected economic indicators paper, one wonders what might be the overall development impact of the same stock of credit less skewed in its distribution.

With these assets in hand, where do the authorities go from here? While recognizing the obvious difficulty and complexity of the problems to be addressed, it is somewhat worrying that the authorities have yet to define an agreed strategy for reducing rigidities in the labor market and correcting relative price distortions, though they are agreed on the urgency of the problem. I note, in particular, the hesitancy, on the part of the monetary authorities. to assign monetary and exchange rate policy a role in this strategy; they prefer to place all the burden on wage and productivity adjustments. Even if, in principle, this has some merit, it runs into practical difficulties, as the baseline scenario arising from this outlook would, in the event that wage and productivity adjustments failed to materialize, lead to higher unemployment because growth would be below the level needed to absorb increases in the labor force, let alone reduce unemployment.

The alternative scenario presented by the staff, based on a more rapid depreciation of the rand and yielding higher growth and reduced unemployment, undoubtedly carries some risk, but it seems that South African social and economic conditions suggest that the risk be faced. I agree that this scenario should be accompanied by a compact on incomes policy among the social partners, as this would help contain the risks inherent in the strategy, and I support the staff in urging the Government to put this at the top of its economic policy agenda. Of course, experience has shown that it is difficult to attract broad social consensus on incomes policies, and they often break down even after succeeding in winning initial support. But there may be no other moment in the foreseeable future in South Africa when the political climate would be more propitious for a workable incomes policy that could hold for the duration of the adjustment.

In the meantime, while the authorities continue to work toward a definitive basic strategy, some important policy issues require continuing attention. In the fiscal area, I join others in supporting the declared intention of the authorities to meet social demands by restructuring expenditures while reducing both the fiscal deficit and the tax burden. In particular, outlays on social services are to be financed in large measure by a shift of resources from military spending. How far has this intention been realized to date? It is estimated that the authorities will manage to narrow the public sector deficit slightly to 6.6 percent of GDP in 1994/95 from 6.9 percent of GDP in 1993/94; but while outlays in 1994/95 on protective services including defense declined slightly in relation to GDP, they were increased in absolute terms. At the same time, outlays for the social areas, while growing steadily in absolute terms since 1989/90, have declined moderately in 1994/95 in relation to GDP, when compared to the preceding two years. This might have been in line with the overall fall by 1 percentage point of GDP in general Government expenditure, but is it the assessment of the authorities that they are on track with their basic policy goal in this area?

The authorities must continue to grapple with two issues here. One is sustaining efforts to generate the resources for social outlays, as well as increased capital spending, within the constraint of deficit reduction. The other is ensuring that the resources generated are effectively utilized for the intended purpose. Regarding the first point, it is noted that Government revenues have been standing at about 24 percent of GDP over the last two years, and one wonders whether there is scope to move them back toward the level of 27 percent of GDP reached in 1989/90. Interestingly, the recommendations of the independent Katz Commission on Taxation, which are to be fed into the 1995/96 budget, hold out the promise of increasing revenue by 1 percentage point of GDP, while achieving the policy aim of easing the tax burden, mainly through streamlining the value-added tax and personal and corporate income tax, and strengthening tax administration and collection.

On the expenditure side, there seems to be scope for considerable further reduction in military spending. In addition, the cost of the overall machinery of government needs to be rationalized. I note, in this connection, that the authorities regard public sector wages, which amount to an impressive 12½ percentage points of GDP, as being difficult to adjust, due to constitutional considerations and the strong presence of unions. But as the Government's wage bill is an obvious source of contribution, both to deficit reduction and to increased social outlays, the authorities may have to maneuver around these obstacles to find wage containment strategies, such as voluntary retirement and freezing of existing and prospective vacant posts that are judged nonessential. The strategy being considered by the authorities of using privatization proceeds to reduce debt, thereby reducing the Government's interest costs, would also provide an important contribution on the expenditure side.

Regarding effective use of resources for social spending, I note that the Reconstruction and Development Program will be unable to fully utilize the R2.5 billion allocated to it for 1994/95. I am sure this is not due to an absence of need in the country for these resources, for the purposes of the program. It is to be hoped that the authorities will urgently address the issue of the capacity of the Reconstruction and Development Program machinery, particularly in light of the intention to make the same allocation to the program in each of the remaining four years of the life of the present administration.

Turning to the area of the exchange system, I support the call for the elimination of exchange restrictions on nationals, and welcome the recognition by the authorities of the need to abolish the financial rand at an early date. I am, however, puzzled by one of the conditions laid down by the authorities, namely a "significant increase in reserves." Whether reckoned on a gross or net basis, reserves presently provide less than two months import cover and are not projected to increase much beyond this level up to the year 2000. In this context, clarification of the meaning of a "significant increase in reserves" would be welcome; and what would be the authorities time frame for abolishing the financial rand?

Let me commend the authorities on the steady course they are striving to maintain, and wish them well in the difficult challenges ahead.

Mr. Dlamini made the following statement:

In discussing this Article IV report, we need to remind ourselves where South Africa was a year ago, and how far it has come. Both politically and economically, the country has changed substantially, and for the better. Politically, minority rule has been replaced by representative democracy; economically, the preference for the dominance of monopoly and the insular policies of apartheid has been replaced by that of economic liberalism and an outward-oriented development strategy. These developments add South Africa to the ranks of the economies undergoing fundamental transformation.

The authorities face enormous challenges: high and rising unemployment; great disparities in income distribution; poor health and education facilities for the vast majority of the population; the concentration of economic power; and a number of outmoded institutions that hamper the smooth functioning of the market. These are, for the most part, the legacies of apartheid. The result is one of modern history's greatest economic paradoxes---a large modern industrial sector, functioning as an island of lavish wealth in a sea of widespread abject poverty.

Correcting the paradox of apartheid is nothing short of rebuilding the nation. From the standpoint of economic management, it must be appreciated that this is more than the usual problem of adjustment or stabilization, though issues of fiscal and monetary prudence constitute important elements of the overall equation. We must consider that South Africa is a special case, deserving timely financial and economic assistance from the international community, which is critical for reconstruction and the achievement of sustainable growth and external viability. In this regard, the assistance provided by the Fund under the compensatory and contingency financing facility is noteworthy.

In this connection, I welcome steps already taken by a number of countries to open up their markets to South Africa. It is evident that the country will need trade much more than aid, given its economic potential and the authorities' commitment to an outward-oriented strategy. However, concessional financial assistance directed at improving health, education, and housing will help the authorities move more quickly in the critical area of combating poverty without added pressures on the budget. This is important for political stability, which is a precondition for economic reform. As the Government noted in its Reconstruction and Development Program, "no political democracy can survive and flourish if the majority of its people remains in poverty."

I am encouraged that in the short time since taking office, the new Government has demonstrated that it is up to the task. The Reconstruction and Development Program, which embodies the Government's general economic strategy appears to favor the application of a steady dose of pragmatic policies. This is reflected in the budget which, as the staff report put it, is a message of macroeconomic moderation. At the same time, the Reserve Bank remains committed to containing inflation and maintaining exchange rate stability. The economy is already beginning to show some positive signs. The recovery, although modest, seems to be taking hold after a long recession, and inflation, though on the up side, is not out of control.

It is important that the authorities stay the course with the process of fiscal consolidation, in order to boost domestic savings and reassure the financial markets. Given the limited room for raising taxes, fiscal policy must remain focused on containing and redirecting expenditure. The authorities should also strengthen revenue performance by improving efficiency in tax administration as well as broadening the tax base, particularly through the integration of the large informal sector into the formal economy. They should also be prepared to make adjustments to the budget in case economic growth, and therefore, revenue fall below expectations.

Steps aimed at trade liberalization lend credence to the Government's commitment to an outward-oriented development strategy. The accession to the General Agreement on Tariffs and Trade and the negotiated Generalized System of Preferences are a further indication of South Africa's reintegration into the global economy. The country already has a strong manufacturing sector, which could become a major source of growth and employment.

Membership in the Southern African Development Community can only serve to further integrate South Africa's economy with the rest of the region. In this context, a vibrant South African economy is bound to have beneficial spillover effects on the smaller economies in the region, helping them to expand their trade and employment.

The staff has raised the possibility of dealing with the competitiveness question through adjustment in the exchange rate, which has some merit. I sympathize, however, with the authorities' concern about the potential consequences for inflation if such a course were to be followed, without having dealt fully with the fundamentals of low productivity and wage rigidity.

It seems to me that the Government's economic program would benefit from policies aimed at raising productivity in order to enhance South Africa's competitiveness. This has to be treated as a medium-term concern, with the focus on education and training. This is an area where concessional support from the international community would be most useful. In the meantime, steps should be taken to rein in labor costs, while efforts are being made to address the institutional constraints that have produced wage rigidity. In this regard, I welcome the establishment of the National Economic Development and Labor Council, comprising government, labor, and business.

The problem of high unemployment is another issue that has to be addressed. Although it is linked to labor market reforms, it is also critical that the economy maintains a high rate of growth. Foreign investment could play a major role in this. Political stability coupled with sound fiscal and monetary policies and a liberalized trade and payments regime should go a long way to restoring investors confidence.

My overall conclusion is that the new Government has made significant progress in laying the foundation for political stability and sound economic management. The situation requires much discipline and hard work; however, the authorities seem to be up to the task. It is reassuring that the Government has been able to forge consensus among widely divergent groups on major policy decisions, as pointed out by Mr. Du Toit. The international community should provide all possible assistance to South Africa to complement the domestic efforts. Such assistance is likely to pay large dividends in the sense that a wholesome functioning South African economy will benefit the southern African region as a whole.

Mr. Kaeser made the following statement:

The staff has produced a very interesting report, which reflects in a lively way the main issues of the economic policy debate that is currently taking place in South Africa.

After the peaceful political transition, South Africa remains in a difficult economic position. Despite the favorable set of macroeconomic policies adopted by the new Government since its installment, economic growth has remained disappointingly weak. Unemployment is high and rising. Overall domestic savings remain low, mainly as a result of large government dissaving. In an environment of persistent uncertainty, investment is low as well, and so are expected rates of future economic growth.

The reasons for the difficulties are manyfold. But one of the most important ones has to do with the deep-rooted legacy of the apartheid system that cannot be overcome in the short run. It will take years of effort to reconstruct a new economic and social structure while maintaining an economic policy that conveys confidence to investors, international markets, and assistance agencies. The balance between what is desirable and what is feasible is indeed fragile. The population showed maturity in the first democratic elections, and we are convinced that it is prepared to give its Government some time to develop and consolidate its economic strategy, as outlined in the Reconstruction and Development Plan. There is no doubt, however, that any such strategy implies hardship for large segments of the population. Evidently, expectations run high, and the Government is under the growing pressure to "deliver" rapidly.

After several decades of inward-looking development, a process of economic restructuring aiming at full integration of South Africa in the world economy was initiated. However, this is a long process, the benefits of which are not expected to accrue quickly. Crucial measures should therefore not be delayed. As we are in broad agreement with the staff appraisal of the economic situation in South Africa and its policy recommendations, in what follows we shall comment only on three aspects: fiscal policy, competitiveness, and employment.

Since the last Article IV consultation, the Government has reaffirmed its intention to gradually reduce the budget deficit. A comprehensive tax reform is under way. Given the large spending needs, particularly in the social and infrastructure sectors, this projected deficit reduction will have to be obtained by a fundamental reordering of expenditure priorities, which will gradually have to go beyond the present budget allocations. It should, however, not be expected that social and infrastructure service levels could be raised for all segments of the population to the level that whites used to enjoy: the Government should caution against unrealistic hopes, define appropriate social and economic targets, and device a strategy of reaching them.

In our last discussion, we referred to defense and bureaucratic expenditures as examples of sectors with large reduction potential. The energy sector is another example of a sector that might harbor sizable potential benefits, both by saving future subsidies to the sector and by taking advantage of lower prices resulting from the opening up of the economy. The old regime pursued an energy policy aiming at reducing South Africa's dependence on foreign energy sources. Best known are perhaps the widely used oil from coal technology and the development of a fully independent nuclear power industry. Some of these energy programs still depend heavily on public subsidies. Here, benefits are expected to accrue soon. Another type of gain is expected to accrue only in the long run. The opening-up of South Africa and the establishment of normal relations with its neighbors, make it possible for this country to have access to much cheaper energy sources, such as, hydroelectric resources from the Congo and the Zambesi basin.

One of the Government's fundamental strategies is to embark on a path of export-led growth. If trade is to be the future engine of growth, South Africa's competitiveness has to be improved. The competitiveness problem is closely related to labor relations. South Africa has a severely segmented labor market. The occupied workers can be considered as insiders, while both the unemployed and low-skilled workers in the informal sector, about 46 percent of the labor force, are outsiders. It is a recognized fact that the level of wages in the formal sector is inconsistent with a strategy of export-led growth. One of the conditions for growth in South Africa is therefore to eliminate the labor market segmentation by freezing or slowly reducing the level of formal-sector wages. We are normally opposed to government intervention in labor relations. But given the extremely distortionary character of the labor market in South Africa, we support the income-policy intentions of the Government to make the development of wages compatible with the development plans of the country. We also agree with the staff suggestion that it would be beneficial to provide some representation for the unemployed in the National Economic Development and Labor Council.

Although the staff rightly identified labor relations as a major reason for excessive production costs, we think that the highly concentrated corporate structure and large state-run industries also contribute to market inefficiency. Eighty percent of the Johannesburg Stock Exchange capitalization is owned by only four conglomerates. We can agree with the staff that this structure may not be a problem in itself, but it is nevertheless to be hoped that the opening of the internal market to international competition would eventually improve transparency and further enhance productivity.

Mr. Sirat made the following statement:

The staff report makes it extremely apparent that since our last Article IV discussion, and following the general elections, the situation in South Africa has been clarified but far from simplified.

Indeed, if the overall economic stance has been generally supportive of private economic activity, economic developments in 1994 were mixed, particularly with growth and investment levels far from being satisfactory.

From this point of view, today's discussion will by and large duplicate last year's, in particular the thorny issue of how to bring about real wage adjustment.

The key issue here is one of sustainability from a double standpoint.

First, sustainability of a "steady as you go" approach aimed at progressively building a "track record" to attract substantial foreign investment through the maintenance of a sound monetary and fiscal policy. Here, the question is whether relatively satisfactory macroeconomic results in the short-run would not suffer in the medium-to-long term in the face of deep social and political constraints.

Second, sustainability of a more risky approach seeking to obtain real wage adjustment through a nominal exchange rate depreciation. The risks involved here are clear enough:

internally, it might just lead to an inflation/depreciation spiral; externally, it might just weaken confidence further.

Faced with such a difficult situation, the authorities should certainly try both to make their present economic policy as conducive as possible to growth and to job creation, including through substantial structural reforms, and to determine what are the needed conditions which would allow for an orderly real wage decrease in the formal sector.

There is a consensus that a significant increase in South Africa's growth can only come from an export-led growth strategy. Besides its exchange rate element--to which I will come back later--this strategy should naturally encompass an appropriate trade policy.

In this regard, measures already taken in 1994 and in particular, the removal of import surcharges on capital and intermediate goods, are extremely welcome, as are the measures aimed at reducing tariffs in the industrial sector and at switching away from quantitative restrictions in the agricultural sector.

Naturally, other far-reaching structural reforms would also be needed, to foster job creation and improve the overall efficiency of the economy, and thus--if accompanied by an appropriate income policy--reduce wage costs.

First, I understand that in a recent report the World Bank has advocated a major rural restructuring program involving a significant transfer of agricultural land to small-scale farmers, including through a strategy using subsidized credits if needed.

Second, the development of small firms will be crucial and will require better access to financing sources. On this question, I was not totally convinced by the background paper.

Clearly enough, the development of small-scale business could have a large impact on job creation and on growth in particular, if it leads to the emergence of a "third sector" intermediate between the formal and informal sectors, in particular, as regards its unionization and level of wages. Needless to say, such a development would also have beneficial effects on the fiscal situation through a broadening of the tax base.

The development of a subcontracting scheme from the formal sector to the informal sector--as suggested in the report--is certainly an interesting avenue to follow. But it might also be needed to resolve some measures aimed at increasing access to appropriate financing because of the constraints faced in this regard by small enterprises, as emphasized by the report.

Whether some form of public intervention aimed at facilitating the financing of small enterprises is warranted is a difficult question, probably more likely to be on the agenda of the World Bank than on our own.

In any case, first, it could be argued that a better access to financing would encompass major externalities in South Africa and, second, that information costs required for such a development have somehow to be paid for at least partly by other than the borrowers. Accordingly, and from a theoretical standpoint, I am not sure our institution should advise the authorities against any credit guarantee scheme.

The agenda for difficult structural reforms is thus a large one. The report implicitly pleads that those structural reforms alone cannot bring back a satisfactory level of growth and employment.

But it should certainly be kept in mind that--whatever the evolution of the price structure in the economy--those structural reforms will be needed, in conjunction with labor market reforms.

That being said, the present centralized wage bargaining might, paradoxically, be an asset in the implementation of a policy aimed at reducing real wages through nominal exchange rate adjustments coupled with an appropriate income policy, inasmuch as it would facilitate a trade-off between a lowering of direct wages and a rise in social expenditures. In addition, I note that the upcoming Labor Council should provide some representation for the unemployed "outsiders," hopefully limiting the pressure for direct wage increases.

Ultimately, it will naturally be up to the authorities to assess whether the political and social conditions are met for the definition of a "social pact" that could limit the level of the nominal depreciation needed to achieve the approximately 15 percent to 20 percent real depreciation which would be required, according to the staff's scenario B.

I must say that the price and wage developments at the end of last year did not bode well for such a perspective because I understand that a 12 percent nominal depreciation has brought about only a 4 percent real depreciation.

But I would urge the authorities not to rely on currency depreciation only. To be successful, a depreciation must be accompanied by a credible package of adjustment measures in order to prevent the buildup of inflationary expectations. A "one-shot" large nominal depreciation, coupled with a strong adjustment and reform program backed and financially supported by our institution is preferable to any form of creeping devaluation.

I am aware of the difficulty of entering such a strategy in the current political context, and I understand why the staff is tempted to recommend a gradual and prolonged nominal depreciation. The authorities may finally turn to this solution, but we should clearly advise them that it is the most dangerous one.

If the authorities come to understand the benefits they would derive from a Fund program, the issue of the financial rand could then be addressed. Its abandonment, or, as we suggested last year, the maintenance of exchange controls only for residents, would certainly contribute to a major element in a strategy of an open economy for foreign investors.

Altogether, the difficulties of the present situation lie less in the definition of an appropriate strategy than in the clarification of the tactics to move from a path of low growth and high unemployment to one of high growth and employment in a context where the need for large flows of capital is met and where confidence in the economic framework is maintained.

The staff has done a tremendous job in explaining and clarifying to a large political spectrum the economic choices facing South Africa.

It is now to be hoped that our institution will prove instrumental in helping to implement a sustainable growth strategy in South Africa.

Mr. Shaalan made the following statement:

The problems facing South Africa are daunting, not so much for a lack of resources, but because of the tremendous unfulfilled basic needs of a large portion of the population. The weight of legitimate popular aspirations, expecting fulfillment in a short time, cannot but weigh heavily on policymakers as they pursue the challenging task of economic management at this historic juncture.

Despite these pressures, the South African authorities are to be commended for initiating policies consistent with the commitments included in the joint policy memorandum that accompanied the compensatory and contingency financing facility request of last year. They formulated a restrained budget for 1994/95 that not only avoided the temptation to increase expenditures but, in fact, targeted a lower current expenditure ratio and, more importantly, included a fundamental reassessment of government spending to redirect it toward developmental objectives. The authorities also took some first steps to encourage private investment and initiated other trade reforms, even prior to the coming into effect of the GATT agreement in 1995, which itself involves a significant trade liberalization program.

Notwithstanding the prudent policies followed so far, serious dangers lie ahead as South Africa attempts to overcome the constraints underlying the weakness in economic activity while addressing the serious social problems that are a legacy of past policies. I am in general agreement with the thrust of the staff appraisal, and will highlight only a few points for emphasis.

First, the exceptionally high and rising rate of unemployment is the most pressing problem facing South Africa today. The social and economic implications of an unemployment rate of about 45 percent are obviously extremely serious. To boost economic activity sufficiently to begin to reverse the unemployment trend, South Africa will need to substantially increase the growth of the manufacturing and services sectors within the context of an open export- oriented trade regime. Critical to that goal, in turn, is the need to address the serious disequilibrium, in relative prices, within the economy, as reflected in the excessively high unit labor costs. Excessive wage costs discourage domestic and foreign investment and, in turn, exacerbate the employment problem itself. The chapter on the South African labor market in the paper on selected economic issues sheds some light on this complicated problem and offers suggestions for wage setting that merit the authorities' serious consideration. I am encouraged by Mr. Du Toit's affirmation, in his most helpful statement, that progress toward agreement on labor issues remains a priority of the authorities, and I would urge them to continue to exert every effort to achieve a viable wage pact between Government, business, and labor soon.

My second, closely related, point concerns the mix of policies needed to effectively address the competitiveness problem. The staff's first best solution would put the burden squarely on incomes policy and productivity enhancing training. However, given the size of the wage adjustment that would be needed, the probability of this solution being agreed upon by the social partners is low. The second best solution, which we understand would include a rapid exchange rate depreciation, a pickup in inflation, and a smaller nominal adjustment in wages, is also problematic and risky. The inflationary effects of a depreciation are an obvious cause for concern, and the strong reservations of the Reserve Bank on the use of exchange rate policy to deal with wage distortions are not without merit, particularly given the pickup in inflation that followed the sharp depreciation of the first half of 1994 and the industrial unrest it precipitated. If inflationary pressures were to cause a catch-up rise in wages, the whole policy would fall apart with serious damage to the authorities' credibility. I would appreciate the staff's comments on this policy dilemma.

This brings me to the role of monetary policy in the course of last year. Notwithstanding the political uncertainty that played a part in inflationary expectations and the reluctance of the authorities to choke off the emerging recovery, a tighter monetary stance to support the depreciation in the first half of the year seems to have been warranted. Given the special factors that complicated monetary policy, I would appreciate further staff comment on the appropriateness of the monetary stance and the lessons that may be drawn for 1995.

Finally, with regard to the budget, given the sharply declining level of savings and investment in the past few years, the importance of reducing government dissaving must be emphasized. Even more important will be the reordering of expenditure priorities in the context of the Reconstruction and Development Program while reducing the budget deficit. Expenditures should be directed to satisfying basic needs such as housing, schooling, and healthcare, while ensuring efficiency and waste reduction. On a different level, it will be essential to define, as early as possible, how the provincial governments are to be incorporated in the announced fiscal targets and whether they will be allowed independent taxing, borrowing, and spending authority.

In conclusion, I would like to wish the authorities well in the enormous task they face. The road ahead will not be easy. But the authorities have begun on a positive note and I hope that their efforts will be rewarded with a substantial and sustainable improvement in living standards in the near future.

Mr. Ismael made the following statement:

It is encouraging to note that the political economy of South Africa has made significant progress since the last Article IV consultation in December 1993. An important milestone was the positive shift in policy direction toward fiscal discipline, privatization, and trade as an engine of growth.

However, as the latest dispute between the African National Congress and the National Party over the issue of indemnity for political crimes clearly demonstrates, the problem of political uncertainty remains. The weak pace of the economic recovery also indicates that stronger efforts are needed to put the South African economy firmly on the path of sustainable growth over the medium term.

In my assessment, the following issues warrant serious attention and should be addressed first: I share the staff's view that the crux of the problem lies with the rigidities in the labor market. This has resulted in a perverse situation of unsustainably high wages in an environment of widespread structural unemployment.

Until and unless these rigidities, particularly the legal and institutional framework for wage setting, are removed, I fail to see the efficacy of a more rapid depreciation of the rand to improve competitiveness. In fact, such a move may prove counterproductive, as it could lead to offsetting wage adjustments and precipitate a vicious circle of price and wage inflation. A depreciation of the rand per se would also not enhance South Africa's export performance if the hypothesis is true that local manufacturers treat foreign sales as a residual and concentrate on satisfying domestic demand.

To address the labor problem, the following options merit consideration: on wage rigidity, the Government, as the largest employer, could set the ball rolling by opting for a pay scheme based on productivity. Alternatively, the Government could expedite its privatization program to expose public sector employees to the discipline of the market place. The Government should also review the existing tax policies to avoid artificially reducing the marginal effective tax rate on capital which imposes a tax bias against the use of labor. On the need for upgraded training, one possibility could be the introduction of an apprenticeship scheme similar to the German model, whereby students go to school for half a day and are required to undergo several hours of on-the-job training in private firms. Another possibility could be the establishment of a skills development fund similar to the one in Singapore, to promote firm-specific training. Such a fund could be financed via contributions from the private sector.

Implementation of the above measures would represent an important first step toward a more flexible wage-setting system based on productivity, while at the same time, promoting higher utilization of labor and greater private sector involvement in skills training.

In the process, this will go a long way toward enhancing the country's competitiveness and set the stage for South Africa's shift toward trade as an engine of growth.

Mr. Waterman made the following statement:

Like others, I think we have an excellent set of staff papers. The presentation is very frank, and the discussion of the key issues is well balanced. I agree with much that is said in both the staff papers and in the statements, so I will focus only on a couple of issues.

The South African Government has made good strides with its economic policies to date. The ongoing challenges are sizable, if not daunting, but some early progress in improving living standards will be important to strengthening the constituency for reform. The South African authorities will need to balance that need for some early results, operating within the existing institutional and economic structure--that is, operating within what appears to be a structure with a concentration of union and employer power--and also taking measures that will improve the present structure by opening up the economy to outside competition and encouraging capital inflow, particularly direct investment from abroad.

Fiscal policy seems to be on the right track, and reduced public sector dissaving should help with available funding for private investment and alleviate some of the pressures on the balance of payments. Fiscal policy--and improved public sector efficiency--will remain a central policy concern, but I do not want to dwell on that now.

I would instead like to say something on the issue of getting the economy growing strongly enough to reduce unemployment without adding substantially to wage and inflation pressures. This is a very difficult task. In large part, this reflects problems with the structure of the labor--and product--markets; the apparent lack of responsiveness of wage growth to the high rates of unemployment is of particular concern.

There seems little doubt that the wage/unemployment trade-off will be improved by increasing competition in product markets, by opening up the economy and exposing domestic firms to international competition through trade and investment--but that will take time.

If it is the case that the formal, unionized sector acts as a pace setter for wage outcomes elsewhere in the labor market, controlling wage growth in the short term might best be achieved through a form of incomes policy and by the Government dealing directly with the main unions and employers.

This could also be a useful way of handling some other concerns including, for example, improving the skills of outsiders, as well as workers in the informal sector.

Over the medium to long term, however, decentralizing the labor market will be necessary to help ensure that wage growth is closely tied to productivity improvements.

A comparison of scenarios A and B is very interesting in that it underlines the potential advantage to the economy of significant improvements in competitiveness through a real depreciation in the exchange rate over the remainder of the decade. The challenge, of course, is how to get the real wage adjustment needed for that. The authorities face the difficult judgment of deciding to what extent that is possible within the existing institutional and power structure while giving themselves time to effect the more fundamental changes that will greatly improve the competitiveness and productivity of the economy. Like the staff, I find it easier to pose the question than to come up with an answer. I am not proposing it, but some further comments from the staff on the pros and cons of a larger up-front depreciation--and associated measures--might be useful.

Mr. Schoenberg made the following statement:

The staff documents on South Africa rank among the very best I have received as a member of this Board and I want to explicitly commend the staff for this excellent piece of work.

South Africa's economy is extraordinary because of the unique mixture of first world and third world characteristics. Infrastructure, administrative capacity, and entrepreneurial potential are clearly first world; high population growth, a low share of employment in the formal sector, and high political uncertainties are, in contrast, third world characteristics. The different worlds clash sharpest on the labor market. Relative to the unemployed outsiders, the formally employed insiders enjoy labor market conditions reminiscent of an industrialized welfare state: being highly unionized, represented in the new Government, and protected by long-established statutory structures governing wages and conditions.

As the staff points out, these first world labor market insiders have enjoyed rising real wages since the mid-1970s. The third world labor market outsiders are, in contrast, disproportionately young, poorly educated, without previous work experience, and politically not organized. If trade is to serve as an engine of growth, as was advocated by many speakers in last year's discussion, the severe imbalances in the labor market will have to be resolved. It will, however, require a political masterpiece to include the disenfranchised without alienating the better-off and without endangering South Africa's middle- and long-term prospects for high quality growth.

We agree with the staff, that considering the circumstances, the Government has so far succeeded in coaxing a very diverse set of interest groups toward a remarkable show of refined economic policies. We also agree with the staff that fiscal policy is on a sensible path. We regret, however, that public consumption is not only rising much faster than private consumption but also crowding out public investments. Maybe, the staff could comment on the development of public capital investments, especially on the projected developments, as several large investments currently are reaching completion. Maybe, the staff could also comment on whether the open questions regarding medium-term fiscal planning have been solved, and whether a decision has been reached on how to use potential privatization proceeds.

As exports remain the only viable source of growth in the medium term, the authorities will have to devise a fully-fledged statute to reap maximum benefits. Such a strategy should contain at least three parts: increasing industrial competitiveness; the dismantling of trade barriers; and exchange rate developments. All three parts obviously interact, and all three will probably have a role to play in adjusting the widely out-of-line structure of relative prices.

Although not fully compatible with the notion that wages should be market determined, a pact between business and labor seems to be an essential component of any policy to improve the competitiveness of South African labor, as the staff also suggests. Clearly, we would, in this regard, also favor the staff's first-best solution of a combination of wage adjustments and training that enhances productivity. Unfortunately, the probability of such an ideal solution being implemented is very low. It would be a major mistake, however, to try and address the competitiveness problem through exchange rate policy without several stringent conditions in place. Among these conditions, the abolishment of widespread cartelization and monopolization of the economy is of equal importance as the above-mentioned wage pact and the dismantling of trade barriers. In this regard, we note with concern that several important industries--motor vehicles, textiles and clothing, and electrical products--are to receive special treatment amidst the effort to reduce trade barriers.

Concerning the level of the exchange rate, I did not detect clear-cut evidence that the nominal exchange rate is substantially overvalued. Without any such evidence, I believe, like Mr. Ismael, that the authorities should not attempt to forcefully devalue the currency to achieve gains in competitiveness. As long as fiscal policy stays on track and monetary policy stays committed to keep inflation down, an abolition of the financial rand, and remaining restrictions on immigrants' interest and dividend remittances, would permit free floating of the currency. Thereby, an element of flexibility would be injected into the otherwise, rather rigid price structure in South Africa. As a floating exchange rate is not dependent on large currency reserves, the current level of reserves does not, to my mind, pose an obstacle against foreign exchange liberalization.

While the recent track record of the Reserve Bank is certainly not bad--given the political uncertainties that added to inflationary expectations, the distortion of relative prices and other major structural imbalances--I agree with the staff and Mr. Shaalan, that monetary conditions were probably too easy over the course of 1994. That will be reflected in a distinct rise in the rate of price increase in 1995. Therefore, I support the staff's call for a tough monetary policy irrespective of the actual exchange rate development.

Economic success for South Africa is all the more important because, as many Directors have alluded to, this country's success or failure will inevitably affect economic development in large parts of Africa. South Africa is a linchpin for economic prosperity for the whole of southern Africa. We commend the South African Government for its increased regional, economic and political cooperation. It should be honorably mentioned, for instance, that South Africa has forgiven Namibia most of its pre-independence debt. For other members in the region, South Africa, through the Southern African Customs Union and the Rand Monetary Area, serves both as a source of financing and relative monetary stability.

The new South Africa Government has achieved remarkable success during the first year in office. We sincerely hope that all parties concerned can muster the strength and political will to continue the path of peaceful change and adjustment, however difficult such a patient strategy may be for those who until now feel left out of the economic chances that are abundant in the new South Africa.

Mr. Koissy made the following statement:

The new South African authorities deserve to be commended for adhering to the pragmatic economic strategy and for maintaining a strong commitment to macroeconomic adjustment and reforms, while making remarkable progress toward full democratic rule. The economic strategy is one that will challenge the authorities as they have never been challenged before. What makes the challenges so daunting is the urgency to sustain a high economic growth, reduce unemployment, and raise the living standards of a large segment of the population. The close link between the economic and social problems will require the authorities' continued attention.

I congratulate the staff for a well-focused set of papers, which should undoubtedly contribute to the extraordinary policy debate in South Africa. I am in broad agreement with the staff appraisal and I will comment briefly upon some of the policy issues that the authorities will need to address immediately.

In the fiscal area, I welcome the authorities' resolve to implement the recommendations of the tax commission and the various measures already taken, or envisaged, to reverse the upward trend in budgetary spending despite the higher than anticipated cost of the political transition and rising interest payments. These measures should reinforce the credibility of the authorities' fiscal strategy. This strategy is not, however, without downside risks, and the staff has pointed out a number of critical ones.

In particular, maintaining the program budgetary allocation to the Reconstruction and Development Program, in order to resolve the inherited inequities, is crucial in achieving the fiscal objectives. We are impressed by the consensus already reached in addressing the housing issue, which appears to be the most difficult one to resolve, and we are confident that if the same consensus-building approach is followed in other sensitive social sectors, the credibility of the authorities' policies can only be enhanced further.

We would urge the authorities to seek a more diversified source of financing for the budget so as to avoid increasing the debt burden and reducing their margin of maneuver in future years. In this regard, the staff's recommendation to rely on non-debt-creating flows, such as through the use of privatization proceeds, to limit the provision of central government borrowing guarantees provided to provinces, and to mobilize concessional resources, appears to be sensible in South Africa's circumstances, and we fully endorse them. Still on fiscal policy, I would like to ask the staff whether they share the broadly revenue-neutral impact of the tax commission's recommendations.

On monetary policy, the newly independent Reserve Bank seems to have coped well with exogenous factors, and to have adopted its monetary policy to the changing economic and financial conditions. From the interesting discussion in the staff report, the staff presents a convincing case for a reassessment of the authorities' present stance on monetary and exchange rate policy, given the competitiveness issue. However, we sympathize with the pragmatic position of the monetary authorities that perhaps, in the present circumstances, the emphasis should be on addressing structural bottlenecks more directly, through reforms in the labor market, rather than through depreciation. Nevertheless, in addressing the many issues facing the economy, the authorities' efforts will be greatly facilitated, and economic costs substantially reduced, by implementing an adequate mix of monetary, exchange rate, and structural policies.

On labor market issues, the assessment made in the staff report of the formidable labor problem in South Africa--complicated by the rapid growth in the active population--is worrisome. We share the staff's views on the broad macroeconomic and structural policies needed to address South African labor constraints. Given the slow impact of many of the structural reform measures, we also believe that, as a priority, the collaborative approach between all social and economic partners is a second-best solution that should facilitate labor mobility, enhance youth employment, and raise labor productivity. I agree with Mr. Havrylyshyn on the important role that dialogue and an information campaign could play in broadening support for the authorities' strategy.

With regard to trade reform, I welcome the authorities' intention to move quickly from a self-centered and protectionist trade regime to a more open and competitive system. The authorities have a window of opportunity to move toward an open trading system, which will not only reduce the monopoly power of some enterprises, but will also remove some of the protection of the stronger trade unions. Trade liberalization and reorientation will be important to unlock South Africa's vast economic potential, and efforts by trading partners to facilitate market access could also help accelerate this process.

Given the exceptional level of unemployment and the comprehensive enterprise restructuring efforts that will be required, we wonder whether the option of export processing zones should not remain on the authorities' agenda. Such zones, where labor and tax laws can be made more flexible, have the potential to alleviate significantly the unemployment pressures, as has been shown by a number of countries that have been able to eliminate unemployment in a relatively short period of time. South Africa seems to be better endowed in many areas than other countries that have successfully made use of export processing zones to improve growth prospects, and this approach could go a long way toward reducing the present imbalances in the labor market. I welcome the staff views on this point.

On the reform of the exchange system, as there is a common ground between the staff and the authorities, I do not have much to add except that the envisaged timing by the authorities seems to be detected by pragmatic consideration, and we support their approach.

Finally, the Fund and the international community have contributed substantially to the ongoing economic debate in South Africa, and they have succeeded in steering the country to a course of action that will be beneficial in the long run to South Africa and to the whole African region. This is a challenging task, but it is the only one available to the authorities to redress in a more permanent way the inequities and the imbalances in the South African economy. Given the impact of developments in South Africa on the region as a whole, the Fund will need to continue to exercise closer surveillance on developments in South Africa. I encourage the authorities to persevere in their restructuring efforts, and I ask Mr. Du Toit to transmit to his authorities our best wishes for rapid economic progress.

Mr. Bergo made the following statement:

Paying South Africa's heavy burden of social and moral debt without resorting to a rapid accumulation of financial debt is a uniquely difficult challenge. Avoiding the pitfalls of this double debt problem will require a difficult balancing act between the desire to correct obvious social injustice and the need to maintain a strong, growing economy that can provide the resources for a more just society, without undermining its dynamic nature and future growth prospects. So far, the South African authorities have proceeded along this tightrope with greater skills and better balance than one could have hoped for.

South Africa's challenging problems have inspired the staff to write a very interesting report, and several Directors to write equally interesting statements that I have found very helpful. Rather than attempting to be comprehensive, I will try to comment on some of the major issues raised in the staff paper as well as in some of the statements.

The extremely high and rising rate of unemployment crystallizes all of South Africa's economic problems, and is a formidable threat to social, as well as economic, stability. I think that there is a broad consensus among all of us that a lasting solution to the unemployment problem can only be achieved in the context of much higher growth rates than South Africa has seen for a long time. The critical questions are from where that growth will come, and how it should be financed. Is it reasonable to assume, as the staff does, that employment growth will mainly have to come from manufacturing and tourism, or is the main source of growth in employment to be found in the nontradable service and construction sectors, as suggested by Mr. Shields? In a broad sense, I am tempted to side with Mr. Shields on this matter. However, these two views may not be so incompatible. The initial spur of economic growth may have to come from the more outward-oriented manufacturing and tourism sectors, even if the main source of employment growth will soon move into other sectors as the economy gathers momentum. After all, this is what we have in mind when we preach the virtue of outward oriented policies and trade as the engine of growth.

It is, however, important to keep in mind the growth potential of nontradable services and construction, as it may have implications for savings behavior and the current account balance. In these sectors, that, in general, tend to be labor intensive, each dollar saved and invested probably mobilizes more labor than in the other sectors. Moreover, there may be a more direct link between the propensities to save and invest in these sectors than in the more advanced sectors. As far as construction is concerned, the need for residential construction is enormous. It will be important to give the large number of underprivileged families, now living under very inadequate conditions, the necessary instruments and incentives to save and invest in home ownership.

This brings me to another, related issue, which is the role played by the informal sector. I agree with Mr. Shields that one should not focus exclusively on the formal sector activity. By its nature, the activity in the informal sector goes unreported. In spite of this, it would be a mistake to completely ignore the economic consequences of this activity when looking for potential sources of economic growth and employment. Neither should the impact on the informal sector be ignored when various policy options are evaluated.

From a crude Keynesian savings function, one might infer that there can be no source of savings coming from a sector where simple survival is a success. Anecdotal evidence and some studies do, however, suggest that this is far from the truth. Where there is survival, there is activity and, often, a surprising creativity. Rather than simply waiting for the informal sector to be absorbed into the formal sector, it could be wise to consider measures to help informal activity to be transformed into the formal one. Once this is acknowledged, the employment prospect may no longer look quite as hopeless. I also note that Mr. Sirat in his statement points to the possible employment effects of developments in the informal sector, or some "intermediate" sector.

A surge in inflation could be particularly devastating for the informal sector, which is not in a position to protect its meager savings. This would call for some caution in terms of relying on depreciation of the currency in order to improve competitiveness. A freeze on nominal wages, combined with vigorous reform of the labor market to reduce rigidities, is a more desirable option. This being said, I recognize that a freeze on nominal wages may not be sufficient in order to improve the competitive position soon enough to generate a significant export expansion. Let me add at this point, that it is disturbing to note that, so far, the authorities do not appear to have fully recognized the urgent need for labor market reform. I urge the authorities to reconsider their position on this and move quickly to improve the situation. However, it will take time before the effects manifest themselves. Consequently, even if I normally tend to value highly the role of exchange rates as a nominal anchor highly, I would hesitate to reject the possibility of allowing the currency to depreciate modestly in order to improve competitiveness, as I would assume that a reduction in nominal wages can hardly be engineered. Although the coefficients of capital and labor may be quite fixed, as Mr. Shields argues, so that consequently the substitution effect from lower real wages is quite small, increased wage competitiveness may still stimulate expansion of capacity, and perhaps the use of some idle capacity. As investment in increased capacity most often also brings with it the latest embodied technology. This will also tend to enhance productivity, which should enable the external sector to compete at higher levels of relative wages in the future. But again--here I emphasize caution.

This brings me back to the problem of how to finance the necessary expansion of capacity. Mr. Havrylyshyn, in his statement, makes some wise remarks on that issue. I fully agree that it is important to emphasize financing through non-debt-creating foreign direct investment and domestic savings. The question is how the domestic saving rate can be increased. It would certainly be beneficial to reduce the government dissavings much faster than now envisaged, in order to induce substantial crowding-in, as mentioned by Mr. Havrylyshyn. I lack however sufficient knowledge to evaluate whether this is a realistic possibility or only wishful thinking. Let me only mention that one would assume that a country that previously devoted a substantial amount of resources to fighting internal enemies that are now in power, and to destabilizing hostile neighboring countries that are now the friendly neighbors, might quite likely find some opportunities for cutting expenditures somewhere. The staff's comments would be welcome. Nevertheless, in light of the fact that faster expenditure reductions may be extremely difficult to achieve, and while I fully agree that increasing taxes is, in general, not desirable, as tax levels are already quite high, I would hesitate to preclude categorically a modest increase in consumption taxes, in order to achieve faster deficit reduction.

Let me say a few words on trade policy. Like other speakers, I am very pleased to note the emphasis on open trade policies by the South African authorities. However, despite significant reduction in protective barriers, tariffs in many areas are still quite high.

Foreign investors are no longer attracted by the comfort of investing behind protective barriers. And South Africa is at a disadvantage in competing with countries like China or India, where investors are, to some extent, attracted by the actual, as well as potential, size of their economies. To some extent, this disadvantage can be overcome through regional integration, and, in general, a liberal trading regime will be essential for attracting foreign investors. Abolishing multiple exchange rate practices would also give foreign investors increased confidence about the authorities' commitment to open trade policies. Like Mr. Jonáš, I am therefore not convinced that there is much to be gained from delaying these reforms. Abolishing the restrictions on domestic residents is perhaps not the most urgent task, but I think it would be beneficial to set a clear timetable for the gradual lifting of these restrictions, which should, however, go hand-in-hand with efforts to strengthen the competitiveness and confidence in the economy.

Finally, let me again express my appreciation of the calm and well balanced policy approach applied by the Government. The benefits of a stable and prosperous South Africa extend far beyond its borders. Hence, the importance of finding a sustainable solution to South Africa's economic and social problems can hardly be overestimated.

Ms. Lissakers made the following statement:

Let me join other Directors in complimenting the new South African Government for its prudent management of economic affairs. The welcome political transition has been a testing time for the economy and for economic policy. The authorities are rapidly establishing a reputation for economic probity. The necessary redirection of economic priorities toward greater social equity is being undertaken within clearly defined fiscal limits and with a clear appreciation of inescapable economic constraints.

I would also like to compliment the staff for a sharply focused set of papers that address the fundamental economic issue facing South Africa: how can the country set itself on a self-sustaining path of employment-generating growth? The report extends the analysis beyond the standard savings/investment/fiscal aspects of the problem. It incorporates a detailed assessment of the structural distortions in the labor market that misalign relative prices and frustrate a smooth transition to rapid growth with rising employment. Debate on labor market reforms is only beginning in South Africa, but the staff analysis should help focus the debate on fundamentals. With 45 percent of the work force unable to find employment in the formal sector, certainly labor market reforms--as my colleagues have noted--must be at the top of the growth agenda.

It is very clear that South Africa does not now generate the savings needed to sustain investment at a rate that would support faster growth. This has not always been so, as the staff paper makes clear. National saving is now a little more than 17 percent of GDP; before the mid-1980s savings rates were typically 25 percent of GDP or higher. The big differences now are that the Government no longer contributes to national savings and the foreign sector has been draining savings out of the economy for over a decade. Both of these developments are reversible.

The budget deficit for FY 1994/95 is projected to be 6.1 percent of GDP, down a little from 6.5 percent the previous year. This is too large, but I agree with the staff that fiscal policy is on the right track. The Government's medium-term plan calls for no increase in recurrent expenditure over the next five years, a rise in the share of capital expenditure in the budget, a constant ratio of revenue/GDP, and a progressive reduction in the deficit to 4.5 percent of GDP by 1998/99. While the deficit reduction would not be particularly large, if the fiscal adjustment proceeds as outlined, it would make an important contribution to setting the economy on a higher growth path. The Government's contribution to national saving will rise as more of expenditure is devoted to public investment. At the same time, restrained taxation will moderate the deadweight loss of expanding tax wedges.

I would not underrate the difficulty of achieving even this fiscal correction, but steady progress needs to be achieved. To meet the basic objective, it will be necessary to avoid fiscal slippage at lower levels of government. Privatization of state-owned assets can make an independent contribution to growth by promoting more efficient use of resources and by providing a vehicle for increased foreign investment. But, as the staff advises, the proceeds of privatization should be used to retire debt, not to finance recurrent expenditure.

As South Africa is reintegrated into the world economy, it is entirely reasonable to anticipate that foreign savings would again make an important contribution to capital formation. The staff suggests that current account deficits in the order of 2 percent of GDP per year, financed by voluntary capital inflows, would be manageable. We agree. The trick will be to motivate voluntary capital inflows. It is at this point that market distortions look most intimidating.

The analysis presented by the staff makes a strong case that South Africa is a high cost location for foreign investment. The jump in unit labor costs in manufacturing since 1985, shown in the staff's chart, must have compressed profit margins sharply. The result is that South Africa is at a disadvantage in international competition to host foreign investment. The foreign investment that is attracted tends to be highly capital intensive, such as in the mining sector, and thus does not provide the growth and job generating potential that the economy needs.

The high cost structure in the formal sector is a more general problem. The experience of the past few quarters indicates that when growth quickens even a little, the trade balance deteriorates. Furthermore, rising demand feeds quickly into inflation rather than expanded output.

Getting a better supply response requires more flexible labor market practice. One of the interesting points brought out in the staff report is that high wage cost in the formal sector is not just a question of unionization. The whole national wage setting apparatus sets floors under wage levels in most of the formal sector, and the informal sector presumably is informal precisely because it involves activities that are designed to remain outside this very restrictive framework. Presumably, with labor market reforms, the distinction between the formal and informal sectors would become somewhat blurred, to the general advantage of the economy.

While it may be difficult to directly bring down the wages of those now employed in unionized companies, it should be possible to modify the national wage setting system so as to permit the unemployed to be priced into jobs. The suggestions on page 74 of the background paper ought to be pursued. Wage differentiation by age should be encouraged. Regional wage differentiation should be introduced. The mandatory extension of Industrial Council agreements to firms not represented on the councils should be terminated.

The staff asserts that job growth is going to have to come from the manufacturing sector and from tourism. I agree with Mr. Shields that this presentation probably overstates the extent to which the insider/outsider problems in the labor market have a mirror image in the tradable/nontradable goods sectors of the economy. I suspect there is also a large potential for major job creation in the domestically oriented service sector, and in light fabrication and construction, if only labor costs were allowed to better reflect productivity. These sectors are largely insulated from international competition. Thus, the argument that currency depreciation may be needed as a device to circumvent the impact of labor market restrictions seems decidedly second best. It would leave untouched restrictions that frustrate job creation in the nontradable goods sector.

Before adopting currency depreciation as a growth strategy, we would prefer to see a concerted effort made to open up labor markets. Policy already strongly supports the opening of the economy to international competition. Increased labor market competition should be seen as the logical internal counterpart to external liberalization. The Government is still young and its thinking in this area is only beginning to take form.

On the question of labor, and particularly employment of the young, I was troubled by the staff report's reference to the lack of progress in the education area. While social expenditure as a part of the budget has increased significantly, as has health care--both absolutely necessary and desirable--a massive and comprehensive approach to improved education and work skills clearly has to be a central part of any successful labor reform and to boost in the overall level of employment. I think Mr. Ismael's suggestions in this area were very interesting. I wonder also, frankly--as I think Mr. Bergo alluded to--whether on the fiscal side more resources could not be shifted out of the defense and internal security side of the budget and into the absolutely essential area of education and job training.

I would also be interested in a little more elaboration of the staff's thinking regarding the potential to improve the flow of financing to small business. Obviously, large businesses and foreign investment can play an important role. As we know, the key to economic success rests on stimulating domestic savings and on effective deployment of those savings to activities that can generate jobs. That, very often, is at the micro level--that may be somewhat more the World Bank's purview than ours, but certainly Chapter VII of the background paper introduces this topic but does not develop any sharp policy recommendations. I suspect that a small redirection of credit flows could play an important role in fostering more job creating growth. I would be interested in the staff's policy advice in this area and whether the staff is contemplating on doing more.

I would also be interested in a little more comment by the staff on the costs and benefits of early elimination of the financial rand. We endorse the Government's strategy of a two-stage approach with liberalization of non-resident capital transactions proceeding ahead of liberalization of resident capital. Reserves are still low, but the capital accounts now seem to be coming into better equilibrium. What sort of policy backstopping does the staff believe would be needed to manage the risks accompanying early elimination of the financial rand?

Mr. Kannan made the following statement:

South Africa has gone through a major social political transformation. This has not been an easy task and the transition period has taken a heavy toll on the economic front. We are indeed happy to note that the South African authorities have lost no time in addressing these issues so as to put the economy on a stable and sustainable path. We congratulate the authorities on the excellent start they have made. We compliment the staff on the constructive and pragmatic approach they have adopted in this policy dialogue with the authorities.

The authorities have recently launched the reconstruction and development program. Many positive factors are now present--namely, the international goodwill, the decline in the inflation rate to about 10 percent in 1993/94 as against 16 percent in 1991, a low level of foreign debt, and extensive infrastructure facilities. These are to be optimally utilized to sustain the recovery process. In this brief intervention, I would like to highlight a few areas that would merit special attention in the coming months.

First, unemployment is going to be an important area that will engage the attention of authorities in the immediate period. To give a boost to employment growth, real wages ought to be restrained and combined with productivity gains. Although there is still some spare capacity in the economy, the current level of labor costs prevents full use of the available labor force, and also depresses the rate of growth of productivity.

Second, it is encouraging to note the decline in the fiscal deficit to 6.6 percent of GDP in 1994/95 from 8.3 percent in 1992/93. Having agreed to cut taxes and, at the same time, to reduce fiscal deficit to 6.1 percent, the authorities would have to call for stringent measures for containing primary recurrent expenditures. In these efforts, it would be necessary to ensure that the investment in sound overheads and the program for the weaker sections do not get affected.

Third, while undoubtedly privatization can be used as an instrument for reduction of domestic debt, the primary objective--namely, that of providing a healthy competitive environment--should not be lost sight of. It should be ensured that the problem does not lead to monopolization of profits in the private sector.

Fourth, we compliment the authorities for their efforts in reducing tariff protection so as to make trade an engine of growth; but, to achieve this, technology transfer should be given more importance so as to make the export sector competitive. In this context, compatible foreign collaboration assumes more importance.

Turning to the exchange rate policy, while we agree that some amount of depreciation of the rand to nullify the inflation differentials between South Africa and her major trading partners will enhance the competitiveness, care should be exercised in avoiding excessive depreciation, as this will kill the adjustment process. Furthermore, we believe that a modest depreciation may strengthen the tourism and manufacturing sectors. This should be carefully planned so as to nullify the monetary impact of depreciation because broad money grew by 14 percent in 1994 against 7 percent in 1993. We also perceive that the necessary mechanism is available in absorbing the excess money supply through open market operations. Hence, a restrictive monetary policy in 1995 is called for.

We encourage the authorities to move toward abolishing the financial rand and strengthen the role of the commercial rand in the exchange rate mechanism. This will substantially contribute to increasing foreign direct investment. The staff has mentioned on page 15: "But the objective--an economy capable of delivering higher living standards to all South Africans--will not be easy to achieve or sustain." While we appreciate the difficulties in attaining that stage, it is not clear why it is unsustainable. The staff may like to elaborate further.

The staff representative from the African Department, recalling Mr. Shields' questions on the exchange rate, wages, and employment, remarked that it was difficult to reconcile the argument that the current account deficit might be difficult to finance even in a low-growth scenario with Mr. Shields' views on whether real wages were too high or the real exchange rate was overvalued. The current high and rising unemployment rate, and a growth rate lower than the rate of growth of the labor force, suggested a prima facie case for some relative price distortion in the economy in wages or the real exchange rate. If one added to that the fact that unit labor costs had risen by 40 percent relative to export prices in the previous decade, and that the unemployment rate--including in the informal sector--had risen continuously for 15 years, then that would prove the existence of a relative and fundamental price distortion.

The unemployment problem, the staff representative continued, could not be solved by a spontaneous shift toward more labor-intensive production or increased activity in the informal sector. That position, taken by the African National Congress in 1993, was no longer the Mandela Government's position. Instead, at the previous Confederation of South African Trade Unions (COSATU) conference, the Mandela Government had taken a position much closer to that taken in the staff report. The notion that factor intensities could change and that one could move toward more labor-intensive production was commendable, but the fact remained that factor intensities responded to relative factor prices--and, so far, all movement had been in the opposite direction. As a matter of fact, as wage rates rose, the tendency of the economy was to become more capital intensive. Also, the idea that the informal sector--at only one tenth of GDP--could solve the unemployment problem was difficult to comprehend. The informal sector, besides the taxi industry, was largely composed of individuals, hawkers and occasional labor, and only 1 million out of the total of 4 million people in the informal sector were also in the formal sector. Only 600,000 of the 4 million worked for someone else, while the rest were casual labor working for themselves.

A takeoff in growth, the staff representative said, could not come from mining, where employment had been falling for some time, years after peaking many years earlier. Nor could it take off from the construction industry, where fewer than 400,000 were employed, compared with the leading sectors of manufacturing and tourism, where more than 2.5 million people were employed. A growth spurt with an export-led model would have to be initiated by the open-trade sectors of manufacturing and tourism. Only in the second growth round could construction take off, and any idea of a government-led construction boom would not be sustainable.

The fundamental point, the staff representative stressed, was that South Africa was competing against a number of other middle-income countries such as Mexico, Brazil, Argentina, the Czech Republic, Malaysia, and Thailand, and that it was losing the competition for foreign investment in export industries of high labor cost. In addition, South Africa was losing the competition for domestic investment. For example, the largest South African textile corporation had diversified production to Zimbabwe, not because of lower taxes or better infrastructure, but because of substantially better unit labor costs, productivity, and wages.

There was a real exchange rate problem, and unit labor costs were too high for South Africa to be competitive internationally, the staff representative emphasized. There was no record of previous experience that could fix the problem. Ideally, there would have been domestic adjustment, but whether that was feasible was an open question. The degree of money illusion that one needed to employ in making that kind of adjustment depended on the specific circumstances. For example, if a wage pact could be negotiated, with wages going up by 3 percent a year for the succeeding five years, there would be no need to change the exchange rate at all. An increase of 3 percent in wages, with 6 percent to 7 percent inflation, would probably solve the problem, but whether such a pact could be negotiated was debatable. The line continuously heard in South Africa was that there would have to be a certain degree of money illusion to generate that kind of change in real wages, and that changes in relative prices would be needed.

It would have been easier to have negotiated a wage pact with 10 percent wage increases for the following five years--impervious to changes in the exchange rate--than it would have been to negotiate a wage increase of 3 percent. It was a second-best solution, but if that was what it took, and if that could be sustained, that ought to be the way the authorities should go.

A one-off devaluation followed by a peg would also be acceptable, the staff representative observed, but the consensus had been that that would have been difficult to achieve, as it would have generated a big increase in prices up front, and it might have endangered the wage pact. Also, one could have taken the view that that should all have been done internally, with very tight monetary policy. Perhaps, in principle, it could have been done with a war of wills between the reserve bank and the union movement, but in practice, it probably could not have been done in a government of national unity with the unions strongly represented in the cabinet. A war of wills might have split the carefully nurtured government of national unity.

In the first half of 1994, monetary policy had been much too easy, with money growth well above the target range, the staff representative recalled. Reserves and the exchange rate had been dropping, but the yield curve had indicated that inflationary expectations had been rising. In addition, inflation had gone up to 10 percent by the end of the year, after having come down from 15 percent to about 7 percent in April. For 1995, the estimate was that broad money growth should certainly not exceed 13 percent. It was not clear whether the changes that had been made since August, such as the raising of the discount rate, would be sufficient to hold money growth. The November, December, and January figures would need to be analyzed carefully, and it was likely that a further increase in the discount rate would be needed early in 1995.

On the savings-investment balance, the staff representative noted that the savings gap was just under 8 percentage points and that it was almost impossible to remove that domestic contemporaneous resource constraint simply through static accounting. What was needed was an improvement in competitiveness and higher profit margins, which would generate more growth of output, more employment, and more savings. That would induce capital inflows--non-debt-creating transfers of domestic resources from abroad--that would ease the constraint. Attention was called to the background paper containing clear econometric evidence of how savings and investment balances tended to work in South Africa--the famous Feldstein and Horioka equations, which attempted to relate investment to domestic savings--and a very clear break in the relationship was observed. During the 1985-93 period of financial sanctions, domestic investment had been absolutely constrained to domestic saving. However, historically, domestic investment had been virtually impervious to domestic saving, and any gap between domestic investment and saving had simply been filled by foreign investment. Therefore, until the financial sanctions in 1985, South Africa had relied on foreign investment. With the lifting of the sanctions in 1993, it was hoped that South Africa could move back in that direction.

Not much more could be squeezed out of government expenditure than had been envisaged in the authorities' medium-term strategy, the staff representative said. Bearing in mind that there was virtually no social safety net in large parts of the economy, very few of the unemployed had any kind of unemployment insurance or unemployment assistance. President Mandela's promise of free health care for pregnant women and young children had already run into very difficult cost constraints. Military expenditure was being cut from 4 percent of GDP in financial year 1991 to 2.7 percent in financial year 1995. Of the 2.7 percent, about 0.4 percentage points were necessary for integrating the military wing of the African National Congress into the national defense force. Most calculations had suggested that military expenditure could not fall much below 2.5 percent of GDP in order to maintain an army of appropriate size. Police expenditure or protective services had risen from 1.6 percent of GDP in 1991 to a little over 2 percent and, therefore, there could be some cuts in those areas, albeit only a little, because despite a drastic reduction in political violence, the crime rate was still high.

The major area for expenditure cutting was the government wage bill, which accounted for more than 50 percent of primary recurrent expenditure, the staff representative observed. The recent petering out of a big public service strike had been an encouraging sign, because government employees had realized that wage demands were inconsistent with the existing state of unemployment in the economy, and could not be sustained. The difficulty would be to take the necessary step of containing employment, which was more important than containing wages.

The medium-term fiscal strategy would increase government investment by 1 percentage point of GDP and reduce the deficit by 2 percentage points of GDP, with the overall contribution of government savings to investment of about 3 percentage points of GDP, the staff representative continued. The notion that a number of public sector investment projects were ending and that public sector investment would therefore go down was incorrect. What was ending were some large projects, mainly in mining and mining-related sectors. Those were highly capital- intensive investments under section 37-E of the tax code, which allowed tax holidays and accelerated depreciation allowances. The staff had been adamantly against those projects because they skewed relative prices toward more capital intensity and less labor intensity. Those projects were not formally in the public sector.

The tax commission's interim report contained balanced proposals, the staff representative noted. However, there were concerns about a big gap between the top marginal rate of income tax and the rate of tax on companies. Many companies in South Africa were "mom-and-pop" companies essentially created for tax purposes to take advantage of the lower company tax rates. Revenue neutrality was premised on the notion of improved tax administration, which would take a while, whereas some of the tax changes being proposed could be implemented quickly.

The issue of privatization had been broached publicly for the first time only a couple of months earlier, the staff representative stated. Just a year before, the African National Congress had been talking about nationalization. The fact that talk of nationalization had moved to talk of privatization was a major change. The previous government had had some experience with the privatization drive between 1988 to 1991, and much had been learned from it. Potential candidates for privatization included the huge electricity company, with a book value of about R16 billion, and the telecommunications company, with a book value of R6 billion. Also, there had been some foreign interest in buying the gas-to-oil conversion and chemicals conglomerate. It appeared that in the first instance, privatization of smaller government land holdings would take place, but nothing had been finalized.

On necessary structural change in the labor market, anything that broke the barriers between insiders and outsiders was considered useful, the staff representative emphasized. Under existing conditions, a thriving micro-enterprise that started employing people and buying machines would quickly become subject to the strictures of the formal wage system and the formal wage policy. Because so many of the unemployed were young, lower minimum wages should be considered. Industrial council and wage board agreements should be voluntary and not obligatory, and they should no longer be extended to companies that had not participated in those agreements. Wage settlements should acknowledge regional differences in the cost of living, and unions should be pressed for wage moderation at the plant level. Any wage pact that would be put in place should seek to reduce insider-outsider differentials, and, in particular, to mute the wage response to a depreciation of the currency. Unions had tended to oppose job-specific training on the grounds that it reduced worker mobility; enterprises, on the other hand, thought that that sort of training would most likely bring rapid increases in productivity. All sorts of training should be encouraged, and the German model and the Singapore model suggested by Directors should be welcomed.

Little was known about black entrepreneurship in the formal sector, apart from the taxi industry, the staff representative observed. There was little organized activity, but there was a need to nurture whatever there was, and to keep small enterprises out of the industrial council wage negotiations or wage settlement strictures--and, wherever possible, to encourage subcontracting between the formal and the informal sectors. Such a practice would be one way of breaking the barriers between the two sectors, and also a way of providing small, informal sector enterprises with access to markets and to credit. It was a great deal easier to borrow money if one went to the bank with an order to fill from a large company than if one went to the bank with no evidence of one's ability to produce or market.

On capital flows, the contagion effects from the Mexico crisis were probably quite small, because South Africa had lost some of its luster as an emerging market, the staff representative noted. There had been a slight rise in yields, as the yield on five-year South African sovereign debt had jumped from 9.8 percent on December 19 to 10.7 percent on December 22. It was currently trading at about 10.25 percent. The financial rand discount had risen from 11 percent on December 19 to 13 percent on December 22, and on January 30 the market had closed at 13.2 percent. Usually, the Johannesburg Stock Exchange gold index had a negative correlation with financial uncertainty abroad, but that had not occurred in current circumstances. Both industrials and gold shares had peaked at the end of December, and had declined significantly during January.

Abolition of the financial rand--at its existing discount of 13 percent--would not be a major shock, the staff representative observed. There would be some depreciation of the commercial rand, and the unified exchange rate would settle somewhere between the two; and if the wage response particularly could be contained within the depreciation, the abolition would not be a major shock. However, the financial rand operated as a sort of shock absorber, with its discount widening in the event of a Mexico-type shock. There had been frequent shocks in South Africa over the previous year or so--for example, the Sebokeng massacre and the Hani assassination. On those occasions, the commercial exchange rate had not been affected at all, and the reserves had been affected minimally because the financial rand discount had spread from 15 percent to 40 percent, thereby increasing the effective yields for foreign investors substantially. With existing reserves very low, the elimination of the financial rand to cushion an economic shock would result in the depletion of reserves, and a substantial change in the exchange rate. Therefore, before getting rid of the financial rand, it would be useful to put in place some kind of wage pact so as to lessen the wage response to a big change in the exchange rate.

Caution was needed in approaching the elimination of capital controls on residents, the staff representative commented. There were institutional investors in South Africa and the contractual savings business was very large. One group of contractual savings institutions had cautioned that, if exchange controls on residents were to be removed at short notice, they would seek to diversify about a third of their portfolios out of the country. Their portfolios--about half of the total in the country--had amounted to $80 billion, thereby raising the possibility of outflows of something like 25 percent of GDP. The institutions had been talking to their counterparts in Zurich, Frankfurt, London, and New York as to how that money could best be placed. That clearly would have been an overwhelming outflow, and unsustainable. A more gradual approach to removing exchange controls on residents might be envisaged, with some kind of portfolio constraints on savings institutions, but the possibility of arbitrage needed to be borne in mind. Even if some institutions were constrained, their connections with foreign institutions--and the possibility of new institutions springing up--would create the potential for arbitrage and for moving a lot of money out of South Africa into foreign markets.

Some of the financing for black micro-enterprises went through the Development Bank of South Africa, which was a wholesaler of funds to nongovernmental organizations that ran those enterprises, the staff representative noted. Financing should not be increased substantially through mechanisms such as government guarantees on bank lending, because the authorities feared that if they guaranteed those loans, the banks would not vet them properly.

Export processing zones would be a second-best solution to the ideal solution of making the whole country an export processing zone, the staff representative from the African Department observed. What would be needed was a zone where producers had access to international inputs at world market prices, that is, an effective duty-drawback system for the whole country, on which path South Africa had already embarked. The other aspect to be considered would be the easing of formal labor regulations in that zone. It was not clear from the authorities whether it would be much easier to do that for any specific zone than it would be for the whole country.

Mr. Schoenberg remarked that the benefits derived from the financial rand during economic shocks should be compared with its drawbacks in terms of distortions, attempts at circumventions and, to a certain extent, a misallocation of capital resources. The balance of the benefits and drawbacks would shift in favor of an abolition of the financial rand system, if it were assumed that South Africa would be reasonably free from economic shocks in the future.

The staff representative from the African Department agreed with Mr. Schoenberg. The financial rand should be eliminated as soon as possible.

Mr. Shields--clarifying his statement--voiced concern about the idea that the high unit labor cost problem related only to the existing formal sector and the existing structure of the unions. The informal sector was being disregarded while overall unemployment stood at 45 percent. It was crucial to address the insider-outsider problem and not let South African society proceed with a segmented labor market. Education and training over the medium term would help to make labor more productive. The danger lay in trying to stitch together a quick and partial solution with nominal wage increases accompanied by a perpetually depreciating exchange rate. The stability of that solution would be questionable. Also, it was not clear where the actual employment growth would be coming from.

The staff representative from the African Department said that he was equally concerned with the notion of going for a wage pact that might put in place high wages and high inflation. The inflation inertia would need to be broken at some stage. The other danger of a wage pact was that it might centralize wage bargaining, which would make it impossible to have a more decentralized plant-based wage bargaining system later--which might be preferable.

Mr. Sirat said he agreed with the staff on the financing of small enterprises, and that, theoretically, it would be preferable to go without any form of government guarantee scheme. However, from a practical point of view, it would be helpful if the World Bank were to look further into the issue.

The staff representative from the African Department noted that the challenge of governance in South Africa in the preceding year had been to take widely divergent interest groups and get them to support the government's program. The principal players were treading a very fine line. However, it was not inconceivable that the Fund could be asked for help some time during 1996, perhaps under the compensatory and contingency financing facility (CCFF).

Mr. Al-Jasser noted that Chart 13 in the staff papers showed that the formal sector employment gap had risen sharply, starting in 1980. It would appear that unemployment in the formal sector had not always been as bad in South Africa. Chart 4 showed that there was a sharp rise in labor costs over export prices starting in 1986. He wondered whether unemployment in the formal sector had risen sharply only in the last 10-15 years and, if that was the case, why had it risen. Perhaps it could be blamed on the sharp rise in labor costs. The most effective way to control labor costs in the short run would be to allow a depreciation of the exchange rate which, in turn, would make those industries in which South Africa had a comparative advantage more competitive in the export market.

On another point, Mr. Al-Jasser suggested that the development of housing schemes on government-owned land for the large disenfranchised part of the population would generate employment and stabilize society in the existing dual economy of South Africa. Those schemes would be market based, but could still be made available to those segments of the population that had never had access to mortgage lending. Also, almost all construction would be from local materials with local contractors.

The staff representative from the African Department replied that, since about 1975, profit margins had been squeezed. Ahead of the previous recession--starting in the mid- to late 1980s--South African mining and manufacturing companies had undergone substantial structural adjustment, resulting in labor retrenchment. Wages had been rising relative to productivity since the mid-1970s, but by the mid-1980s those companies had been trying to maintain profits by adjusting through the retrenchment of workers. In the recession that had ended in 1992, employment had fallen faster than output, because the worker retrenchment had taken place even before the recession had actually begun, so that productivity had actually increased. Therefore, the reason that unit labor costs had dropped in 1993--in the first year of the recovery--was because of a 2.5 percent cut in employment through retrenchment in the nonagricultural part of the formal sector. Relating the situation to exchange rates and international competitiveness, the real exchange rate was derived from both domestic and foreign consumer price indices, producer prices and labor costs, and they determined the relative value of exports and imports. There had not been a big increase in nontraded goods prices, which would have shifted resources from the traded to the nontraded sector and affected the exchange rate. However, the situation was much more dire with labor costs as an indicator of relative competitiveness. In addition, many traded goods companies would have to deal with the elimination of the general export incentive scheme--a straightforward export subsidy that was slated for gradual elimination.

Enormous progress had been made in housing, and the authorities were talking about building a million houses over five years, the staff representative noted. The whole scheme--probably the most advanced element of the Reconstruction and Development Program--would be run by the banks with a subsidized financing program graduated according to householders' incomes. However, there was concern that the scheme would be open to abuse because the highly graduated schedule of subsidies gave a better tax advantage to those with lower incomes. There appeared to be great scope for subcontracting to local contractors.

Mr. Vernikov made the following statement:

South Africa is in the middle of a challenging political and economic transformation. Notwithstanding the various internal and external challenges, the Government has been doing its best to establish or restore investors' confidence by adopting and carrying out prudent economic policy. Its main focus is on financial stability, acceleration of growth, and gradual liberalization of the economy.

The South African authorities have to address simultaneously such challenges as meeting the expectations of the majority of the population for better living standards, absorbing mass unemployment, finding additional resources for investment, and improving the competitiveness of the industry after decades-long inward orientation.

The two medium-term scenarios in the staff report demonstrate that there is a general consensus and belief about the Government's ability to effectively control the situation and lead the transition. The overall projections for the year 2000 are quite positive and optimistic; the difference between the two scenarios being that the second one is more aggressive in speeding up growth and absorbing unemployment. I would like to support Mr. Havrylyshyn's statement, that the problem is not with the proposed program; the problem is whether the population is sufficiently aware of the wisdom of such a strategy, and whether it will be prepared to maintain patience for some time. As a matter of fact, some points need more careful consideration.

It is logical to assume that a transforming economy is exposed to all kinds of internal and external shocks and pressures. Internally, fiscal discipline will be seriously tested in the years to come, under implementation of any policy mix. If Scenario A is followed, then pressures from the domestic labor market combined with general expectations of improved living standards may jeopardize the efforts to reduce government spending as a proportion of GDP. Under Scenario B, devaluation of the rand, adjustment of relative prices, and implicit indexation may accelerate inflationary pressures, with some fiscal implications.

Prospects for the external sector are reasonably good. According to the staff paper, a deterioration of the current account is likely to be offset by medium- and long-term capital flows. I think that if the economy were to become more open, then pressures on the current account would increase. Notwithstanding the diversification of exports after 1987, its concentration on several commodities remains high, and thus implies vulnerability to exogenous price shocks. Further, liberalization is likely to benefit the industry's competitiveness with a certain lag only, while imports would grow rapidly due to expanding domestic demand. In the short run, liberalization can exert a controversial impact on manufacturing and non-gold exports.

As to the capital, the most likely source would be foreign borrowing at a rate that would include a rather high risk premium. Time and effort are required for South Africa to establish a track record and high credibility with outside investors, who would be discouraged by any unforeseen development in the economy or in politics. I also note that capital flight led to a sizable decrease of international reserves in 1993/94. Pressures are not unlikely to intensify again, for instance, due to political uncertainties or tensions between the main political parties. I do not think much was said on this phenomenon during our discussion.

Last, but not least, I wish to speak with regard to foreign exchange arrangements, namely the "financial rand" system and restrictions on capital transfers. From a theoretical viewpoint, as argued by research carried out in the Fund, liberalization of the capital account improves the credibility of domestic policies and precedes an inflow of foreign capital and repatriation of domestic capital, while fears and difficulties tend to be exaggerated. In practice, however, South Africa's attractiveness for foreign investment depends rather on assessments of the global environment. An immediate removal of all exchange restrictions may, in the short run, trigger additional pressures on the balance of payments. Therefore, I share the pragmatic and cautious approach to this issue implied in the staff paper.

Mr. Schlitzer made the following statement:

I would like to join other Directors in commending the new South African Government for its efforts in leading the country toward a future of fundamental political, economic, and social change. The South African economy presents a number of problems and structural weaknesses that are extensively and very clearly documented in the staff papers, and have been already commented on by previous speakers. I would like, briefly, to add a few considerations to the current discussion just for emphasis. The South African authorities face a difficult dilemma of meeting the needs of the population without disrupting macroeconomic balance. While I am aware of the fact that the commitment of the authorities to pursue sound fiscal and monetary policies is necessary to attract foreign investment, it appears to me that if the needs of the population are not met in the short term, it might lead to risks associated with political instability, which would contribute to a worsening of the business climate for foreign investors. The country's recent experience with capital outflows is evidence of how crucial it is to preserve the confidence of private investors. In this respect, raising the welfare of the population seems compelling to me. The most pressing problem for the authorities is the massive unemployment that the country is experiencing--currently exceeding 40 percent. As highlighted in the staff papers, the labor market suffers from a number of civil distortions which the authorities should try to remove. However, it is clear that even in the most favorable scenario, the unemployment rate is bound to exceed any reasonable level. The staff has presented us the basic scenarios which have different implications concerning, among other things, the rate of growth of the economy and unemployment. This chair finds these kinds of exercise particularly stimulating, especially in light of the numerous trade-offs that the South African economy faces and the relevance of the medium-term strategy. Unfortunately, some important questions remain unanswered. Which one of the two selected scenarios is deemed more likely to occur? The comment on the two scenarios is limited to a very short appendix which, in my opinion, would need more analytical elaboration to provide the Board with the necessary information. For example, we do not know anything about what happens to the consumer price index in the two cases, as only the implicit GDP deflator is reported. As the two scenarios have different implications concerning the exchange rate, the consumer price index will give more reliable projections of the inflation rate. Moreover, it is not clear to me how in the second scenario the higher exchange rate devaluation can lead to such a strong increase in consumption and imports. The role of interest rates is also neglected in this exercise, so maybe, the staff would like to elaborate more on these points. Under the baseline scenario, that is, Scenario A, the unemployment rate is projected to rise even further in coming years. As I do not see how the unemployment rate can be higher than the current one and be socially and politically sustainable, I find Scenario A alarming. Scenario B foresees a decline in the unemployment rate, thanks to a faster exchange rate depreciation. Nonetheless, the unemployment rate is projected to remain higher than 35 percent. The crucial issues are then, how to drastically reduce these alarmingly high unemployment rates to reasonable levels. The staff has suggested a number of practical solutions that are certainly worth considering. However, I wonder whether more explicit efforts to shift production toward labor-intensive sectors of the economy would help in reducing unemployment, and whether this might be a viable prescription; but I think, the staff has already commented on this point. I share with the other Directors the appreciation of the Fund's role in supporting the development process in South Africa, and wish the South African authorities every success in their endeavors.

Mr. Leiva made the following statement:

I would like to join previous speakers in commending the South African authorities for managing the economy through a period of sweeping political change. I also commend the staff for its interesting and incisive work, and fully endorse their analysis and policy recommendations. Therefore, I will comment briefly on three points of special concern.

The nearly 30 percent of open unemployment, its composition, and the continuous upward trend of the formal employment gap make unemployment the central economic problem in South Africa. The main question is what policies will be more efficient to sustain vigorous real growth. The answer seems to be centered on the solution to two main problems: uncertainty and competitiveness.

With respect to uncertainty, the new government programs and policies should gradually strengthen confidence in South Africa's economic and political future. It must be kept in mind, however, that political events--not necessarily related to economic policy--have an important incidence in relieving uncertainties.

Enhancing international competitiveness seems to be the key to spur investment and ease balance of payments constraints, providing the thrust for export-led solid growth. Relief of the overwhelming unemployment calls for gaining competitive edges in the export sectors.

The staff report aptly distinguishes a first best solution with medium- to long-term results from a more pragmatic solution with more rapid results. The first is a combination of productivity enhancing training and wage adjustment. The latter combines exchange rate, monetary, and income policies to attain a real depreciation of the rand.

It must be pointed out that these policy mixtures are not mutually exclusive. In many outward-looking development programs, training, re-training, and education, in general, along with labor markets reforms, are permanent features among policies designed to achieve productivity gains.

These policy mixtures do not exclude the option of policies assumed in the report's medium-term Scenario B. Faster results for the pressing issue of expanding output and employment can be expected through a real depreciation of the rand, correcting relative price and cost distortions. Size and timing of estimates of likely impacts of such policies on savings, investment, output, and employment are very appealing.

Whatever policies are implemented, overcoming labor and product market distortions and rigidities should be given high priority. I think the corresponding sections of the paper on selected economic issues are a valuable contribution on these matters.

The staff considers it "inadvisable for the Government to embark now on an extensive program of foreign borrowing." Its likely effect on relative prices of nontraded goods would be detrimental to international competitiveness. Although I agree with this argument, I would like the staff to comment on the limits this recommendation imposes on the funding of social programs that could be financed by international or national agencies as well as nongovernmental organizations.

International goodwill on behalf of the new Government has been exceptional. The peaceful transition to majority rule has fulfilled, at this moment, the world community's expectations. I wish the South African authorities similar success in managing the difficult challenges still ahead.

Mr. Al-Jasser made the following statement:

Economic developments in South Africa since the last Article IV consultation have been most encouraging. Faced with daunting tasks in reforming and resuscitating the economy, the authorities' sound economic management has enhanced credibility and improved growth performance. The challenges facing the authorities, however, are of a formidable magnitude that is as demanding as those faced by the economies in transition.

The most immediate challenge facing the authorities is the need to place the economy on a path of high and sustainable growth. The staff presents three convincing reasons for the low growth performance of the economy, namely, uncertainty on the part of investors, a dearth of domestic savings, and disequilibrium in relative prices--notably wages--that are eroding international competitiveness. Addressing these problems requires measures that involve all policy instruments and options.

Fiscal policy needs to balance the difficult task of addressing large expenditure requirements with that of reducing the deficit. Clearly, such a goal can only be achieved through careful prioritization of all expenditures. The authorities' management of fiscal policy to date has been commendable. However, the need for enhancing saving would suggest that more ambitious goals for reducing government dissaving are in order. On this issue I find myself in agreement with the arguments in Mr. Havrylyshyn's statement.

Unemployment is clearly the central economic problem in South Africa. The authorities' recognition of the importance of this problem is reflected in their White Paper on Reconstruction and Development, which states that "the fundamental goal of the Reconstruction and Development Program is an employment creating, labor absorbing economy which will ultimately lead to full employment." With unemployment about 45 percent, full employment is years away, and a problem of this magnitude requires bold measures. Current economic policies are simply not sustainable unless accompanied by strong measures to enhance competitiveness.

Enhancing the competitiveness of the formal sector is a complicated task, as the staff papers illustrate. Labor market rigidities, coupled with the strength of the labor unions, have been the primary cause of the phenomenon of rising real wages and unemployment.

The authorities could pursue one of two strategies to address this problem. The first-best solution presented by the staff entails a combination of productivity-enhancing training and downward-wage adjustments. But experience in many other countries would suggest that a downward adjustment of wages of the magnitude needed would be difficult to implement.

The alternative strategy would entail a depreciation of the rand that is supported by a tough monetary stance and a wage pact with the labor unions. The authorities' caution in pursuing such a course is well placed. A depreciation in the absence of a wage pact, which would ensure that nominal wages will rise only minimally for several years, would defeat its purpose, lead to higher inflation, and undermine the Government's economic program. Furthermore, the case for a depreciation is not very clear-cut, and it is difficult to judge whether the real exchange rate is overvalued. Clearly, the authorities should keep it under close review.

The medium-term scenarios presented by the staff suggest that even with a depreciation, unemployment will fall to only 38 percent by the year 2000. This is a strong decline, but unemployment will continue to be high. So, while a depreciation of the rand may help in reversing the rising trend in unemployment, and address the need for relative price adjustments, it is by no means sufficient. A greater decline in unemployment will only be achieved through the pursuit of a broad-based economic growth strategy that is not only outward-oriented, but also encompasses domestic-oriented productive activities such as housing--as I mentioned earlier.

A successful outward-oriented growth strategy depends, inter alia, on enhancing the flexibility of both the labor market and the economy as a whole. Here, breaking all barriers to internal integration that have given rise to the dual nature of the economy is of paramount importance. Moreover, further reform of the external trade regime and improvement of the climate for foreign investment are critical for the success of export-led growth.

Greater foreign investment would depend on a number of variables. First, tax rates must be at an attractive level. Second, a reform of the exchange rate system, including the abolition of the financial rand, is also necessary for ensuring economic efficiency and the long-run equilibrium of the balance of payments. Here, I am encouraged by what the staff reports as the authorities' distaste for the current system, and I hope that existing restrictions will be removed at an early date. Third, greater confidence should be attained through the authorities' establishment of a strong track record in sound economic management.

In sum, the challenges facing South Africa are formidable by any standard. As Mr. Du Toit points out, despite the fact that the authorities assumed power only recently, substantial progress has been made towards establishing credible domestic policies that enhance international reintegration, while addressing the distortions created by past policies. The Fund should do all it can to help the authorities choose the most suitable policy options for South Africa's transition into a truly market-based economy and an integrated society.

Mr. Rouai made the following statement:

I commend the authorities for their ability and commitment to conduct their economic policy with the same emphasis on a strategy of liberalization that worked well in the area of political reform. As I have no difficulties in supporting the staff analysis and recommendations, I will offer the following comments as a contribution to emphasizing the issue of unemployment in South Africa.

With a record unemployment rate estimated at 29 percent, or the equivalent of 45 percent of the labor force, the dramatic unemployment situation in South Africa confirms once again the acuity of this problem not only in developing countries, but also in many industrial countries. The growing emphasis on job creation in the political agenda of many governments highlights, in our view, the need for the Fund to reassess the importance of this issue in its relations with member countries. In this connection, we find interesting the chapter in the staff paper on recent economic developments devoted to the labor market in South Africa and we encourage the Fund to devote more resources to the issue of unemployment in developing countries.

The staff study concludes that unemployment in South Africa is overwhelmingly structural and affects particularly young, black, and unskilled people. Although there is a general recognition that the first best policy to reduce unemployment is for the authorities to promote an environment for sustainable and high growth for the private sector, we encourage the authorities to give early consideration to the staff recommendations to upgrade training and differentiate wage minima by age in order to address youth unemployment. In addition, one cannot ignore the growing tendency in many countries to recommend active government intervention to promote job creation. The chapter in the staff paper on recent economic developments on financing small business in South Africa clearly shows that financing is one of the major constraints faced by small scale projects, which are usually labor intensive. We can share the staff skepticism with regard to government intervention to provide guarantee or direct credit. We also agree that, in most countries it is the access to financing, and not necessarily the cost, that constitutes the major constraint. We consider, however, that skepticism about government intervention should not be exaggerated. Many experiences show that when government support to small or individual enterprises is targeted, institutionalized, transparent, and distributed through the banking system, it could go a long way toward building the entrepreneurial base for the economy and providing for the absorption of low-skilled workers. We would be interested in the staff's comments on these policies and their usefulness for South Africa.

Mr. Ishida made the following statement:

I note with pleasure that the new Government of South Africa is fully aware of the importance of stabilizing the macroeconomy and liberalizing the trade system, and has been making efforts to achieve these goals in many areas.

Despite the authorities' efforts, however, the economy continues to deteriorate: economic growth is slow, inflation is accelerating, and the external position has weakened. In particular, unemployment is at a dangerous level and could threaten the stability of the society. Moreover, the medium-term scenario illustrates that this difficult situation will not improve dramatically in the medium term. It is clear that priority should be given to boosting growth and reducing unemployment. While there are a number of problems that the authorities need to resolve, in order to achieve sustainable growth at a reasonable level, I believe that particular importance should be given to reducing the fiscal deficit, primarily by reordering current expenditures, devaluating the nominal exchange rate, restraining wages, continuing to liberalize the trade and exchange system, and promoting foreign capital inflows, in particular, direct investment. In view of seriousness of the situation, the authorities are strongly urged to carry out these policies as a matter of urgency.

I would now like to focus on four specific areas. First, on fiscal policy, although the economy is sluggish and the Reconstruction and Development Program is probably very expensive, the authorities are encouraged to continue to reduce the fiscal deficit in view of the high debt/GDP ratio. A further increase in the fiscal deficit would result in the crowding out of private sector activities.

Second, on the issue of restraining public sector wages, it might be worthwhile to consider, for example, reaching a consensus on a rule under which public sector wages would be adjusted automatically in line with the average increase in the private sector wage bill. In any event, although the issue of restraining wage increases is, in general, very difficult, as some Directors pointed out, many countries have succeeded in resolving this problem, and ample experience has been gained. Differentiating wage minima by age, as the staff suggested in the background paper, is a good example to be considered. The authorities should study these experiences and undertake some appropriate measures as a matter of urgency.

Third, on exchange rate policy, the staff reports that the central bank argued that a more rapid nominal depreciation would not bring about sustainable real depreciation, because it is uncertain whether the authorities will succeed in restraining nominal wage increases. The concern of the central bank is understandable, and I see that some Directors expressed their sympathy for it. However, because at the present level of the exchange rate, international competitiveness has been eroded, and as it is difficult to imagine a decline in the nominal wage bill, I think that it is necessary to allow the exchange rate to depreciate more rapidly, and to employ wage restraint. In this connection, the establishment of an institutional framework to restrain wage increases is urgently needed.

Finally, in order to attract foreign capital, in particular, foreign direct investment, it is crucial to stabilize the macro-economy and liberalize the trade and exchange system. In addition, I think that the wise use of tax incentives would help attract foreign capital. As it is imperative to attract foreign capital to improve the high unemployment economy, the effective use of tax incentives is worth studying. In this connection, in order to build the confidence of both domestic and foreign investors, a more rapid depreciation of the exchange rate would seem to be appropriate.

The staff representative from the African Department stated that while the staff preferred Scenario B, it would be in favor of any scenario under which real wages and the real exchange rate would be adjusted regardless of the inflation outturn. The relative movement of the consumer price indices and GDP deflators was not an issue under Scenario A, because relative prices were fixed under that scenario. Under Scenario B, traded goods prices rose relative to nontraded goods prices, resulting in relative price adjustments. It was not known how the GDP deflator would play out.

The costs of foreign borrowing could be greater or lesser in the context of an exchange rate that was out of line, depending on whether the adjustment came by way of the nominal exchange rate or relative internal prices, the staff representative continued. Borrowing abroad to finance programs, even those with a low import content, would tend to result in a larger current account deficit, rather than additional saving, in the case of South Africa.

Public sector wage increases should not be indexed to private sector wages, the staff representative stressed. Instead, public sector wages should grow more slowly than private sector wages, if only to correct the upward movement over the previous five years. Wage leadership from the public sector was needed.

Mr. Du Toit stated that an understanding of the political background was needed to understand current developments in South Africa. The Government of National Unity had put together a Reconstruction and Development Program, which would address the constraints in the economy and continue the process of building on the auspicious political developments. The Program aimed to improve the position of small business in the economy as well.

The transformation of South Africa was continuing, Mr. Du Toit emphasized. The Program had been accepted not only by the Government of National Unity, but also by the National Assembly. In March, a review of progress in restructuring the economy would take place.

The National Economic Development and Labor Council had been created to handle labor issues, Mr. Du Toit said. In the past, labor policies had been addressed by two separate forums: the National Economic Forum, which had been created prior to the coming to power of the Government of National Unity; and the National Manpower Commission, also inherited from the past. Under the new framework, those two forums would be brought together under one national authority to address not only labor issues, but fiscal and monetary policy issues as well. In that context, efforts were being made to draw in the widely divergent population groups in South Africa, and to break through the barriers of the past. South Africa had embarked on a process of restructuring its economy; the advice of Directors that he had received that day would contribute to that process.

The Acting Chairman made the following summing up:

Executive Directors congratulated South Africa on its momentous transition to democratic rule, and characterized the announced macroeconomic objectives and policies of the new Government as prudent. They praised the high quality of the documentation prepared by the staff and associated themselves with the thrust of the staff appraisal. The Government's endorsement of a more liberal trade regime and its move toward fiscal retrenchment were especially welcomed. Improved business and external confidence were contributing to social and political stability, but the South African economy faced considerable hurdles and historic challenges. Directors commended the pragmatism of the Government's economic strategy as reflected in the Reconstruction and Development program.

Directors noted that real GDP growth remained slow two years into the economic recovery, and they expressed concern that the modest growth projected for the medium term would be insufficient to arrest the upward trend in unemployment from a level that was already very high. Moreover, the recent increase in inflation and the disappearance of the external current account surplus suggested that the unemployment problem was essentially structural in nature. The rise in labor costs had squeezed profit margins in traded goods industries, and was inconsistent with a high-employment balance of payments equilibrium and a strategy of export-led growth. Directors, therefore, urged that the authorities give the highest priority to easing structural rigidities in the labor market, and many speakers supported the structural changes already embarked upon that would facilitate an appropriate incomes policy.

Directors were of the view that labor cost restraint to improve domestic labor market fundamentals and external competitiveness would have beneficial effects on growth, employment, and the balance of payments. Various approaches to the problem could be envisaged, but all would require some combination of real wage containment and worker training to boost productivity. In ideal conditions, real wage correction would be brought about by breaking the inflation inertia in nominal wage settlements, but it was not clear that those conditions prevailed in South Africa at present.

Many Directors believed that the exchange rate could also play a useful role--at the right time--in correcting the competitiveness problem. They stressed, however, that any depreciation of the rand would need to be considered in the context of ongoing real wage correction and labor market reform, and be supported by flanking macroeconomic policies--in particular, a tight monetary stance--and also by a social pact on wages; otherwise, it might spark a wage-price spiral.

Directors expressed support for the Government's medium-term fiscal stance. By announcing appropriate targets and adhering to them, the Government would establish a track record of responsible fiscal management. The credibility of fiscal policy was seen as particularly important under the present transitional circumstances in which it was likely that uncertainties were holding back investment and employment decisions. Directors also welcomed the authorities' commitment to undertaking the Reconstruction and Development Program within a stringent medium-term fiscal framework, involving a focused effort at reorienting government spending, mainly by reducing the wage bill and government employment, and eliminating inefficiency.

Directors cautioned the authorities to take care that aggregate fiscal control be maintained in the process of devolving some fiscal powers to lower tiers of government. A number of Directors also endorsed the authorities' intentions with respect to privatization--as much for its effects on efficiency and the structure and role of the private sector as for its direct fiscal impact. However, a warning was sounded against using privatization receipts to finance additional recurrent expenditure.

Directors observed that monetary policy had been conducted in an unusually difficult environment in 1994. Nevertheless, the upturn in inflation and the sharp deterioration in the external current account in the second half of the year suggested that the monetary stance had been insufficiently restrictive in 1994. Directors hoped that the policy changes since August and the continued vigilance of the Reserve Bank would ensure that would be corrected in 1995.

Directors expressed optimism that the ending of financial sanctions had eased the external constraint that had existed in the past decade. They stressed the importance of foreign direct investment, and observed that significant inflows would be contingent, in part, on an improvement of the competitiveness of South African producers in international markets and on a further strengthening of confidence. Many Directors also favored early action to eliminate the financial rand system, arguing that would help clear the way for more foreign direct investment.

Directors urged the authorities to eliminate the existing exchange restriction on remittances of emigrants' interest and dividend earnings, which is subject to Fund approval under Article VIII.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/95/8 (1/25/95) and EBM/95/9 (1/30/95).

4. WORLD SUMMIT FOR SOCIAL DEVELOPMENT - RELEASE OF INFORMATION

The Executive Board approves the proposal to make available the staff paper entitled "Social Dimensions of the Fund's Policy Dialogue" to the participants in the Third Session of the Preparatory Committee of the World Summit for Social Development to be held in New York on January 16-27, 1995 and, thereupon, to the participants in the World Summit for Social Development to be held in Copenhagen on March 6-12, 1995, as set forth in SM/95/13 (1/19/95), Supplement 1 (1/23/95), and Supplement 2 (1/26/95).

Adopted January 26, 1995

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/95/13 (1/24/95), EBAM/95/14 (1/26/95), and EBAM/95/15 (1/25/95) and by Advisors to Executive Directors as set forth in EBAM/95/13 (1/24/95) and EBAM/95/14 (1/26/95) is approved.

APPROVAL: July 31, 1996

LEO VAN HOUTVEN
Secretary