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Minutes of Executive Board Meeting 90/148

3:00 p.m., October 10, 1990

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Z. Iqbal, Temporary
	S. Gurumurthi, Temporary
	G. C. Noonan
	D. Powell, Temporary
	Zhang Z.
	B. S. Newman, Temporary
	F. Moss, Temporary
	L. B. Monyake
	F. E. R. Alfiler, Temporary
	M. Hepp, Temporary
	A. Napky, Temporary
	B. Bossone, Temporary
	O. A. Himani, Temporary
M. Fogelholm	
	M. A. Hammoudi, Temporary
	B. Goos
	Hon C.-W., Temporary
	L. I. Jácome, Temporary
	J.-L. Menda, Temporary
	C. V. Santos
	P. Wright
	G. P. J. Hogeweg
	S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
S. L. Yeager, Assistant

Also Present

O. Kaba, Director, Foreign Exchange Department, and Advisor to the Governor of the Central Bank of Guinea. F. Le roux, Principal Resident Representative of South Africa; M. Grote, Attaché for Finance. African Department: E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; P. Beaugrand, J. P. Briffaux, P. Dhonte, P. L. C. Hilbers, I. Kapur, S. N. Kimaro, M. M. Mateus. Asian Department: B. Smith. European Department: P. B. de Fontenay, Deputy Director; M. Guitián, Deputy Director; T. A. Bayoumi, K. B. Bercuson, D. Lachman. Exchange and Trade Relations Department: T. Leddy, Deputy Director; A. Basu. Fiscal Affairs Department: A. A. Tait, Deputy Director. IMF Institute: A. Camara, Participant. Legal Department: D. Asiedu-Akrofi, H. Elizalde, P. L. Francotte, R. B. Leckow. Advisors to Executive Directors: Y. Patel, N. Toé. Assistants to Executive Directors: T. Berrihun, B. A. Christiansen, A. Y. El Mahdi, B. R. Fuleihan, K. Ichikawa, K. Ishikura, K. Kpetigo, M. Mrakovcic, D. Saha, G. Serre, M. J. Shaffrey, D. Sparkes, S. von Stenglin, Wang J., J. C. Westerweel.

1. GUINEA - 1990 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/90/147, 10/10/90) their consideration of the staff report for the 1990 Article IV consultation with Guinea (SM/90/142, 7/17/90; and Sup. 1, 9/17/90). They also had before them a background paper containing a statistical annex (SM/90/178, 8/13/90).

Mr. Santos recalled that some Directors, particularly Mr. Goos and Mr. Yoshikuni, had raised doubts about the authorities' commitment to economic reform and had even suggested that a number of prior actions would be required for approval of a request by Guinea for an enhanced structural adjustment arrangement in the near future. In that regard, he would underline the significant accomplishments that had been achieved in the area of economic reform in Guinea over the past 4-5 years. After more than 20 years under a centrally planned economy, considerable effort and political commitment had been required to restructure the economy and lay the foundations of a market-oriented system. Moreover, progress had been achieved under difficult circumstances, including a lack of statistical comparators, limited administrative capacity, and serious financial constraints. Thus, evaluating progress, the starting point must be clearly defined and assessed.

The Board had welcomed the package of measures already implemented or planned for the second half of 1990, Mr. Santos observed. While his authorities recognized that much remained to be done to strengthen the macroeconomic framework and deepen structural reform in the coming years, they understood that the implementation of the package of measures set out in their letter to the Managing Director would serve as a solid basis for discussions with the staff on a successor program under the enhanced structural adjustment facility in 1991.

The staff had clearly explained in its report the reasons why the negotiations for the third-year arrangement under the structural adjustment facility could not be completed in time, Mr. Santos remarked. The difficulty lay in the timing and efficacy of the proposed measures and not in the authorities' determination to implement reforms. He was grateful to Executive Directors for their extensive comments and for their encouragement.

Mr. Goos commented that he had no doubt about the authorities' commitment to reform, but rather--based on the record of adjustment--was concerned about their commitment to the adjustment targets. That was a fair statement in view of the substantial deviations from the program targets in the past. Moreover, he recalled that he had earlier commented positively on the measures recently implemented or announced by the authorities.

Mr. Yoshikuni said that he wished to associate himself with Mr. Goos's remarks.

Mr. Santos stated that he was grateful for the clarification provided by Mr. Goos and Mr. Yoshikuni.

The Acting Chairman made the following summing up:

Executive Directors expressed broad agreement with the thrust of the staff appraisal for the 1990 Article IV consultation with Guinea. While Guinea had made some progress in recent years in initiating structural reforms and reviving real GDP growth, Directors observed, the economy remained beset by a weak productive base. They also expressed concern about the continued rapid rate of inflation and the persistence of sizable fiscal and external deficits, which in turn had prevented the elimination of domestic and external payments arrears; the substantial drain on resources by loss-making public enterprises; and the excessive reliance on mining sector activity.

Directors noted that with a strong and sustained implementation of appropriate policies, Guinea's medium-term growth prospects would appear to be favorable. To exploit the economy's potential, there was a need to remove structural and institutional constraints, strengthen the savings effort, and foster private sector confidence. Directors therefore welcomed the authorities' recent measures to restructure the petroleum sector and to improve tax administration. They also welcomed the additional measures taken to contain the fiscal deficit and strengthen the balance of payments, including the latest increase in retail prices of petroleum products.

Directors encouraged the authorities to make sustained efforts to reduce the fiscal deficit through improvements in tax collection, as well as through tight control of the wage bill and other current outlays. The strengthening of the fiscal position should be accompanied by further progress in restructuring the petroleum sector and the major public enterprises. The efforts to improve public savings should provide more scope for an expansion of bank credit to the private sector within a framework of greater restraint in the growth of total domestic credit and money supply. To ensure efficient resource allocation, stimulate financial savings, and limit inflationary pressures, Directors urged that interest rates be maintained at positive levels in real terms. The authorities were also encouraged to save the windfall gains from the higher-than-expected mining revenues in 1990 and beyond.

As regards the policies required to promote nonmining output and exports, Directors stressed the need for the authorities to urgently address structural rigidities, including inadequacies in the legal framework and administrative bottlenecks. Directors agreed that it was important to maintain an exchange rate that ensures external competitiveness. To that end, they emphasized the need for strong discipline in macroeconomic policies, as well as strengthened structural reforms. Directors stressed the importance of accelerating the reduction in external arrears as well as domestic arrears.

Finally, most speakers stressed that a major and continued strengthening of macroeconomic policies and structural reforms would be necessary before the Executive Board should consider any access by Guinea to the resources of the enhanced structural adjustment facility.

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

The Executive Board took the following decision:

1. The Fund takes this decision in concluding the 1990 Article XIV consultation with Guinea, in the light of the 1990 Article IV consultation with Guinea conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Guinea maintains exchange restrictions in the form of limits on travel allowances and unrequited transfers, in accordance with Article XIV, Section 2. The Fund encourages Guinea to eliminate these restrictions as soon as possible.

Decision No. 9558-(90/148), adopted
October 10, 1990

2. SOUTH AFRICA - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with South Africa (SM/90/172, 8/22/90). They also had before them a background paper on recent economic developments in South Africa (SM/90/176, 8/28/90; and Sup. 1, 10/5/90).

Mr. Le roux made the following statement:

The staff report for the 1990 Article IV consultation portrays a positive picture of the present stance of monetary and fiscal policy in South Africa and acknowledges the achievements over the past year. These positive developments would not have been possible without the assistance of the management and staff of the Fund who, over time, have continued to cooperate with the South African authorities in a constructive and professional manner. For their part the South African authorities have always held the economic and financial analysis and policy advice of the Fund in high regard, and this has undoubtedly strengthened the hands of the authorities in instituting and explaining necessary policy changes. It is therefore appropriate for me, as the new resident representative, to place on record the appreciation of the South African authorities for the assistance and cooperation of the management and staff of the Fund.

The staff report that forms the basis of today's discussion is no departure from what we have become accustomed to: based on exhaustive consultations, it is an incisive document highlighting the policy achievements of the past year and, more important, focusing on various economic problems the authorities will have to address as the country moves toward a new constitutional dispensation. It is this forward-looking approach, especially, that renders the staff report of such great value to the authorities. We are also encouraged by the knowledge that our present policy approach comports with the general policy prescription of the staff.

Extraneous developments impacted negatively on the growth potential of the economy during the latter half of the 1980s. The large-scale withdrawal of loan funds, the disinvestment campaign, as well as trade boycotts and sanctions applied against some of South Africa's imports of strategic materials and also against a selected spectrum of export products put the overall balance of payments--and therefore the level of gold and foreign exchange reserves--under severe pressure.

This led to the introduction of various punitive control measures, including the debt standstill arrangements, which restrict the repayment of short-term foreign liabilities; the financial rand system, whereby the capital amount of foreign investments cannot be repatriated through normal banking channels; exchange controls, which continue to restrict foreign investment by South African residents; restrictive monetary and fiscal policies, including an import surcharge, applied to restrain the domestic absorption capacity for imported goods and to release more manufactured goods for export; and, the resulting appreciable depreciation of the exchange rate of the rand.

As correctly pointed out in the staff appraisal, this situation is by no means ideal. In sum, the surplus on the current account of the balance of payments must be regarded as artificial, and created through an administratively burdensome and inefficient system that results in the misallocation of resources. Indeed, it can be argued that South Africa would, under normal circumstances, have qualified for one or more of the Fund's various financial assistance facilities.

These negative extraneous developments coincided with a phase of accelerating domestic political and social change, accompanied by uncertainty, loss of confidence, rising structural unemployment, and, eventually, a forced decline in living standards, especially in the lower income groups of the population.

There can be no doubt that the interaction of all these factors severely undermined the growth potential of the South African economy. The study on the implication for output and employment of capital constraints and financial sanctions, in the appendix to the background paper trenchantly confirms this fact and further concludes:

> Without access to foreign saving and an associated strengthening of confidence, the economy will probably continue to stagnate, and be unable to create enough jobs to avoid a secular rise in nonwhite unemployment. The lifting of investment associated with a restoration of access to foreign capital (involving both the lifting of financial sanctions and resolution of political uncertainty) could, on the other hand, lead to significantly higher economic growth, employment generation in the nonwhite community that matches the growth in the labor force, and an accelerated reduction in income disparities.

A further example is provided by the findings of a study by the Manpower Commission in South Africa that the economy needs to grow by at least 5 percent a year to absorb new entrants to the labor market. To reduce structural unemployment, an even higher rate would be needed. The actual rate of growth averaged only 1 1/2 percent during the 1980s as a whole.

Fundamental and irreversible political changes have manifested themselves during the past year, these changes being the culmination of a process initiated during the 1980s and involving, inter alia, the scrapping of more than 100 discriminatory laws and regulations, the most recent example being the Separate Amenities Act. The Group Areas Act and the 1913 and 1936 Land Acts will be submitted early to Parliament for repeal in the 1991 Session. The only remaining so-called apartheid law will then be the Population Registration Act, which is an inseparable part of the present Constitution Act and can thus be dealt with only in conjunction with that Act during future constitutional negotiations. While some de jure impediments remain, the present de facto situation is the disappearance of any of the rigidities that impeded the efficient allocation of resources in the past, especially as regards the labor market.

Over the past few years, and in keeping with political developments, South Africa has restructured its economy on the principles of a socially responsible, market-oriented system. In this effort, firm control over public sector spending necessitated drastic changes in budget priorities in favor of socioeconomic expenditure. These structural changes had to be instituted without access to the normal external financial facilities that are as a rule generally available for such adjustment programs. Despite these growing demands, the country also had to apply strict monetary policy in order to create and maintain a stable financial environment conducive to long-term growth and development. As experience worldwide has proved, this is the only sound manner in which to meet legitimate demands in the long term. It should be emphasized that the structural adjustments were achieved mostly through the market system, without the suspension of market forces and despite many nonmarket forces deployed against the country.

The current state of the South African economy is well documented in the staff report. It is clear that the artificial constraints on the economy, transmitted mainly through the balance of payments, necessitated a more restrictive monetary and fiscal policy during the second half of 1988 and forced the economy to move into an "induced recession" from February 1989. The seasonally adjusted and annualized rate of contraction in the real gross domestic product in the five quarters of this downswing to mid-1990 amounted to approximately 1/2 percent, while aggregate real gross domestic expenditure declined at an annual rate of some 2 1/2 percent. That this downturn has not been even sharper was due mainly to firm domestic demand coupled with a continued good export performance.

Despite sanctions, the total volume of exports increased by 6.8 percent over the 12 months to June 1990, while the volume of merchandise imports declined by 8 1/2 percent over the same period. The surplus on the current account of the balance of payments improved from a seasonally adjusted annual figure of R 1.4 billion in the first half of 1989 to R 4.6 billion in the first half of 1990. This enabled the country to meet a fairly heavy commitment in respect of maturing loans during the first half of 1990, as well as moderately increase the level of its net gold and foreign exchange reserves to R 6.4 billion at the end of June 1990--the equivalent of about only six weeks' imports of goods and services or roughly half of what the authorities regard as a sufficient level. During July and August 1990, however, reserves increased by R 2.1 billion. These figures thus confirm that the balance of payments continues to pose a serious constraint on the economy.

There is some evidence that the recessionary trend has deepened since midyear, exacerbated also by the adverse effects on production of industrial action and the recent spate of violence in certain metropolitan areas with its accompanying loss in labor productivity.

As with most other non-oil producing countries, the outlook for South Africa's economy has become increasingly uncertain with the crisis in the Middle East and the concomitant increase in oil prices. The substantial rise in oil prices will result in a considerable increase in the cost of South African imports. At the same time exports may increase at a much slower rate if the growth in the main industrial countries decelerates. All in all, at an average oil price of some $30 per barrel, the surplus on the current account of the balance of payments during 1991 may be slightly lower than the foreign debt commitments of the country and may place considerable pressure on the exchange rate of the rand and the rate of price increases in the country. This must be regarded as an unfortunate setback in the fight against inflation. Under these circumstances the real gross domestic product is expected to increase only very slightly in 1991, and, consequently, a premature easing of monetary policy through a reduction in interest rates can hardly be contemplated.

The impact of the various forces referred to above and the policy responses of the authorities cloud the prospects for economic growth in the short term, especially as the country is still in the process of dealing with the negative influence of the adverse developments of the past five years. In retrospect, however, the South African economy has shown remarkable resilience in adapting to a hostile environment.

In these circumstances the thrust of economic policy in South Africa is now increasingly toward medium- and long-term objectives, with less emphasis on stabilizing or moderating short-term cyclical movements. The authorities are confident that this policy approach, if coupled with a less hostile external environment, will help unleash the economic growth potential of South Africa to the advantage of its people and of the region as a whole.

In this regard, the Governor of the South African Reserve Bank recently emphasized the commitment of the monetary authorities to reduce the rate of inflation further to bring it more in line with the average rate of inflation in our trading partner countries; manage the process of money creation in such a way that an adequate, but not an excessive, amount of new money will be supplied to the system; maintain positive real rates of interest; increase the gold and foreign exchange reserves to a more comfortable level; and develop a sound financial infrastructure, consisting of healthy financial institutions together with efficiently working markets that can facilitate the implementation of policy and provide the financial services needed by a developing and vigorous economy.

As regards fiscal policy, the thrust of expenditure is, as previously mentioned, increasingly toward socioeconomic development and the alleviation of poverty through expenditure on shelter, education and training, basic health services, and other factors enabling people to play a meaningful, productive, and rewarding role in the economy. Expenditure on socioeconomic development as a percentage of the total budget--excluding interest on public debt--has increased from some 37 percent in 1985/86 to 46 percent in 1990/91 and a further increase to about 48 percent is foreseen for 1991/92. The creation over a number of years of institutions such as the Development Bank of Southern Africa, the Small Business Development Corporation, the South African Housing Trust, and more recently, the Independent Development Trust with an initial capital of R 2 billion and a further R 1 billion to support the purchase of land and the building of houses and schools in black areas are further manifestations of the Government's resolve in this regard.

However, the authorities are committed to maintaining fiscal discipline, and there is a thorough determination and evaluation of public expenditure priorities and the cost effectiveness of programs.

Less prominent, but equally important, is tax reform, which is progressing along the lines envisaged in the Government White Paper on the Margo Tax Commission report. In this regard, the introduction of a value-added tax will be a major step.

In his statement during the 1990 Annual Meetings, the Governor of the Fund for South Africa emphasized the rapidly changing internal political situation in South Africa and the general acceptance of the irreversibility of the process of change. In both South Africa and the region, former adversaries are identifying and developing common objectives and moving away from confrontation toward more representative political systems and constitutional structures.

In spite of this political peace dividend, economic problems still exist and will persist. In fact, political successes run the risk of being jeopardized by the absence of a sufficiently vibrant and growing economy. The staff report aptly cautions against imminent problems facing the economy, especially the urgent need to restore economic growth while at the same time reducing inflation and maintaining fiscal discipline in a climate of rising expectations.

These challenges can be faced only when those policies that have constrained the income- and employment-generating opportunities of the economy are reversed. As has been pointed out in the staff report, the authorities are alert to these problems and are serious in their efforts to address inefficiencies and create an environment conducive to economic growth.

There can be no doubt that the depth of knowledge, expertise, and experience in the Fund can be of great support to the South African authorities, who for some time now have also been liaising with various nongovernmental institutions and extraparliamentary groups on these matters. This Board is uniquely placed to make a real difference in the way the authorities face up to these challenges. If ever there were an opportune moment for more active and visible Fund involvement in South Africa, it is certainly now.

Extending his remarks, Mr. Le roux said that he wished to emphasize three important points, namely, the current economic situation, the process of political change in South Africa, and future challenges facing the economy.

A realistic evaluation of the current stance of the South African economy must take cognizance of the interaction of three complex and, to some extent, conflicting forces: the effects of structural adjustments that were forced on the economy by extraneous developments, especially during the past five years; the effects of the current cyclical downswing in domestic economic activity; and the effects of the ongoing reform process in the political and socioeconomic areas, Mr. Le roux considered. The hostile international environment since the mid-1980s had created many frustrations for the economy, which had been in the process of being restructured on the principles of a socially responsible, market-oriented system with increasing emphasis on socioeconomic expenditures. Those constraints on the economic growth potential of the country, which had been transmitted mainly through the balance of payments, had effectively kept actual growth well below the proven long-term potential of the country. That had resulted in structural, and from time to time, cyclical unemployment, a forced decline in living standards, and an inability on the part of the authorities to adequately address socioeconomic backlogs. Those aspects were all thoroughly analyzed in the staff report.

The current economic situation was delicately balanced, Mr. Le roux observed. Figures released during the past few days showed that the rate of inflation had edged up to 13.6 percent in August from 13.3 percent in July and the level of gold and foreign exchange reserves had dropped by R 240 million during September. Nonetheless, the Government's firm resolve to continue with the process of restructuring the economy had been unequivocally reaffirmed by the State President in a major policy speech during the past week. It had been again emphasized that everything possible would be done to reduce government expenditure in real terms over the next three years, while increases in spending on socioeconomic services would be provided for by a rearrangement of spending priorities.

Fundamental and irreversible political changes had manifested themselves during the past year, and were the culmination of a process initiated during the 1980s, Mr. Le roux commented. That fact had enabled State President F.W. de Klerk during his recent visit to Washington, D.C. to trenchantly and convincingly declare that "the time has come to realize that apartheid is something of the past.... My Government's commitment to remove the last pillars of apartheid is final and irreversible." The track record as regards the dismantling of apartheid legislation and regulations spoke for itself.

Political challenges were being addressed and de jure and de facto impediments to change were being removed, Mr. Le roux observed. The economic challenge that needed to be addressed urgently was how to reactivate the engine of economic growth in order for the economy to perform to its true potential and accommodate the realistic demands of the political processes. In this regard, the staff report aptly cautioned against the imminent problems facing the economy but also identified opportunities for growth should all the impediments constraining the economy be removed. The report acknowledged that the South African authorities were alert to the problems and impediments and were serious in their efforts to address them.

He was certain that the Board discussion would build on the forward-looking approach in the staff report, and would thus be constructive and of assistance in mapping out workable economic strategies for the difficult road ahead, Mr. Le roux commented. The Fund had indeed much to offer in that regard.

Mr. Monyake made the following statement:

> Recent political developments in South Africa are a welcome departure from the past. The lifting of the ban on political groups, the release of political prisoners, and the easing of emergency laws are all steps in the right direction. The South African Government has finally started to address the fundamental, underlying cause of all its socioeconomic problems--the system of apartheid. While the start of negotiations with leading political groups and the steps taken to repeal the Reservation of Separate

Amenities Act are encouraging signs, the process leading to the eventual breakdown of apartheid is far from being firmly in place. Concrete, irreversible steps are still to be taken before South Africa can begin to realize its full economic potential--an economic potential that is vast by any standard.

Meanwhile, South Africa's economic priorities continue to be securing sufficiently large surpluses on the current account to finance the capital outflows arising from the imposition of financial sanctions and, more recently, reducing inflationary pressures. Measures to achieve these two objectives are undoubtedly mutually reinforcing. The authorities have pursued tight monetary and fiscal policies to restrain domestic demand--which is necessary for securing a comfortable current account surplus. The staff report shows that both objectives are being achieved to a reasonable extent, but as Mr. Le roux has rightly pointed out, the achievement of a large surplus can be considered to be artificial. Moreover, the deep entrenchment of inflationary expectations calls for a continued tightening of financial policies which, given South Africa's self-imposed balance of payments constraints, makes growth prospects minimal, if not nonexistent. Although the challenge to policymakers of achieving adequate growth while keeping inflation under control and maintaining a strong external position is a familiar story, in South Africa's situation, it assumes greater proportions. The larger segment of the population consists of low-income earners with low levels of education and standards of living and with very high rates of unemployment, I wonder whether South Africa can survive a recession with its attendant stagnation in employment and the further widening of the untenable disparities that already exist.

The staff and Mr. Le roux agree that the situation is by no means ideal. I would go further to say that the situation is potentially explosive unless the authorities promptly proceed to solve their internal problems and thereby create a more favorable external environment. Mr. Le roux has also drawn attention to the background paper, which brings to the forefront the tremendous gains in terms of economic growth and job creation that would be possible with a restoration of access to foreign capital. I sincerely hope that such an incentive will encourage the authorities to enhance the pace of economic and political restructuring.

Having said this, one must concede that sound macroeconomic policies are a necessary prerequisite for sustainable growth. Moreover, as a representative of member countries of the South African Currency Union (SACU) which are being adversely affected by the high rate of inflation in South Africa, I welcome the recent reorientation of policies toward curbing inflation.

With regard to monetary policy, the data available thus far in 1990 indicate that some progress is being made in reducing the growth in money supply and inflation. However, we remain concerned that the high interest rates necessary to curb consumption and reverse the decline in savings are having their toll on fixed investment with adverse effects on growth, not only domestically but also on the other countries in Southern Africa.

As to fiscal policy, the staff report indicates that in order to meet social needs, a major realignment of public expenditure priorities is taking place while aggregate expenditure is being kept under control. Although I see much scope for savings through expenditure cuts in defense, public administration, and infrastructure, I cannot envisage how this could be adequate to meet the needed expenditure on education, training, and health. I therefore fully agree with the assessment that the feasibility of the medium-term expenditure goal will need to be reconsidered. However, in view of the need to maintain sound macroeconomic management, satisfying the demand for improved human resource development can only be accommodated under a scenario of economic expansion.

On the revenue side, the reduction in the import surcharge is a welcome development, and we urge the authorities to quickly follow with its complete elimination. The intended introduction of a value-added tax next year will undoubtedly broaden the tax base while promoting neutrality and uniformity of the tax burden. Nevertheless, there is a clear need to compensate the poor for this uniformity--a need that the authorities intend to address by their planned strengthening of social support programs. At this point, I would be interested to learn what percentage of the population is considered needy or disadvantaged and thus requires compensation. Also, how will such compensation programs reach the poor in the urban informal sector, those with small rural incomes, and the old?

In conclusion, the staff report succinctly portrays the many challenges facing the South African authorities in the coming years, challenges that have undoubtedly become more pronounced in the wake of recent and prospective sociopolitical and global developments. However, South Africa cannot hope to effectively address these challenges unless it proceeds decisively with the dismantling of the system of apartheid. My authorities urge them to do so, while welcoming the steps so far taken in that direction.

Mr. Grosche said that he wholeheartedly welcomed that the South African Government was undertaking decisive steps to address fundamental social issues that had put a heavy burden on South African society and the economy. He encouraged the authorities to broaden and deepen the reform process. Where appropriate, they might ask for the Fund's advice and technical assistance, for example, in introducing a value-added tax.

The authorities were confronted with difficult policy conflicts, Mr. Grosche observed. To overcome the stagnationary process was a daunting task in itself. At the same time, expenditure needed to be restructured to make room for additional outlays, particularly for education; in addition, labor market reform would put some pressure on wage costs. The best way to deal with all those conflicting challenges was to follow the staff's advice and put the emphasis on reducing inflation. Indeed, only a concerted and decisive attack on inflation would reduce severe distortions in resource allocation and help to improve growth performance in the medium and longer run.

He welcomed that the firm anti-inflationary stance of monetary policy had led to a marked deceleration in monetary growth and that M3 had been growing within the official guidelines of 11 percent to 15 percent for the year as a whole, Mr. Grosche remarked. He agreed with the Governor of the South African Reserve Bank that the time for a relaxation of monetary policy had not yet arrived, and he supported the Bank's intention to keep real interest rates at positive levels.

The medium-term scenarios clearly demonstrated the importance of comprehensive structural reform of the labor market in order to increase the growth potential of the economy, Mr. Grosche commented. After overcoming apartheid, it should be relatively easy to finance the growing needs of a liberalized economy through a larger recourse to the international capital markets. In sum, fast and comprehensive reforms that would enable the country to normalize its economic relations with the rest of the world would constitute the best expansionary finance program imaginable.

Mr. Alfiler said that the staff report on the 1990 Article IV consultation with South Africa clearly set out the choices facing the South African authorities. He welcomed the better balance that was currently apparent in the economy as providing a more solid foundation for addressing the deeply embedded distortions in the economy. He was in broad agreement with the staff appraisal.

South Africa undoubtedly faced a difficult period as it attempted to meet the legitimate aspirations of disadvantaged groups while at the same time maintaining an appropriate economic balance, Mr. Alfiler commented. However, in the current situation of economic contraction and rapidly rising unemployment, progress was unlikely in addressing the disparities in the socioeconomic fabric. Consequently, the challenge confronting the authorities was to set the economy once again onto a path of sustained growth. Bringing inflation under control must be a high priority, and he welcomed the indications that monetary policy was having some success in arresting inflation--but there was a long way to go.

Fiscal policy was definitely not providing backup to monetary policy in the battle against inflation, Mr. Alfiler considered. While the demands on the budget were enormous, he strongly urged the authorities to heed the staff's calls for firm control over expenditure. He agreed fully with the staff's view that raising government savings was a prerequisite for improving the country's growth prospects, although indications were that not much progress would be made toward that objective in the current financial year. The choices confronting the authorities were difficult, but they must be made if fiscal discipline was to be reasserted.

In that respect, he very much welcomed the increasing emphasis on socioeconomic objectives in the current budget, but at the same time, spending in other areas must be cut back and the advisability of tax reductions in current circumstances must be examined closely, Mr. Alfiler remarked. In sum, he welcomed the changes that were occurring in South Africa, which carried the promise of removing the obstacles which had impeded its economic development. Although many uncertainties remained in respect of those changes, they in no way lessened the need for the authorities to stabilize the economy and foster the conditions for growth.

Mr. Hogeweg recalled that over the years, his chair had consistently commended the staff on the clear analysis of the South African economy, which successive staff reports had provided. The current year was no exception. Since a considerable dismantling of the effective system of apartheid had taken place, the report had become even more forceful and explicit on the issues that had to be addressed.

He fully endorsed the staff appraisal, Mr. Hogeweg continued. He especially agreed with the emphasis on the fact that there was no shortcut to economic growth, no matter how much growth was needed to satisfy the rising economic aspirations among disadvantaged portions of society. Past attempts to stimulate growth directly through financial policies had led to entrenched inflationary expectations, had added to the extremely skewed income distribution, and had distorted resource allocation. Hence, inflation reduction, which would create conditions for growth, should be the focus of financial policies. In that connection, he wondered whether it should indeed take until the medium term to substantially reduce inflation. That forecast seemed to indicate that the authorities doubted their own credibility and ability to influence expectations more quickly.

He noted with interest that the rand has remained broadly stable in nominal effective terms since mid-1989, Mr. Hogeweg commented. That indicated that monetary policy had been used to restrain domestic demand to a level consistent with the need to continue to generate sizable current account surpluses in connection with foreign disinvestments and lack of access to world financial markets. The focus of monetary policy on nominal exchange rate stability was fully appropriate, but seen in that perspective, it was clear that financial sanctions had had an important effect on the South African economy.

The medium-term scenarios highlighted the sharp contrast between success or no success in resolving South Africa's internal problems and structural restrictions, and hence, the possibilities for restoration of access to international capital markets, Mr. Hogeweg observed. Obviously, the efficiency gains of abolishing the artificial segmentation of markets which apartheid implied must be sizable, but the greatest effect in those scenarios seemed to come from the contrast between the need to continue to generate current account surpluses and the possibility to finance large current deficits. No wonder output growth could be much larger in the second case. He invited the staff to elaborate further on the effects of the abolition of apartheid as such, apart from the effects of the abolition of financial sanctions. In that connection, he noted that Mr. Le roux had indicated that the rigidities that had impeded the efficient allocation of resources in the past had in fact already disappeared.

With respect to growth-oriented structural adjustment, clearly one consequence of apartheid had been the extreme degree of income inequality, Mr. Hogeweg continued. It was essential that, with the abolition of apartheid, the distribution of income would indeed be allowed to shift. At the same time, that raised enormous challenges. The staff drew attention to the need to keep the aspirations of the disadvantaged within the bounds set by the economy's ability to satisfy those aspirations and warned that efforts to quickly redress income disadvantages of the black population through large wage claims bore the risk of stifling the growth of needed employment opportunities. Those aspects of the transition to a society which was no longer apart deserved more analysis. The economy had evidently grown used to an abundant supply of cheap, nonwhite labor. Unavoidable--even say desirable--rising labor costs did not seem conducive to growth at first sight, but of course in time they would create huge domestic markets. Also, some of the fiscal measures mentioned in the report, such as reducing top marginal tax rates, broadening the tax base, and introducing a value-added tax, might be conducive to growth but they seemed to run counter to the narrowing of income differentials. In his view, in those aspects of the transition of South Africa lay its greatest challenges.

Mr. Menda said that he fully endorsed the thrust of the staff report. South Africa had entered a period of transition, during which substantial political and constitutional changes were expected. His authorities approved and welcomed these changes. Those changes would have major implications for the future and the medium-term growth prospects of South Africa. In that respect, two areas were of particular importance.

He agreed that priority should be given to promote a more equal distribution of income, Mr. Menda continued. Indeed, South Africa knew a very high level of inequalities, as indicated by the fact that the Gini coefficient exceeded 0.65, with the top 10 percent of income earners absorbing one half of the total income and the lowest 50 percent of earners receiving about 10 percent of total income. It was also striking that, despite the recent reduction in wage disparities, average black wages remained at one third the average wage for white workers.

One of the most powerful ways to improve that situation was to tackle the considerable rigidities that existed in the country, particularly with respect to the use of human resources, Mr. Menda considered. Indeed, many impediments existed in that area: a lack of skilled workers, owing to the insufficient effort in the field of education, administrative restrictions to geographical and sectoral mobility, and obstacles to development of the informal sector, were among the main elements. All those elements constituted considerable impediments to an efficient functioning of the labor market. Reducing the segmentation of the market would allow the reduction of unemployment among the black population, and therefore reduce a major source of inequality. He therefore welcomed the authorities' intention to dismantle the remaining legislative foundations of apartheid, and the first concrete steps in that direction.

As to macroeconomic policies, he welcomed the progress registered so far in cooling down domestic demand, Mr. Menda remarked. The tightening of monetary policy had clearly been instrumental in that regard. The most recent data reported in the supplementary paper pointed to a significant decrease in the rate of expansion of M3. That success was also reflected in the consumer price index, which had declined to 13.2 percent in annual terms by July 1990.

He was particularly gratified by the authorities' emphasis, endorsed by the staff, on the stability of the nominal exchange rate as a tool for macroeconomic stabilization, Mr. Menda continued. Moreover, very few staff reports contained such a clear recognition of the role played by a stable exchange rate for reducing inflation.

The authorities note that the maintenance of a tight monetary policy needed to reduce inflation expectations would tend to encourage more stability than in the past in the nominal exchange rate. They expect that any competitiveness loss implied by this policy approach would be temporary as the accompanying squeeze on profit margins would be translated into wage discipline, at first in the traded goods sector, and later in the economy as a whole. That formulation, which was endorsed by the staff in its appraisal, was fully shared by his authorities.

It appeared that monetary policy could not bear the brunt of macroeconomic stabilization, Mr. Menda observed. It was, however, certain that in the transition period facing South Africa, fiscal policy would be increasingly constrained by the necessity to increase social and education expenditures. He shared the staff's view that the authorities should avoid crowding out savings from the private sector. A strict control over the global amount of expenditures would therefore be necessary, as well as the generation of additional revenues, if needed. To that end, the tax reform currently being implemented would be an essential instrument in the hands of the authorities.

He would like to convey to the South African authorities the positive assessment of the changes currently under way and urged them to complete the full elimination of the apartheid legislation, Mr. Menda concluded.

Mr. Wright made the following statement:

> First, let me warmly welcome the profound political changes under way in South Africa and express the hope that, if sustained, they will end South Africa's isolation from the international community. As the staff report makes clear, only by dismantling internal restrictions and regaining access to world capital markets can South Africa achieve the durable growth that will be necessary to meet the needs of the country's rapidly growing population. It is also important that positive developments in South Africa are matched by an appropriate response on the part of the international community.
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> The South African authorities face, albeit in a particularly acute form, a familiar policy dilemma. Inflationary expectations are deeply entrenched, requiring policy to remain tight for a long period. At the same time, formidable pressures for higher social spending are already emerging and will threaten constantly to blow macroeconomic management off track. It must be recognized, however, that social and macroeconomic objectives are not really alternatives. The transition to a more stable and open society will not be made any easier by compromising on economic fundamentals.
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> I welcome the fact that monetary policy is now being set in a medium-term framework and directed primarily toward reducing inflation. Success in this area will depend crucially on the Reserve Bank's willingness to maintain interest rates at their present levels for as long as necessary. As the staff report makes clear, monetary policy has, in the past, lacked both consistency and credibility. Although it is difficult to form a judgment without an assessment of prospects for 1991, the stance of monetary policy seems to be broadly appropriate. In particular, I endorse the importance attached to maintaining the anti-inflationary thrust through the exchange rate, however uncomfortable this process may prove. This approach, of course, will have some impact on the external position. The current account position looks comfortable, although 1991 projections taking into account the impact of higher oil prices would have been useful.

I am less happy about the stance of fiscal policy and have my doubts whether, in view of recent public sector pay increases and past slippages, the authorities will meet this year's spending targets. Although the authorities now seem to be making less active use of fiscal policy to stimulate activity, I have some doubts about whether the current fiscal stance is sufficiently demanding to support monetary policy and contribute to the badly needed recovery in national savings. The slippages reported by the staff also raise doubts about the robustness of the authorities' fiscal objectives in the light of the extraordinary pressures that are already emerging. In this connection, I share the staff's doubt as to whether it is appropriate in the current circumstances to reduce the income tax rate where this involves a net revenue cost.

The University of Stellenbosch has estimated that bringing all educational, health, housing, and welfare standards up to the levels presently enjoyed by the white population will cost the equivalent of more than a year's total public spending. I have some sympathy with the authorities' view that in the current circumstances, much social spending, in contributing to human development, should be seen as investment in the widest sense. Despite its manifest importance, however, it is clear that spending on the scale required will have to be carefully phased and kept within the bounds of the economy's capacity to afford it. Pursuing ambitious social policy objectives within a sound policy framework will be a tough challenge. The authorities will have to make much greater inroads than they have so far into areas such as defense spending, the excessive multitier bureaucracy, and the civil service salary bill.

I welcome the attention being paid to supply-side improvements such as privatization and tax reform, although I remain doubtful whether, when the value-added tax is introduced next year, it will be feasible to extend the tax base to foodstuffs if no machinery exists for protecting the incomes of the most vulnerable groups. As to other structural reforms, the authorities could usefully examine the high degree of concentration in the corporate sector and ways of encouraging greater financial intermediation in the townships. Last year Mr. Monyake rightly condemned the imposition of import surcharges and the effect these had on neighboring countries. I was interested to see from the background paper that the authorities now recognize that these surcharges are counterproductive, and I hope that they can be eliminated entirely.

In conclusion, let me join other speakers in encouraging the South African authorities to maintain the momentum of reform. I would encourage the staff, in next year's consultation discussions, to focus in some detail on the specific issues for economic management arising out of the constitutional changes currently under way. More immediately, Mr. Hogeweg has already referred to the impact of these changes on wage levels in the black population. I would be interested to hear the staff's views on this matter.

Miss Powell observed that South Africa was facing major challenges at the current juncture, both politically and economically. Prospects for the period ahead depended crucially on how those challenges were met. On the political front, she very much welcomed the initiatives taken in the past year, in particular the start of a dialogue with the African National Congress and other political groupings on a new constitution. She urged the authorities to move ahead with that process, and with the dismantling of the apartheid system as rapidly as possible. Without a stable political environment, the economic prospects for South Africa would be dim. A political system based on the full participation of all groups and the removal of the many rigidities and barriers that had distorted the economy were essential to economic and social progress.

She was in broad agreement with the staff appraisal, and therefore, would focus her comments on economic policy on two points that she regarded as particularly important, Miss Powell continued. The first was the stance of financial policy, particularly monetary policy. The decision of the Reserve Bank to narrow the goal of monetary policy to maintaining the value of the currency was a welcome development. In her view, that was the essential contribution that monetary policy could make to sustained economic growth. Indeed, South Africa's experience over the past few years had clearly demonstrated the danger of allowing that goal to be compromised by other conflicting goals. The stimulus to growth had been short-lived, and inflation had became more entrenched.

With the slowing of demand over the past year, the economy was no longer overheated, Miss Powell remarked. However, while demand pressures had eased and the rate of increase in consumer prices had slowed somewhat, inflation--at over 13 percent--remained a serious problem. She fully agreed with the staff that financial policies should not be directed at stimulating growth. Instead, monetary policy should be firmly directed toward a further reduction of inflation. Such a policy could imply a real effective appreciation of the exchange rate, as a substantial reduction in inflation might take time to achieve, in view of the strength of inflationary expectations.

The second point concerned the need to increase the long-term growth potential of the economy, Miss Powell said. While much could be done over time to increase efficiency through the removal of labor market rigidities and other distortions and by improving education and training, increased investment was clearly a prerequisite for higher growth. As the staff report made clear, the necessity of running a current account surplus in recent years had been a serious constraint on investment and growth. However, before South Africa could expect to borrow again on international capital markets to supplement domestic savings, confidence in the longer-term political and economic stability of the country would need to be restored. That implied progress in negotiating a new constitution, the dismantling of apartheid, and sound macroeconomic policies.

The most hopeful feature of the past year's developments was that South Africa appeared to have set itself on an economical and political course that should lead in time to a restoration of confidence, Miss Powell observed. However, the fundamental changes in South African society that were involved clearly created both major opportunities and substantial risks. Over the longer run there was the potential for creating a much more efficient, productive, and fairer society, but it would also be necessary to ensure that rising expectations did not run ahead of what was possible and undermine the effort to reduce inflation and put the economy on a sound footing.

Even if the expectation of major constitutional and economic changes over the coming few years was borne out and South Africa regained access to international capital markets, it would face a world where there was a strong demand for global savings, Miss Powell remarked. In view of the need for higher investment to ensure a satisfactory rate of growth in output and employment, that would point to the desirability of efforts to strengthen domestic savings. As there would also be a need to meet rising social demands, she agreed with the staff that the authorities should proceed very cautiously on measures to reduce taxes.

Mr. Newman made the following statement:

> South Africa is now embarked on a major political transformation which, when fully and successfully implemented, holds out the promise of greater social stability and increased economic prosperity. However, realizing this promise will require sound macroeconomic and structural policies. It would be unfortunate if the authorities were to slacken current adjustment and restructure efforts in the mistaken belief that renewed access to international capital markets would provide both the necessary and sufficient conditions for reconciling present economic problems. Therefore, I welcome the statement by Mr. Le roux of the authorities' intention to stay the economic course.
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> The staff's medium-term scenarios assume that South Africa will be able to attract the same level of net capital inflows as a share of GDP that occurred in the early 1980s, and that this would permit a restoration of the earlier level of investment. However, as recent Executive Board discussions have stressed, competition for the stock of global savings has increased significantly during the 1980s and South Africa, like other countries, will need to

continue to rely primarily on policies to increase domestic savings as the principal source of investment funds. Access to foreign savings will help, but cannot substitute for domestic policies to reduce public dissaving and curb inflation. In these circumstances, I share the staff's concern that the authorities' objective of a budget deficit of 3 percent of GDP over the medium term, which is more than twice the average level of the early 1980s, does not appear sufficiently ambitious.

The scope for maneuver on government expenditures is constrained by the need to increase substantially social welfare spending. It was, however, disturbing to learn that the authorities may relax their medium-term expenditure goal, particularly in view of the sharp increase in spending in recent years and the fact that the recent improvement in the deficit reflects a surge in revenue that is unlikely to be sustained as the current recession continues. Therefore, I would urge them to intensify efforts to reduce lower priority expenditures, particularly for administrative and defense spending. In this connection, I would appreciate a staff explanation of the rationale for treating certain social welfare spending off budget and the prospects that the revenues earmarked for these expenditures will be sufficient.

While the authorities' desire to reform the tax system to improve efficiency is understandable, I am concerned that possible revenue losses could increase public sector dissaving, particularly in view of the growing pressures for increased spending. In this regard, the proposed adoption of a value-added tax to replace the sales tax provides a useful opportunity to expand the tax base. However, I have some reservations about the decision to exclude capital goods while taxing foodstuffs. Such action would appear contrary to other policies aimed at encouraging labor-intensive investment and redistributing income to the disadvantaged segments of society, particularly in the absence of a clearly defined social safety net.

Monetary policy has borne the brunt of macroeconomic management and, until recently, there has been a considerable tolerance for inflation as a temporary means of avoiding needed adjustment in the face of external constraints. This has contributed importantly to the current recession combined with continued double-digit inflation. I therefore welcome the authorities' intention to focus primarily on combating inflation and the indication in the supplementary paper that further monetary restraint is having some success in reducing price increases. I can certainly understand the pressures that the authorities are facing in view of the recession and growing unemployment, especially among already disadvantaged groups, but would urge caution regarding an easing of monetary policy at this juncture. With rising expectations leading to strong wage pressures, an easing of monetary policy at this point could wipe out the recent modest inflation gains and trigger renewed price pressures. This would lead to increased external pressures that would undermine South Africa's ability to finance capital outflows, trigger new pressures on the rand, and weaken the confidence essential to attract foreign savings when access to international capital markets is restored.

The slowdown in economic activity is contributing to an increase in the current account surplus, which should be sufficient to finance net capital outflows without pressure on the exchange rate and reserves. I welcome the authorities' actions to reduce export subsidies and import surcharges and hope that these initial steps will soon be followed by further steps to remove these trade distorting measures.

Ultimately, South Africa's ability to increase the productive potential of the economy will depend on implementing structural reforms that will expand employment opportunities and the skills of the labor force. My authorities welcome the progress that has been achieved in eliminating the regulations and controls making up the system of apartheid. They urge the authorities to move boldly in removing the remaining legal barriers to labor mobility and social equality and reach agreement on needed constitutional reforms that will provide the basis for more normal economic relations between South Africa and the international community.

Mr. Yoshikuni said that the authorities were to be commended for their recent efforts aimed at restructuring the economy and encouraging their further efforts. He was in broad agreement with the staff's appraisal and would therefore only emphasize a few points.

The authorities were facing the formidable challenge of economic management in the context of a major constitutional and socioeconomic transition, Mr. Yoshikuni observed. On the one hand, the authorities should pursue structural adjustment policies, particularly on the labor front, to accelerate the economy's transformation to a post-apartheid system. Priority should also be attached to social development spending in the budget in order to assist the disadvantaged segments of society under the diminishing apartheid system. At the same time, the authorities should continue to pursue price stability further, as inflation, although having decelerated in the past several months, was still running high. The economy was undergoing the most critical phase in the abolition of apartheid, and the authorities should firmly support a swift transformation by providing economic stability.

To reconcile those objectives, the authorities should establish a medium-term policy framework and pursue prudent financial policies, while making vigorous efforts to expedite the liberalization of the economy, Mr. Yoshikuni continued. In particular, as strong demand pressures were emerging for social expenditures and higher real wages, close monitoring of government aggregate demand, as well as monetary aggregates, was necessary. In that regard, he fully agreed with the staff that an expansionary financial stance at the current stage would have undesirable effects both on the sustainability of growth and on income distribution, which would undermine the recent progress on the structural front.

As to fiscal policy, he recognized the difficulties in containing social expenditure at the current critical juncture, Mr. Yoshikuni commented. Nonetheless, expenditure in low priority areas, such as military outlays, should be curtailed vigorously, in order to maintain the government surplus. Close monitoring of off-budget spending was also required, ultimately, consolidated control of all spending should be established. Those efforts were needed to extend and finance a social safety net for the disadvantaged, as well as to avoid the overheating of the economy. A social safety net was particularly needed at an early stage if the authorities were to introduce the value-added tax successfully. Meanwhile, every effort should be made to attain the revenue target, and, in that regard, caution was warranted in reducing the direct tax rates for the high-income group.

Much uncertainty remained with respect to employment and wages, particularly in the absence of official controls on private wages, Mr. Yoshikuni observed. As a significant increase in job opportunity was socially called for on the social front, the authorities should lift any restrictions and segmentation on the labor front in order to avoid rigidities in wage determination. In that regard, monetary policy would be expected to play an important role in avoiding a wage-inflation spiral.

On the external front, the authorities had pursued a policy aimed at strengthening the current account balance so as to offset the net outflow in the capital account owing to economic sanctions, Mr. Yoshikuni remarked. The authorities' aim had been achieved to a certain degree in the past year despite the appreciation of the rand. Nevertheless, the staff's two alternative scenarios projected that continued limited access to the international capital markets would slow capital accumulation and repress the growth of real incomes. That suggested that the authorities should abolish apartheid completely as soon as possible and regain their access to international financial markets, if they were to improve growth prospects. It was disappointing, however, that the authorities were responding to sanctions by creating restrictions in the trade and exchange regime. That action further intensified their isolation from the world capital market and would make it difficult to adapt to the changing world economic circumstances. With those remarks, he supported the proposed decision.

Mr. Fogelholm observed that following a successful cooling down of domestic demand, the South African economy had entered a recessional phase, which foreboded new economic policy problems. Unemployment would rise as the growth in the labor force could only be absorbed--according to some estimations--if growth in the economy reached at least 5 percent. In addition, private saving was expected to fall, and fiscal policy restraint was becoming more difficult. Overall, the fairly high inflation rate continued to endanger the stability of the economy.

It stood to reason that the staff had recommended that the authorities direct their economic policies toward curbing inflation and avoiding the stimulation of growth, Mr. Fogelholm commented. There, stronger medium-term monetary policy should be one of the main components. As regards the fiscal policy stance, it was most welcome that the Government, as a budgetary target, explicitly addressed the need for a restructuring of the economy, with an attendant increase in allotments for social programs surpassing those of other programs. Nevertheless, as public savings needed to be increased, the budget deficit should be reduced from that targeted by the Government. To hold down aggregate government spending, it was crucial that measures designed to curb expenditures in the identified areas were implemented. On the revenue side, he supported the authorities' intention to introduce a value-added tax.

Overall, the authorities had to perform an extremely difficult balancing act between the maintenance of a macroeconomic balance--including the task of containing inflation--and attacking the enormous problems of development and income and wealth distribution, Mr. Fogelholm considered. In that regard, he fully shared the views expressed by Mr. Hogeweg.

The Nordic countries continued to believe that the key to sustainable economic growth over the medium term lay in the complete abolishment of the apartheid system, Mr. Fogelholm stated. Consequently, his authorities considered the measures that had been undertaken lately to be positive steps but urged a quick implementation of the announced plans to eliminate the remaining pillars of the apartheid system. Abolishment of the apartheid system would also contribute to a normalization of South Africa's relations with the outside world, inter alia, in the area of finance and trade. Such a development would, of course, have far-reaching, beneficial effects on the South African economy. As had already been noted by some Directors, that could be clearly seen in the staff's second medium-term scenario, which assumed that South Africa would be successful in its efforts to resolve its internal problems and remove the structural restrictions in the labor markets. That would result in a substantially higher growth rate in the medium term, based on, inter alia, restored access to international capital markets and a return of private capital to the economy. In that connection, he would like to echo Mr. Newman's observation that such capital inflows should not be taken for granted.

If the basic principles applying to the society remained unchanged, however, economic development would be severely hampered by structural rigidities, which would prevent the full utilization of available resources, Mr. Fogelholm commented. For instance, inadequate training of the black population would exacerbate the chronic shortage of trained labor in the country. Mr. Le roux's forthright statement lent hope to the belief that the unsustainability of the current situation had been acknowledged and that the authorities were determined to carry through the necessary reforms.

The staff representative from the European Department observed that one reason why the authorities had not been more ambitious in reducing inflation had been the need to establish credibility for their monetary policy. The inflation rate had not fallen below double-digit levels for almost two decades, and in the light of experience, the authorities were reluctant to promise a quick resolution of the problem. The staff agreed with Mr. Hogeweg that the authorities' targets were too cautious if they succeeded in generating the exchange rate stability required to achieve price stability.

The staff had not attempted to estimate the effects of apartheid on growth, although the medium-term projections suggested the costs of apartheid, the staff representative observed. For example, the turnaround in the balance of payments after 1985 indicated the costs of apartheid in terms of international capital markets. There had been some academic studies on the effects of apartheid on growth, and although the results were not conclusive, they suggested that partial attempts to dismantle the apartheid system did not lead to big payoffs, but the complete abolition of the system--and the resulting distortions--was estimated to yield a 6 percent increase in GDP.

As to the current economic transition, there was no doubt that reconciling the conflicting and competing demands for resources was a formidable challenge, the staff representative remarked. That issue was being clearly addressed within South Africa in the context of a wide-ranging dialogue on the shape of the new South Africa between the different parties. Previously excluded groups such as the African National Congress and the black community in general were undertaking a broad dialogue, at various levels, with the Government and elements of the establishment. Although there were many strands of opinion, there were five main elements. The first was economic orthodoxy--the view that the future of South Africa was tied to continued economic growth. That view incorporated the idea that inflation must be reduced and that unreasonable burdens on the established economic structure must be avoided, which led to views about tax reduction and tax reform in general. The second main element was the widely held idea that past inequalities must be made up as a matter of necessity. That required the elimination of the remaining vestiges of apartheid as well as the economic and social backlogs. Of course, the cost of addressing that backlog was staggering in that it included not only education, but also health and housing, which posed enormous costs. For example the area of education, whereas in the early 1970s the share of spending on the education of blacks was very small, expenditures in recent years had increased substantially but were still equivalent to only one fourth of the amount spend on the average white student. Bridging that gap alone would call for a quadrupling of spending in real terms. Nevertheless, that was a burden that South African society was willing to assume. The Government had created funds outside the budget to meet promises made in the political arena. While the staff did not agree to that approach in principle, the amounts involved were not so large as to create an imminent problem for the financial situation.

The third element was that existing income disparities must be redressed, the staff representative continued. Although progress had been achieved in that area, an enormous gap still remained. Black wages were still only 30 percent of average white wages. The staggering inequalities in income were well understood, as were the costs that came from rising aspirations as political reconciliation progressed. In that connection, an estimation of the numbers in need of a social safety net, especially in the context of the value-added tax was not very meaningful. In a country like South Africa, where so many needs had yet to be met, the first problem was to define "social safety net." Only the very poorest could be protected, and then only to some extent, because the numbers involved were so large. The staff was encouraging the authorities to think along those lines because in the short term, there was no realistic solution to provide an adequate safety net.

The final main element of the debate was the view held by some segments of the population that some redistribution of wealth would be an important element of the transition, the staff representative from the European Department commented. The continuing debate meant that the authorities faced difficult policy choices. Moreover, containing inflation was going to be especially difficult owing to rising aspirations. The staff would be watching that problem closely in the period ahead. Also, containing the size of Government would be difficult in an environment in which it was being called upon to perform an increasing number of tasks. Finally, balancing objectives in such areas as taxation and incentives for enterprises would also be difficult in an environment in which the authorities were trying to pursue economic growth while meeting social needs.

Mr. Monyake said that he wished to emphasize the enormity of the problem of providing a safety net for the poorest segments of the population as well as the fact that the demands flowing from the different programs that were being proposed in the course of the ongoing debate indicated that there were huge expectations.

Mr. Le roux commented that the final discussion had been instructive and a few random, off-the-cuff remarks would certainly not do justice to it. Directors could, however, rest assured that the South African authorities would make an in-depth study and evaluation of the proceedings as part of its ongoing process of policy formulation.

He would, however, like to react to the last point made by Mr. Monyake concerning the value-added tax and the so-called safety net, Mr. Le roux continued. Following the publication of the Value-Added Tax Bill in South

Africa, a special VAT Committee, comprising representatives of the authorities, various political parties, trade unions, extraparliamentarian groups and even consumer bodies had been formed to evaluate all aspects of the bill, including the so-called safety net for the underprivileged that was being considered as a quid pro quo for including food in the value-added tax base. So the whole matter of the safety net was being addressed by a broad spectrum of opinion in South Africa.

His final two comments were first to again reiterate the fact that political change in South Africa was irreversible, and second, to give a further indication of the financial implications of that change by referring to the results of a recent study by two highly respected researchers in South Africa, Mr. Le roux remarked. Directors held divergent views on the process of political change and the disappearance of rigidities, especially in the labor market. That was not unexpected: the changes had been so fundamental and decisive that even in South Africa the very fact of change and its implications had not yet been fully assimilated by everyone. Two further examples of the irreversibility of change would suffice: first, the opening up of membership of the previously white-only ruling Nationalist Party to all people; and second, the announcement during the past week by the State President that the existing system of provincial and homeland government would be scrapped and replaced by a system of strong autonomous regional government.

In a recent study, two Natal University researchers--Professors McGrath and Holden--concluded that government spending would have to rise from 30 percent of GDP annually to 50 percent to wipe out backlogs in pensions, education, health services, and housing within a decade, Mr. Le roux recalled. According to their findings, parity in respect of education, health, housing, and pensions could be attained by increasing total government expenditure by about 35 percent above its current level. However, it was possible that government expenditure could remain at about 30 percent of GDP if the economy grew at an average real rate of 5 percent per annum. Therefore, despite a rise in government expenditure, its share of a strongly growing GDP need not rise to an unacceptably high level such as 50 percent. Given the high growth scenario, the deficit as a percentage of GDP need not significantly exceed the current benchmark of 3 percent. Those results clearly demonstrated the urgent need to remove the remaining constraints on the economy.

In conclusion, the apartheid factor that had dominated and often clouded the debate on South Africa for so long, was no longer an issue, Mr. Le roux stated. Its legacies, however, remained as had been noted by Directors. But, so did the legacies of inappropriate policies in various other parts of the world. For quite some time concerted efforts had been initiated and resources mobilized to address those other legacies. South Africa looked forward to benefit from those efforts in due course.

The Acting Chairman made the following summing up:

Executive Directors were in basic agreement with the thrust of the staff appraisal for the 1990 Article IV consultation with South Africa.

Directors welcomed the important political and social changes that had occurred in South Africa since the occasion of the last Article IV consultation. Noting that the constraints to sustained growth had been particularly related to the apartheid system, Directors were encouraged by the recent progress that had been made in reducing restrictions on labor and business activity. Directors also noted the Government's announced intention to remove the remaining legislative vestiges of the apartheid system, and they urged that these be acted upon with dispatch. Directors welcomed that the thrust of economic policy in South Africa was now increasingly geared toward medium- and long-term objectives. They were hopeful that further progress would be made toward a rapid political transition that would permit the reintegration of South Africa into the international community.

Directors observed that there had been a significant tightening of monetary and fiscal policies, which had been necessitated by the binding nature of South Africa's external constraint coupled with the severe structural limitations on the economy's growth potential. Directors emphasized that the best contribution that financial policy could make to improving economic performance was to reduce inflationary pressure, which distorted resource allocation and redistributed income in an undesirable way. Accordingly, Directors welcomed the determination that the Reserve Bank has shown in combating inflation. They cautioned, however, that in view of the entrenched nature of inflationary expectations, a policy of monetary restraint would best be framed in a medium-term context. Directors agreed that in implementing monetary policy, it was appropriate to aim at greater exchange rate stability in view of both its link to prices and its role in reconciling domestic demand to the external constraint.

Directors commended the authorities on the sharp reduction in the fiscal deficit over the past two years, which had played an important complementary role to monetary policy. They expressed concern, however, that the prospective increase in the deficit in the current fiscal year, which was largely the result of tax concessions, would complicate the task of monetary policy. Over the medium term, Directors felt that tight monetary and fiscal policies would represent the Government's strongest contribution to raising national savings, enhancing growth, and eventually eliminating the external constraint. They recognized, however, that in the short term these efforts at reducing inflation might have an immediate effect on growth and employment prospects which might limit the scope for early progress in satisfying social needs.

Directors welcomed the recent shift in expenditure priorities to address the large social backlog, especially in housing, health, and education. While encouraging the authorities to intensify their efforts in this direction, including reducing expenditures for low priority items as well as for defense, Directors stressed that this would need to be done within the overall context of fiscal prudence. For this reason, every effort would need to be made to restructure budget expenditures, and due consideration should be given to revenue-augmenting measures. In that context, Directors welcomed the proposed introduction of the value-added tax in 1991. Concern was, however, expressed about the impact of the value-added tax on low-income groups, particularly in view of its application to food. The reduction in the import surcharge in 1989 was also welcomed, and Directors encouraged the elimination of the import surcharge, partly in view of its negative impact on neighboring countries.

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

APPROVED: August 27, 1991

LEO VAN HOUTVEN
Secretary