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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/144

10:00 a.m., October 9, 1987

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	Yang W., Temporary
	M. K. Bush
	D. C. Templeman, Temporary
J. de Groote	
	R. Morales, Temporary
M. Finaish	
	B. Goos
	A. Bertuch-Samuels, Temporary
	Hon C.-W., Temporary
	J. E. Zeas, Temporary
	M. Foot
M. Massé	D. McCormack
	D. Saha, Temporary
	I. A. Al-Assaf
	V. J. Fernández, Temporary
	D. Marcel
J. Ovi	
	G. P. J. Hogeweg
	I. Sliper, Temporary
G. Salehkhou	O. Kabbaj
	L. E. N. Fernando
	T. Morita, Temporary
S. Zecchini	

C. Brachet, Acting Secretary
R. Gaster, Assistant

<u>Also Present</u>
E. Links, Principal Resident Representative for South Africa;
E. Matthee. European Department: M. Guitián, Deputy Director;
B. Rose, Deputy Director; J.-P. Cotis, M. T. Hadjimichael, H. Vittas.
Exchange and Trade Relations Department: E. Brau, S. Kanesa-Thasan,
P. J. Quirk. Fiscal Affairs Department: A. A. Tait, Deputy Director.
Legal Department: H. Elizalde, J. K. Oh. Middle Eastern Department:
A. S. Shaalan, Director; P. Chabrier, Deputy Director; S. H. Hitti,
M. D. Knight, E. B. Maciejewski, M. F. Melhem, C. Sassanpour,
M. Yaqub. Personal Assistant to the Managing Director:
H. G. O. Simpson. Advisors to Executive Directors: A. A. Agah,
P. E. Archibong, M. B. Chatah, A. G. A. Faria, G. D. Hodgson,
A. Ouanes, I. Puro. Assistants to Executive Directors:
O. S.-M. Bethel, H. S. Binay, F. Di Mauro, S. King, V. K. Malhotra,
W. K. Parmena, L. M. Piantini, S. Rouai, V. Rousset, G. Seyler,
H. van der Burg, D. A. Woodward, I. Zaidi.

1. SOCIALIST PEOPLE'S LIBYAN ARAB JAMAHIRIYA - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with the Socialist People's Libyan Arab Jamahiriya (SM/87/196, 8/6/87). They also had before them a background paper on recent economic developments in Libya (SM/87/208, 8/14/87).

Mr. Finaish made the following statement:

As in many other oil exporting countries, economic policy in the Jamahiriya has focused in recent years on the need to adjust to the substantial decline in oil export revenues. With the weak international demand for oil and the increase in the exports of non-OPEC oil producers, the country had to lower its oil production levels successively since 1980. With the exception of the first part of 1986--when the aim of oil policy was to increase output in order to regain the country's share in the international oil market--oil production in the Jamahiriya in the last few years has been about half the levels achieved in the period 1975-1980. The decline in production, coupled with falling prices, resulted in a decline of more than 50 percent in oil revenues between 1980 and 1984. The adjustment task which faced the authorities was, therefore, quite considerable, particularly in light of the predominance of the oil sector in both the fiscal and external accounts.

During the period 1982-84 the authorities responded to the new circumstances by making substantial reductions in public expenditures. As a result, the fiscal and external deficits declined sharply. However, given the magnitude of the decline in oil export revenues, some depletion of external reserves could not be altogether avoided. Moreover, the sharp fiscal adjustment and the reduced availability of imports also affected economic activity in the non-oil sector. Consequently, the rate of growth of non-oil GDP dropped to less than one half of the levels achieved in the previous decade. While adjusting to the decline in oil income, the authorities have continued their efforts to diversify the export base and thus to reduce the economy's reliance on a single export commodity.

In the period since the last Article IV consultation, adjustment policies have been strengthened further, particularly in the fiscal area. The authorities' objective has been to eliminate the external deficit and recover the loss of external reserves which occurred in the preceding few years, while continuing the policy of avoiding recourse to external borrowing. As the balance of payments data for 1985-86 indicate, this objective has, by and large, been achieved. The substantial reduction in fiscal expenditures, which averaged about 12 percent annually during the period 1982-84, and the associated decline in imports have enabled the authorities to recover most of the reserve loss which occurred in the preceding three years. Even in 1986 when export revenue declined by about 50 percent as a result of the collapse of international oil prices, the external account was approximately in balance.

While a significant part of the burden of fiscal adjustment has fallen on development expenditures, recurrent outlays, including on wages and salaries, were also reduced. The freeze on hiring new civil servants was also maintained. In addition, certain fees and charges were increased, although the structure of the economy makes it difficult to raise non-oil revenue by any significant extent. Moreover, in spite of the sharp decline in international oil prices, domestic prices of petroleum products were kept at their 1982 level both for conservation purposes and also as part of fiscal adjustment. The authorities expect to maintain a tight fiscal policy in 1987-88. Current projections for 1987 indicate a further substantial reduction in public expenditures despite the recovery in revenue associated with the firming of the international oil market.

The sharp fiscal adjustment and the associated decline in imports have inevitably had an adverse effect on the general level of economic activity. This was particularly the case in the industrial sector which has traditionally depended on imports and foreign labor. The low capacity utilization in the recent period has also been due to certain technical and marketing problems and to the low international prices of some industrial products. The authorities are concerned about the performance of the industrial sector and are giving careful consideration to the restructuring of industry by, inter alia, transferring ownership and management to workers, and even closing certain industrial units in extreme cases. They are also encouraging individual initiatives in small industry in the form of partnerships.

Notwithstanding the generally sluggish growth in non-oil GDP, the growth of agricultural output in the period 1981-85 averaged 6 percent annually and has probably exceeded that level in 1986. In addition to the favorable weather conditions, the incentives provided by the Government, including remunerative producer prices, have also contributed significantly to the performance of this sector. Over the medium term, the authorities expect agricultural production to benefit substantially from a major irrigation project which will bring water by a pipeline network from desert aquifers to the coastal farm lands.

As I mentioned earlier, the strong adjustment effort mounted by the authorities in response to the decline in oil export revenues has successfully produced a balanced external position. Indeed, current projections indicate that in the period 1987-89 it will be possible to increase imports somewhat while at the same time generating a small balance of payments surplus. Nevertheless, the authorities continue to believe that growth and external financial stability over the longer term depend on success in diversifying the export base. They are therefore particularly concerned at the increasingly restrictive trade practices of the EC countries, as these restrictions hamper the growth of the petrochemical industry in the Jamahiriya. In spite of the fact that the gas provided to petrochemical plants is priced at international levels and export prices are determined on a commercial basis, the EC has recently established a base price for certain petrochemical imports which is substantially higher than the prevailing market price, in addition to imposing a special tariff on these imports. Such practices not only impede the efforts of the Jamahiriya and other oil exporting countries to diversify their economies, but are also inconsistent with an efficient allocation of global resources.

With respect to exchange rate policy, the authorities decided in March 1986 to change the peg of the Libyan dinar from the U.S. dollar to the SDR. The main objective of this change has been to restore the historical value of the Libyan dinar and introduce some flexibility in the system. The rate at which the dinar was pegged to the SDR also implied some depreciation vis-à-vis the U.S. dollar. Given the weight of the U.S. dollar in the SDR basket, the nominal effective exchange rate of the Libyan dinar has continued to depreciate in the period following the change in the peg, albeit at a slower rate. In the authorities' view, the new peg and the margins around the peg which were introduced in May 1987 provide an adequate degree of flexibility, which obviates the need for further discretionary measures. Moreover, the structure of the balance of payments and the allocative system make the sensitivity of trade flows to exchange rate changes quite limited.

Finally, the authorities wish to reiterate their disappointment at the position taken by the Fund with respect to their complaint regarding the freeze of Libyan assets imposed by the U.S. Government in January 1986. The U.S. action, given the large weight of the United States in international trade and banking and its position as the key reserve currency country, carries serious and wide-ranging implications for international financial relations. Such actions call into question the obligations of reserve currency countries, put at risk national reserves and other assets held in other member countries, shake confidence in the international banking system and the security of international investments, and disrupt trade and international financial transactions in general. These implications should clearly be of serious concern to the international community and to the Fund in particular.

Mr. Al-Assaf made the following statement:

The authorities have continued to adapt their economic policies to the steep decline in their export earnings. Financial policies are becoming tighter, and imports are being compressed further. While these economic policies have been successful in containing domestic and external imbalances, they have understandably been accompanied by a sharp decline in economic activity. Non-oil sector growth slowed considerably before contracting in 1986, and again in 1987. The issue facing the authorities is, therefore, how to sustain the needed adjustment, especially in the fiscal area, while restoring economic growth in the medium term.

As the authorities realize, the growth impetus--in the context of uncertainties related to oil market developments--has to emanate mostly from outside the public sector. In this context, I welcome recent measures by the authorities aimed at encouraging individual initiative. This is a step in the right direction. I encourage them to widen the scope of these measures, in light of the experience gained during this initial phase.

It is equally important to foster a domestic economic environment conducive to increased participation in economic activity by the private sector. In this connection, it is crucial to avoid excessive controls and to reduce restrictions. The intensification of restrictions, while it may give temporary relief, would neither remove the underlying causes of imbalances, nor enhance individual initiative.

The recent contraction in economic activity has softened conditions in the labor market, thus permitting a considerable reduction in wage and related costs. The end result has been significantly positive for both public finances and the country's international competitiveness. Furthermore, the reduction in export earnings has heightened the need for a more careful scrutiny of government spending. I therefore encourage the authorities to pay particular attention to the quality of public spending, and to target such spending on the priority sectors.

Looking ahead, I welcome the improvement in the performance of the agriculture sector. I also share the authorities' concern about the limited market access available for their petrochemical exports. As this chair has stated on previous occasions, efforts by developing countries to diversify their exports in line with the principle of comparative advantage should be encouraged by their trading partners. This is obviously in the best interest of all countries. Unfortunately, recent Fund reports on a number of oil-exporting countries have clearly demonstrated that efforts to diversify exports by those countries continue to be frustrated by harmful protectionist policies.

Mr. Templeman made the following statement:

In general, we continue to be impressed with the realistic way in which the Libyan authorities have sought to adjust their fiscal and external accounts to the reduction in oil prices in recent years. In particular, the cuts in public expenditures and in import levels have been considerable. However, less progress seems to have been made in pursuing policies aimed at achieving adequate levels of economic growth and economic diversification over the longer term. In particular, we would raise some question about the potentially negative effects on these two objectives of trade and payments restrictions, the exchange rate policy, and the cautious approach adopted to the encouragement of individual initiative.

It is somewhat difficult to assess the extent to which diversification of the economy is being accomplished. Growth in the agricultural and manufacturing sectors seem to be growing reasonably well, but the decline of income in the oil sector is inevitably having some depressing effect on other sectors, and some retrenchment from the earlier boom years in sectors such as construction is not surprising. Overall, having an oil sector which continues to represent about half of all economic activity leaves the country quite vulnerable to energy market uncertainties. Some very cautious moves seem to be under way to encourage individual initiative as a potential new source of economic growth, and there should also be some potential for export diversification. We concur, however, with the staff that more comprehensive measures are needed, to create a favorable environment for such activity, if prospects for growth are to be fully realized. In that connection, the lack of current price data and uncertainties about future pricing policies must create an impediment to individuals' investment in new productive activity.

Considerable progress has been made in reducing the fiscal deficit, from over 26 percent of GDP in 1981 to less than 13 percent in 1985--before the decline in oil prices in 1986. In fact, the authorities have adopted a prudent position in focusing on the need to limit public spending to the revenue available. Still, the paucity of fiscal data and the extremely large discrepancy between revenue and expenditure data and corresponding data on credit to the public sector raise important questions about the true fiscal situation. Fortunately, the indications are that the fiscal deficit may be overstated. Indeed, based on deficit financing statistics alone, one might even conclude that there were surpluses in 1983 and 1986. This ambiguity underlines the need for the authorities to collect comprehensive information on all public finance activities to allow for the presentation and monitoring of data on the public sector's overall financial situation, so that economic policy decisions can be made with confidence. Uncertainties about oil revenue over the medium term already hinder fiscal planning, so it is all the more important that an accurate picture be available of past and current revenue and expenditure levels.

Similarly impressive adjustment can be seen in the current account of the balance of payments, where a deficit of 13 percent of GDP in 1981 was reversed and a substantial surplus achieved in 1985. Even after the drop in oil prices last year, approximate balance in the current account has been achieved and remains possible over the next few years. Still, the fact that a large component of the adjustment took the form of cuts in import levels raises some question about the adequacy of such a level of imports--or even about the slightly higher levels anticipated by the authorities for 1987-89. We would welcome a comment by the staff on this matter. In any event, a stronger contribution from export growth and diversification would add a greater degree of certainty concerning sustainable economic growth and balance of payments prospects.

In that connection, we wonder about the present stance of exchange rate policy and the continuation of comprehensive restrictions on trade and payments. Specifically, we notice that the nominal effective exchange rate remains substantially appreciated compared to the early 1980s, despite the depreciation since early 1985 caused by the peg to the dollar and then to the SDR. Export growth and diversification are sufficiently important that exchange rate flexibility as a means of assuring international competitiveness needs to be carefully weighted in the balance of policy goals. Mr. Finaish's statement is reassuring on that count. At the same time, so long as the economy remains considerably insulated from external competition by trade and payments restrictions, it will be difficult to build up an efficient economic structure that would permit the Jamahiriya to participate fully in the growth of world trade.

Mr. El Kogali made the following statement:

Like many oil exporting countries, the Jamahiriya experienced serious economic and financial difficulties as a result of the substantial decline in oil prices in recent years. However, the Jamahiriya is among the few countries that have achieved considerable success in adjusting to the adverse external developments, and the authorities are to be commended for their prudent policy of containing expenditure while avoiding foreign borrowing. I also welcome the manner in which the authorities have utilized the sizable income from oil in financing the development of the economic infrastructure and in improving the living standard of the population, as reflected in the economic and social indicators described on page 2 of the staff report. The substantial decline in oil revenue has no doubt made it difficult for the authorities to maintain their development strategies, as is shown by the continued decline in development expenditure in recent years. I am in general agreement with the staff description and analysis of the recent economic and financial developments in the Libyan economy, and with the detailed description of the authorities' policies in Mr. Finaish's statement.

While the Jamahiriya has achieved notable success in adjusting its fiscal position and external accounts in response to the reduced oil income, the economy remains very vulnerable to external developments in the oil market, a problem that can be overcome only by diversifying of the economy and reducing of the country's dependence on oil. The staff projections for 1987 indicate that GDP will decline by more than 11 percent in real terms, reflecting a substantial shortfall in oil production--which is projected to drop by almost 20 percent. The fiscal deficit remains large as a percentage of GDP, having reached 25 percent in 1986 despite continued efforts by the authorities to restrain expenditure. All these developments are clear indications of the need to diversify the economy and to reduce the dependency on oil. I expected the staff report to indicate potential areas of diversification and to discuss in more detail the authorities' plan for broadening the production base away from the oil sector. I note from page 11 of the staff report and from Mr. Finaish's statement that the authorities' efforts to diversify exports through expansion of petrochemical product production have been hampered by the restrictive practices of the EEC countries, which represented the major market. Growing protectionism in industrial countries makes it difficult for developing countries such as the Jamahiriya and other oil countries to diversify their exports so as to benefit from their comparative advantage.

In several parts of the report, the staff has drawn attention to the lack of data and to the absence of the information needed to reach certain conclusions. Reliable data and comprehensive information are essential for correctly evaluating the situation, for designing appropriate policies, and for sound monitoring and the implementation of policy measures. The authorities should therefore give particular attention to the problem of data.

Finally, I sympathize with Mr. Finaish on the issue of the freeze of Libya's assets, and I hope that the circumstances which have led to that situation will ease soon.

Mr. Zecchini made the following statement:

The staff report and the background paper on the evolution of the Libyan economy over the past two years do not lend themselves to extensive analysis and comments. It is not clear whether this is due to the lack of economic issues, to the limited articulation of this economic system, or to weaknesses in the data base. The staff seems to indicate that in some crucial areas--like public finance--comprehensive information is still unavailable. I wonder whether and to what extent this shortcoming affects the effectiveness of the surveillance exercise carried out through the Article IV consultation.

Apart from this general point, the Jamahiriya seems to have been successful in adjusting its policies and levels of domestic expenditure to the deterioration in the external terms of trade--and in particular to the decline in oil revenues--without substantially compromising the social welfare of the people.

Undoubtedly, fiscal and monetary policies have played an important role in that success. But public intervention in the economic process is extensive in the Jamahiriya, and a better assessment of the role of administrative controls and measures is therefore required.

Since I broadly share the staff appraisal, I will limit my remarks to a few comments on the evolution of economic structures, public expenditures, and external policies.

As to the economic structures, given the decline in oil production and revenues, it was to be expected that the authorities would try to spur the development of the non-oil sectors. That development must rely significantly on the inventiveness of private individual initiative to complement the lagged response of public initiative to the changing economic environment. Moreover, progress toward greater efficiency in the allocation of scarce resources should be sought without reinforcing public control of economic processes. In contrast, the roles of the price mechanism and of increased competition among economic agents should be re-evaluated by the authorities in the context of the present economic system, which still includes widespread controls on prices and economic activity. Such public intervention in the economy might not always provide economic agents with the right signals for their decisions to consume, to produce, and to invest.

The authorities have been successful in correcting the fiscal imbalance by reducing public expenditures. However, the sharp decrease in the relative share of development expenditure between 1982 and 1986 might raise some questions as to its likely impact on the growth of the non-oil sectors. In the short run, such a reduction cannot curtail the expansion of non-oil output, as the economy is now experiencing a large underutilization of industrial capacity. Nevertheless, over the medium term the process of output diversification might be negatively affected by the recent changes in the composition of public expenditures unless private individual initiatives can fill the resulting gaps. In this connection, the staff should further analyze, in depth, the recent progress made in output diversification, as well as the trends that are now emerging.

In the area of public finances, we hope that the authorities will cooperate with the Fund in improving the quality of budget data. Similar improvements should also be made in the monetary statistics to clarify, for instance, some aggregates like the "other items net" entry in the monetary survey, and whose variability is not fully explained.

As regards external policies, we notice not only the persistence of exchange restrictions, but also, contrary to our expectations, the introduction of new restrictions, although these are presented as temporary measures. Resorting to such restrictions in dealing with an external imbalance is, besides being regrettable, not advisable since it tends to increase the number of distortions and inefficiency in the economy and does not tackle the basic causes of the imbalances. A policy shift toward a liberalization of the exchange system, together with a coherent management of macroeconomic policies, could foster a more efficient allocation of resources and viable development of the non-oil sectors. In this context, there is room for more flexibility in exchange rate management while the same flexibility would not be justified if other components of the present policy approach to economic management remained untouched. Exchange rate depreciation is, in theory, intended to be a tool to change the level and the pattern of domestic expenditures and to switch resources toward the more competitive sectors. In a system with extensive price controls like that of the Jamahiriya, exchange rate flexibility would not accomplish this intended function; domestic prices would not fully reflect the impact of the exchange rate changes.

Mr. Salehkhou made the following statement:

I support the proposed decision. The Libyan economy continues to heavily depend on the oil sector, since virtually all of the Jamahiriya's exports consist of oil products. In recent years, the unfavorable impact of the downturn in the international oil market resulted in a sharp decline in oil exports and corresponding revenues from $14.7 billion in 1981 to $5.7 billion in 1986. Consequently, government revenues were reduced by more than half during the same period.

The response of the authorities was initiated in 1981 and consisted mainly of sharp cuts in administrative and development expenditures, which were reduced by 47 percent between 1981 and 1986. In the external sector, the authorities pursued an adjustment policy through restraining imports and the outflow of remittances, while continuing to avoid foreign borrowing. This effort resulted in an overall surplus of $2.6 billion in 1985 compared with a deficit of $5.1 billion in 1981. However, this restrained policy had a depressing impact on the non-oil sector, whose growth slowed to an annual average rate of 1.6 percent between 1982 and 1985, against 7.9 percent in 1981.

The authorities' development strategy has centered around the vertical integration of the oil sector through local refining and expanding production of gas and petrochemicals. Total refining capacity reached 350,000 barrels a day in 1986, compared with 60,000 barrels a day in 1974. This achievement expanded the domestic production of petroleum products by about 60 percent between 1981 and 1984. Efforts are also being made to increase natural gas production, processing, and utilization in local plants. The Jamahiriya increased its production capacity for petrochemicals through the construction of new plants to produce methanol, ammonia, urea, and ethylene. With the completion of the Ras Lanuf complex a further step toward a substantial integration of the oil sector will be achieved, and export proceeds from petrochemical products will constitute an important source of foreign exchange. The EC has recently established a base price for petrochemicals which is substantially higher than the market price, thus reducing the Jamahiriya's natural comparative advantage derived from its proximity to the EC. It remains to be seen whether protectionist policies of EC countries will ease, so that the prospective increased earnings do indeed materialize. In this regard--and given the low level of Libyan petrochemical exports--I wonder how developing countries can heed advice to diversify their economies if they are not allowed to benefit from their comparative advantages even if they do manage to succeed in their diversification efforts.

While the oil sector remains the main component of GDP, a substantial effort has been made by the authorities to expand the non-oil sectors--particularly agriculture, manufacturing, and construction. In order to move closer to self-sufficiency in food and to improve the welfare of the rural population--which accounts for 20 percent of the labor force--the authorities have pursued an active policy of subsidizing agricultural inputs and expanding the cultivable area, which represents only 2 percent of the country's total land area.

The manufacturing and construction sectors were affected by the departure of a large number of expatriate workers and by the cuts in public expenditures resulting from budgetary limitations under the adjustment program. Table 5 of the background paper shows that underutilization of capacity in several industries remains at very high levels and is a source of great concern for the authorities. In this regard, I welcome the authorities' efforts to transfer workers from the administrative services sector to directly productive sectors and to encourage the establishment of industrial ventures aimed at promoting the participation of the population in economic activities. These efforts should be strengthened.

A substantial improvement in the current account occurred in 1985, although this was mostly achieved through import compression and reductions in workers' remittances. Such policies would be difficult to maintain in the coming years if greater utilization of capacity in the manufacturing sector is to be achieved. The authorities should aim at export growth and diversification in order to alleviate the country's dependence on oil, and to widen the economic base.

I have consistently questioned the appropriateness of the Fund's explicit or implicit support of the restrictions arising from the freezing by some industrial countries of other members' assets under the pretext of national and/or international security. Some of my authorities, who themselves have been victims of such actions under the decision on payments restrictions for security reasons (Decision No. 144-(52/51), fully share the disappointment expressed by the authorities in the Jamahiriya regarding the Fund's lack of support for their complaint despite the protection that they had sought as a member of the institution. They are puzzled by the fact that the Fund, while presumably avoiding involvement in judgmental issues of a political or military nature, permits itself to approve, explicitly or by implication, restrictions arising from such considerations.

It is worth noting that while the Fund supposedly is not in a position to pass judgment on such matters as national security, the United Nations, under whose auspices we are organized, did not fail to take a position on this subject. During its Forty First Session, the UN General Assembly condemned the military action against the Jamahiriya--considering it in violation of the UN Charter and of international law--and affirmed the victim's right to receive "compensation for the material and human losses inflicted upon it."

Since the motives behind the military action were similar to those advanced on the occasion of the freezing of Libyan assets, I wonder if the time has not come for the Fund to review the case with or without the concerned authorities' request, as a matter of principle. The Fund's failure to take any corrective measure stems from the open-ended nature of Decision No. 144-(52/51), which is contrary to the institution's position on almost all other financial restrictions applied by members. Given the open-endedness of that decision, freezing Libya's assets--or those of any other member--is tantamount to de facto confiscation of those assets, regardless of the cause of, or any justification for, the action. The supportive role of the Fund in such expropriations, which is contrary to the Fund's cooperative spirit if not indeed the letter of its charter, is incomprehensible. I will not go further into details on the adverse consequences that result from abuses of this decision, and associate myself in this regard with the points highlighted by Mr. Finaish in his statement. I would therefore like to call once again for a review of Executive Board Decision No. 144-(52/51); a review which is long overdue.

Mr. de Groote said that he endorsed the main recommendations of the staff report, especially the need to diversify exports, to improve statistics--it was quite surprising that a country with the Jamahiriya's resources should have such scant statistical material--and ensure a broader participation of the population in the development and progress of the economy. In that respect the difficulties associated with the absorption problem in countries in similar circumstances were well known, and the World Bank had devoted numerous studies to that topic. But the authorities could improve the situation by allowing more scope for private initiative, and by implementing their decision on workers' participation in the ownership of some companies.

The staff report described the imposition of a 10 percent fee on all foreign exchange transfers, Mr. de Groote continued. If that fee was a general one on all exchange transactions, then it was not a multiple currency practice, although it might still be unacceptable to the Fund.

It was his understanding that the mission had told the authorities that the Fund stood ready to assist them in matters relating to the country's outstanding claims, such as overdue bank deposits and loans with certain member countries, Mr. de Groote said. However, it was also his understanding that management's position was that the Fund was not in a position to assist in the matter of the Jamahiriya's frozen assets in a member country. He wondered whether there was not a slight contradiction between those two viewpoints.

The staff representative from the Middle Eastern Department remarked that the authorities had recognized that the import situation had tightened up considerably in 1985-86, and that they intended to allow a greater flow of imports in 1987. The authorities hoped to maintain an equilibrium in the balance of payments, but they planned to increase the flow of imports even if that resulted in a small deficit. The latest indications were that there had indeed been some loss of reserves through August 1987--perhaps $400-500 million--which suggested that the authorities were carrying out their intention of allowing more imports.

A substantive step had been taken in 1986 toward greater flexibility of the exchange rate, the staff representative continued, and that had helped to reverse--to some extent--the appreciation of the exchange rate that had occurred during an earlier period. The authorities had further increased flexibility by widening the exchange rate margins, but the authorities remained reluctant to make numerous changes in exchange rate arrangements within a short period. They recognized the significance of exchange rate policy for private sector development, but while they maintained an open mind on the issue, they believed that for the time being they should maintain the existing arrangements, while waiting for developments in the international market to unfold.

The pervasive and widespread policy of controls in economic management was undergoing gradual revision or reinterpretation within the context of the planned economic system to which the Jamahiriya adhered, the staff representative noted. Elements of flexibility were emerging in some areas, though perhaps not as fast as had been hoped. Movement had nonetheless occurred, and that should be recognized.

As in many other oil producing countries, the infrastructure had largely already been developed, and there was little further need for expanding it, the staff representative considered. That factor allowed cuts in development expenditures. Capital expenditures on a large water project was not reflected in the data, but that project was an important investment that would have implications for the future growth of the economy.

The staff fully agreed with the comments on the weaknesses in the data base, the staff representative remarked. The staff had taken up the question of technical assistance with the authorities during the 1987 Annual Meetings and requests from the authorities for assistance might be forthcoming.

The staff report did reflect the concerns of the Libyan authorities about the freezing of Libyan assets by the United States, the staff representative from the Middle Eastern Department said in conclusion. The authorities wished to record their disappointment and concern that the complaint that had been presented to the Board had not received the support for which they had wished. As the staff understood it, the authorities had recorded their concern and disappointment but were not seeking to raise the question again at the present time.

The staff representative from the Exchange and Trade Relations Department said that as the fees imposed on exchange transactions applied only to outgoing transactions, there were indeed two exchange rates. That arrangement amounted to a multiple currency practice.

Mr. Zecchini remarked that the Libyan authorities clearly attached great importance to the stability of the exchange rate and agreed that if changes in the exchange rate were not reflected in the domestic supply structure, they would have little, if any, impact. He wondered whether the authorities had dealt with that relationship in the recent past by changing the structure of relative prices while retaining a certain degree of stability in the exchange rate. Prices were tightly controlled by the authorities, and he wondered whether there had been any attempt to achieve results similar to those that could be achieved in an open, free market economy by directly operating on the price system while maintaining a degree of stability in the exchange rate.

The staff representative from the Middle Eastern Department said that the authorities were more concerned about the procedure through which the exchange rate was set than the stability of the exchange rate itself. The authorities had first changed the peg, and had then widened the margin, and they did not believe in making extensive changes in those arrangements within a short period. However, the authorities did not pursue a stable exchange rate regardless of its impact on the domestic economy, and circumstances within the economy were currently changing. As the significance of private initiative grew, the level of exchange rates became of more direct relevance as a signal to individuals.

Mr. Salehkhou commented that while he noted that the Libyan authorities wished only to register their disappointment and were not making any request for action, the freeze of Libyan assets raised more general issues and his call for a general review of Decision No. 144-(52/51) was still warranted.

The Chairman said that he noted Mr. Salehkhou's request. As to the supposed inconsistency in the Fund's attitude toward handling various restrictions, a distinction had to be made between cases requiring the good offices of Fund management--when formal or informal intervention by the staff could help to find solutions to difficult problems between members--and cases in which specific positions had been taken by the Executive Board, in which event the freedom for maneuver for management was very limited.

Mr. de Groote commented that he still did not quite see why the Fund could not offer its good offices in a case in which a country requested them. The authorities of the Jamahiriya had requested such good offices, and the Fund could have presented the case to the U.S. authorities without either implying that the United States would accept or react positively, or acting inconsistently with the provisions of Decision No. 144-(52/51).

The Chairman remarked that the fact that the Board had taken a certain position at a certain time did not totally close the doors to the provision of its good offices by management. Such good offices were however a matter of judgment, and one aspect of such judgments was that such good offices' efforts should not be expended in the absence of some advance indications that progress might be possible. While opportunities for movement should be exploited quickly, influence should be applied only when positive movement appeared possible. Circumstances might change, and Fund management stood ready to use its good offices whenever such actions seemed likely to be successful.

Mr. Templeman commented that he wished to distinguish between two different kinds of cases. It was entirely the business of the Fund to offer its good offices in helping member countries to deal with financial obligations between them. Decision No. 144-(52/51) was however a special decision involving national security matters, and it was very dangerous for the Fund to enter into a national security issue. The last time that the overall question of national security matters had been examined--in 1986--it had been the general consensus of the Board that that was not an area where the Fund could usefully be involved.

Mr. Finaish said that the authorities agreed that there were deficiencies in data which it would be useful to remedy. In the past, the Fund had provided technical assistance, particularly in the area of the balance of payments, and such assistance would be useful in the future.

The authorities intended to maintain their adjustment effort, Mr. Finaish continued; there was certainly a need for that adjustment, given that oil revenues had dropped from about $22 billion to $5-6 billion in recent years, and those revenues were expected to be around $6-7 billion in the coming two or three years. That development called for continued adjustment, particularly in the fiscal area, and for a more serious look at the efficiency of the allocation of resources--especially human resources. He agreed that wider and more effective participation of the population in economic activities would be good for the Jamahiriya and for the Libyan people.

The Board had discussed the issue of the frozen assets extensively in January 1986 (EBM/86/17, 1/31/86) and it was not the authorities' intention to resubmit that complaint at the present meeting, Mr. Finaish noted. Twenty months had elapsed since the introduction of the freeze. The authorities had raised the matter when the staff mission was in Tripoli, and had also discussed it with the Managing Director and the President of the World Bank during the 1987 Annual Meetings. The authorities were disappointed by the Fund's response because Libya was a small country that had never used Fund resources since joining the institution in 1958. The freeze represented the first issue on which the Jamahiriya had needed help from the Fund and the authorities thought that they had a fair case with implications that went beyond the bilateral dimension, and were of great importance to the Fund.

Decision No. 144-(52/51) had been taken in 1952, with a small majority, Mr. Finaish recalled. It might be noted that the United States had been by far the most frequent user of that decision. The decision had been invoked 42 times to date; on 26 of those occasions, the decision had been invoked by members imposing restrictions involving Rhodesia or South Africa, out of what could be broadly termed reasons of "international or collective" security. Of the remaining 16 cases, the decision had been used as many as 9 times by the United States, a country that most vocally proclaimed the cause of freer international trade and financial flows. It was noteworthy that it had been the United States--the largest member of the Fund and the most powerful country--that had felt the need to use the decision dealing with payments restrictions in conditions of a threat to security the greatest number of times, and against countries that in comparison were very small. Could it not be said that a mechanism that was supposed to allow members to resort to temporary payments restrictions in self-defense in situations of legitimate security risks had a serious flaw, allowing it to be misused for other purposes by the more powerful among the membership? Did not the possibilities of abuse of Decision No. 144-(52/51) represent a serious chink in the ability of the Fund to enforce its jurisdiction, and one that particularly compromised the protection of the interests of its smaller members?

He had reminded Directors at the Board meeting of January 31, 1986 that they had before them not only a complaint by a member against another member--on a question of great significance to the member making the complaint--but also a matter that extended well beyond the bilateral dimension and that should be of concern to the expanded membership at large, Mr. Finaish recalled. The matter entailed broad implications for the prestige and credibility of the institution; its integrity in the discharge of its responsibilities; and the sanctity of its Articles of Agreement, particularly the protection of the interests of its members, both large and small, under those Articles. The U.S. actions, given the large weight of the United States in international trade and banking and its position as the key reserve currency country, also carried serious and wide-ranging implications for international financial relations. Those actions put at risk national reserves and other assets held in other member countries, belittled respect for the obligations of reserve currency countries, shook confidence in the international banking system and the security of international investments, and disrupted trade and international financial transactions in general. Those implications should clearly be of serious concern to an institution such as the Fund.

He still felt strongly that Decision No. 144-(52/51) should be reviewed, Mr. Finaish remarked. He noted that at the meeting of January 31, 1986, he had stated, as the minutes showed, that: "A review clause had been explicitly incorporated in Decision No. 144-(52/51), Mr. Finaish noted. Paragraph 2 of the decision stated that 'the Fund will review the operation of this decision periodically.'" It was surprising that, despite the serious doubts and misgivings expressed at the time of its adoption, and despite the clear injunction in the decision to undertake periodic review, not a single review of the decision had yet taken place. However the term "periodically" might be defined, a period of three and a half decades was long enough for at least one review to have taken place in pursuance of the decision. On the occasion of the U.S. invocation of Decision No. 144-(52/51) against the Islamic Republic of Iran in 1979, questions had again been raised about the decision and the possibilities of its misuse. In his statement at a Board meeting held in that connection (EBM/79/191, 12/27/79), he had asked specifically for a staff paper to review certain aspects of the decision, particularly important issues such as the circumstances in which a member was justified in acting under that decision. Some explanation of why no review of that decision had been undertaken to date was in order. He wished to stress again the need for a review, both to re-examine the substance of the decision as well as to clarify concepts to limit the possibilities of its misuse.

During the January 1986 discussion of the case of Libya, all doors had remained shut, Mr. Finaish observed. The Board had not objected to the restrictions imposed by the United States, and although his chair had requested a review of the decision, there had been insufficient support in the Board.

The decision currently before the Board called on Libya to reduce restrictions on allocations for travel allowances, Mr. Finaish noted. His authorities considered those restrictions as transitional measures which were part of a substantive adjustment package formulated in response to the sharp decline in export revenue. But they also asked the Fund to help them to deal with the frozen assets--a substantial amount. In addition, they asked for Fund help concerning EC protectionism in the area of petrochemicals. Thus, while the authorities accepted the need for adjustment, they, like other small countries without major voting power, deserved and expected to receive substantive help from the Fund and not just a call to increase travel allowances.

A second issue concerned assets outside the United States, Mr. Finaish remarked. Libya had won its case against Bankers Trust in London on the grounds that the rights and obligations of the parties in respect to the London account had been governed by English law. Therefore, in the future, such deposits would not be affected by U.S. actions, and foreign branches of U.S. banks would not be subject to U.S. law. The issue of the freezing of the assets by the United States was a concern for his constituency as a whole. It had been a general question on the agenda of the August 1987 meeting of the Governors of central banks of Arab countries, and it had also been on the agenda of the recent meeting of Ministers of Finance of the 21 Arab countries that were members of the Fund. At that meeting, the Ministers had agreed: "First, to call on the United States to preserve and respect international laws and regulations and thereby lift its freeze on the Libyan assets. Second, to continue their cooperation at the level of international organization and to make every effort to help in defending the rights of Libya on this matter." The Ministers had also said that: "It is essential that all countries, particularly the reserve currency nations, refrain from practices that impede capital movements and trade flows including the freezing of foreign assets. Such actions not only present a threat to the international financial system, but may also undermine economic and political relations among nations." He hoped that the Board would try, as much as possible, to put aside the political sensitivities involved and address the issue that he had raised, for the good of the whole membership.

Mr. Salehkhou said that he had meant to make two points. First, the Fund could not take a decision on a case over the merits of which it claimed no jurisdiction. Second, the issue of the Fund's judgment was in any event not germane, as the case of the Jamahiriya had already been judged by the United Nations.

The Chairman made the following summing up:

Directors were in general agreement with the thrust of the staff appraisal. Directors commended the authorities on the substantial progress achieved in adjusting the economy to sharply declining levels of income from oil. Expenditure restraints had been a principal factor in the adjustment efforts and had also helped to maintain the policy of avoiding recourse to external borrowing. A further compression of imports through administrative restrictions had also contributed to a sharp turnaround in the balance of payments, and to the restoration of official reserves to a reasonable level. Directors, however, expressed concern regarding the stagnation of economic activity. In addition to reduced expenditure levels, economic performance has been hindered by pervasive controls and structural rigidities. In that connection, Directors welcomed the recent initiatives aimed at diversifying domestic production and at encouraging wider participation by the population in the economy, but stressed that further substantial policy measures allowing for an extension of those initiatives were needed. Emphasis was also placed on the importance of paying attention to the quality of public sector spending.

While welcoming the increased flexibility of the Libyan dinar that had resulted from the change in its peg within wider margins, Directors encouraged the authorities to exercise flexibility in exchange rate management, both to avoid an appreciation of the dinar under the present economic circumstances, and to encourage export diversification. The need for fair access to foreign markets for petrochemical exports was also stressed.

Directors noted that the foreign exchange restrictions maintained by the Socialist People's Libyan Arab Jamahiriya for certain invisible payments had been intensified, and that fees on certain foreign exchange transactions had resulted in a multiple currency practice. They urged the authorities to ease those restrictions as soon as possible.

Several Directors noted that widespread data weaknesses had hampered the development of a more precise assessment of the overall economic situation, and in particular of the public sector's financial position. In that regard, the authorities were encouraged to give priority to improving economic and financial statistics, so as to provide a reliable basis for policy analysis. The authorities were also encouraged to work with the Fund in improving the data base. The question of the freeze on the Jamahiriya's assets by the United States came up during the discussion and some Directors asked whether Decision No. 144-(52/51) should not be reviewed at this time. The chair took note of that question.

It is expected that the next Article IV consultation with the Socialist People's Libyan Arab Jamahiriya will be held on the basis of a 24-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to exchange measures of the Socialist People's Libyan Arab Jamahiriya subject to Article VIII, Sections 2 and 3, and in concluding the 1987 Article XIV consultation with the Socialist People's Libyan Arab Jamahiriya, in the light of the 1987 Article IV consultation with the Socialist People's Libyan Arab Jamahiriya conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Socialist People's Libyan Arab Jamahiriya maintains restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV. The present exchange regime also involves a multiple currency practice and exchange restrictions subject to Article VIII, as described in SM/87/208. With recent changes, access to foreign exchange for some invisible payments has become more restrictive. The Fund urges the authorities to liberalize the exchange system and to eliminate the multiple currency practice as soon as possible.

Decision No. 8705-(87/144), adopted
October 9, 1987

2. SOUTH AFRICA - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with South Africa (SM/87/232, 9/3/87; Cor. 1, 10/5/87; and Sup. 1, 10/7/87). They also had before them a background paper on recent economic developments in South Africa (SM/87/236, 9/25/87).

Mr. Links made the following statement:

The consultations with the South African authorities were conducted in the same affable yet critical fashion as those of previous missions. I want to thank the members of the delegation on behalf of my authorities for the valuable contribution that they have once again made to the analysis of the South African economy and for the policy measures proposed by them.

Although my authorities may differ from the staff report on a few points of emphasis, they are in general agreement with the staff that the greatest challenge facing the South African economy at this juncture is the need for sustaining the present growth of the economy, in both the short and especially in the medium term. This challenge becomes even more difficult given a declining growth rate in the industrial economies, as well as increased economic and financial boycotts and the resultant effect upon the demand for South Africa's exports--mineral and nonmineral alike.

After enjoying a period of relative economic prosperity in 1979-81, the South African economy entered a serious recession, brought about by a number of factors, both foreign and domestic. This position was not alleviated by the disruptive social unrest of the mid-1980s and negative foreign perceptions of the country's economic position. As the staff noted, the withdrawal of credit lines by certain foreign banks in 1985 forced South Africa to become a net exporter of capital, notwithstanding the growing financing needs of the country. This combination of adverse conditions called for a wide range of policy adjustments. It is difficult to achieve the desired economic and social objectives in any developing country under normal conditions, let alone under such a combination of adverse circumstances. In retrospect, it is remarkable that the economy has now reverted to a situation in which normal market forces, especially in the foreign exchange market, can to some degreee again be relied upon to correct maladjustments.

South Africa's adjustments are reflected in the trends of a number of important indicators. Thus, the past year now under review began with high levels of unemployment and inflation, an exchange rate at a much lower level than two years ago, and an economy that was generally in a lethargic and hesitant mood.

Given the hesitancy in the other components of expenditure, exports provided some stimulus for the recent mild upturn in the economy. Greatly assisted by the exchange rate policy, the current account of the balance of payments again showed a surplus in excess of R 5 billion for the current year. This external adjustment has been a feature of the economy for the past ten quarters. The first seven months of 1987 have seen the trade balance increase to R 8.36 billion compared with R 7.73 billion in the corresponding period in 1986. Encouragingly, this increasing trade surplus is due to exports rising more--by R 1 billion since June 1987--than imports--R 400 million--reflecting both an increase in value and an increase in volume. This improvement clearly allows the authorities more scope in the application of moderately expansionary economic policies. The upturn in imports also confirms that the domestic economy is still expanding, albeit slowly. This positive development, combined with a rise in the gold price over recent months, has increased the foreign exchange and gold reserves of the Reserve Bank to a record level of R 7.1 billion at the end of July 1987, equivalent to approximately 3.5 months' imports. However, given the projected growth in GNP for 1987 and 1988, the authorities still see a meaningful role for domestic expenditure expansion, yet recognize the pressures which this might exert on imports and the inflation rate.

In the midst of the growing international concern about the developing countries' debt problem, South Africa successfully negotiated a second interim debt repayment arrangement with its creditor banks in early 1987. South Africa agreed to redeem a further $1.5 billion of "affected" debt by June 1990. This first installment of approximately $300 million has already been paid in July of this year. Further, South Africa is about to make the final repayment to the Fund on the stand-by arrangement granted in 1982, and authorities are grateful for the support of the staff and management of the Fund during this difficult period of the early 1980s.

As noted above, the domestic economy had not recovered sufficiently, despite expansionary policy measures. After growing at a seasonably adjusted annual rate of 3.5 percent for the third and fourth quarters of 1986, the real GDP growth slowed down to annual rates of only 2 percent for the first and 1.5 percent for the second quarter of 1987. There are, however, signs of further positive movement in some of the latest indicators.

Auto sales are up by 11 percent for July and the fixed property market is also showing an upward drift. In addition, the Reserve Bank states in its Annual Report that "conditions still existed that were friendly to a renewed and more vigorous acceleration in consumer expenditure, to its translation into increased fixed investment spending, and to the eventual mutual reinforcement of consumption and investment through the multiplier and accelerator mechanisms."

The adoption of a 14-18 percent target range for the projected increase in the money supply (M3) for 1987 reflects a continued concern about inflation. In their efforts to stimulate domestic expenditure, the authorities believe that interest rates and the exchange rate should be allowed to adjust to changes in underlying demand/supply conditions. Although inflation remains a great concern, the rate has at least not increased recently, and has shown signs of declining as reflected in the marginal drop to 16.3 percent in July on a year on year basis, compared with 17.2 percent in June. Acknowledging the undesirable effects of inflation, the State President's Economic Advisory Council has been asked to prepare a special report for the Government on this subject.

Nowhere are the effects of the economy's sluggishness more severely felt than in the labor market. Although the problem is to an important extent related to the unsatisfactory growth of the economy, my authorities have realized the importance of alleviating the structural elements of the problem through the deregulation of economic activity and through special programs for the training of the unemployed. If these measures have not reversed the trend, they have at least contained the size of the problem thus far.

On the general labor front, many of the remaining impediments to the movement of labor that were mentioned in the staff report are being seriously addressed. First, the final remnant of job reservation--the definition of a "Scheduled Person" in the mining industry--was abolished on August 10. Further impediments to labor mobility were removed through the opening up of central business districts and all industrial areas to everyone. Further progress is likely following the submission of a report to Parliament on the Group Areas Act by the State President's Council. To further accentuate these developments, the informal sector in the economy has been recognized as an important employment source and has accordingly been supported in various positive ways, such as assistance provided by the Small Business Development Corporation and further deregulation.

A major test of the new labor legislation regarding trade unions has also been successfully passed during the August strike of mine workers. Although there were some incidents, the settlement reached reflected greater maturity in the labor relations field on the part of the industry and of the unions, while it also emphasized the determination of the Government to stay out of the wage bargaining process.

On the related issue of human capital development, there is also movement toward greater equity in the allocation of resources for education and housing. Of the total increase in education expenditure in the 1987/88 budget, 17.86 percent has been allocated to Whites and 64.18 percent to Blacks. Social expenditure in general was increased far in excess of the growth in other expenditures and of the inflation rate. Besides education increasing by 40 percent, expenditure on social services also increased by 40 percent, and development for the homelands increased by 26 percent. My authorities realize the importance of these investments in human capital and of the contribution that it can make toward promoting growth. In this regard the Government is selling 500,00 housing units to lower-income households, and owning these houses is expected to have a positive effect on the social stability of the community. Another laudable development in this field is the recent announcement by South Africa's biggest mining corporation that it proposes to construct 24,000 homes over the next three years for black workers and their families. This would not only involve the private sector in the supply of housing in a bigger way, but would, in effect, also make it possible for workers to live together with their families. Almost half a million immigrant workers have been attracted to the mines from outside the borders of South Africa, and the Republic of South Africa thus makes a very significant contribution to the economies of neighboring states.

Government expenditure has now increased to a level that would normally be judged as excessive. At present, the Central Government's projected deficit before borrowing is estimated to be 4.7 percent according to the budgeted figures for 1987/88. This deficit will probably be higher by the end of the year. In the light of the present spare capacity in the economy, the danger that this expenditure or financing requirements might crowd out private endeavors are remote. Given the enormous pressure on the Government for social expenditures in the area of housing, education, and health, which have also been identified in the Fund document as urgent priorities, there is general consensus that a relatively large deficit can for the time being be tolerated.

The privatization drive moved further on August 3, when a White Paper was introduced that signaled the start of an intensive three-year program for deregulating and privatizing economic activity to a greater degree. The White Paper details a number of examples in which the privatization process has been fully or partially implemented.

The Government is committed to reducing expenditure, and has embarked on a medium-term strategy, which is still tentative but which represents a move in the right direction. It is the aim to reduce total public sector expenditure from the present 38 percent to 34 percent of GDP by 1992, although the Government's discretionary expenditure is very limited, and it could take a long time to realize the desired relative decline in the role played by the general government sector in the economy.

The report of the Commission on Tax Reform--the Margo Report--was the result of two years' work during which more than 1,000 representations were heard. The Report was finally introduced in Parliament on August 20, and it endeavors to address all the major issues raised in recent years with regard to the problems of the present tax structure. Of the more than 300 recommendations in the Report, the most important are: first, to make the tax system more productive, addressing the enormous loss of revenues via the avoidance and evasion of taxes and the increasing importance of fringe benefits as a form of remuneration; second, to attain greater neutrality between various categories of income and taxpayers; third, to limit the tax expenditures to the absolute minimum, and to encourage direct assistance through the budget; fourth, to simplify the tax structure and to redistribute the overall tax burden to achieve greater fairness, certainty, and acceptability and increase confidence; and fifth, to strike a fair balance between direct and indirect taxes, taking into account the skewed income and wealth distribution in the economy. The Report has in general been well received by the broad public and by the business community, and the Government is studying the recommendation in order to draft a White Paper.

The economy's performance over the past year was characterized by only a mild response to the stimulatory policies introduced by the authorities. The staff's appraisal that a lack of confidence is to blame for the moderation of the upswing cannot be contradicted.

Although domestic perceptions and confidence in the future of the economy has improved and this change has also been evident from the reaction of businessmen abroad--as indicated by a 35 percent appreciation of the Financial Rand exchange rate over the first half of this year--the Governor of the Reserve Bank's Annual Address correctly points out that "the economy will not approach anything like its optimal performance until businessmen and consumers gain a more positive vision of South Africa's social and political future. There is little that monetary and fiscal policies can do to extricate economic decisions from the political considerations with which they are currently entwined in South Africa."

Mr. Foot noted that the staff report addressed both the immediate problems facing the authorities in their efforts to bring about rapid and sustainable growth, and the need for structural changes to underpin that sustainable growth. The report brought the immediate difficulties facing the authorities into sharp focus. The economy had been slow to respond because of a lack of confidence and there was a danger that, when it did respond it would hit an external financing constraint. Nevertheless, there were hopeful signs: there had been a marked improvement in business profitability, and there were some indications that growth had recovered in the unrecorded, or informal, sector. He endorsed the staff view that policy should be geared to externally generated growth, and that competitiveness should at a minimum not be allowed to fall further.

He welcomed the staff's reiteration of the need for a more balanced medium-term strategy designed to restore confidence and to improve economic performance, Mr. Foot remarked. He also endorsed the three main elements of the necessary policy. The first element involved the reorientation of and an increase in government spending to improve standards of provision for black communities, which would promote faster and more labor-intensive growth and would enable the rapidly growing black population to play a full economic role. He welcomed the announcement by the authorities of a five-year public spending program, although, as the staff recognized, the pursuit of the program objectives would be difficult. He also welcomed the steps that had already been taken in that direction--for example, the declared intention of the authorities to achieve equality of state spending in black and white education within ten years. The staff was to be commended for its attempt to show the implications of the reorientation of spending for the overall budget described in Appendix I of the staff report. It was possible to argue from that description that significant progress in upgrading spending on currently less well-financed groups was possible in ten years at the cost of only a fairly small increase in the tax burden--so long as reasonable growth persisted.

The second element of the strategy was that interest rate policy would have to be designed to encourage savings and discourage capital-intensive investment, Mr. Foot continued. That objective was clearly sensible in the medium term, given South Africa's resource endowment.

The third element, and in many ways the most important, was wide-ranging deregulation, Mr. Foot said. He strongly endorsed the staff account of the extent of regulatory and bureaucratic interference with markets, which affected all parts of the economy. The growth of the informal economy showed the potential for the development of the more labor-intensive forms of activity, which would be necessary if the enormous problem of black unemployment was to be tackled. It was highly desirable that all parts of the economy should be free of unnecessary restrictions, and the existing slow rate of progress in that area was a cause for some concern.

He recognized that in the short term fiscal policy had remained principally dedicated to stimulating demand, despite evidence that the economy was proving slow to respond to traditional demand management, Mr. Foot remarked. In his view, the staff had correctly identified the appropriate twin medium-term objectives for fiscal policy if it was to help strengthen growth: creating more room for private sector activity, and placing greater emphasis on meeting the needs of the poorest parts of the population. Success would depend on the Department of Finance receiving support for the redirection of expenditure and the introduction of mechanisms to monitor and control expenditure. Much had yet to be done in that area, and the problem of controlling the central government wage bill required particularly urgent attention.

He agreed with the staff's assessment of South Africa's inflationary problems and the conduct of monetary policy, Mr. Foot concluded. South Africa's internal and external economic problems and constraints would not begin to be solved until there was a widespread perception that the overall policies had a real chance of promoting long-term stability.

Mr. Abdallah made the following statement:

> The staff papers on the Article IV consultation with South Africa show unmistakably the signs of an economy under siege, reflecting both what the staff euphemistically calls "strong sociopolitical rigidities and uncertainties," and the Governor of the Reserve Bank's candid assessment that "the economy will

not approach anything like its optimal performance until businessmen and consumers gain a more positive vision of South Africa's social and political future." Economic growth has faltered; a relaxed fiscal policy stance underpinned by an accommodative monetary policy has failed to provide the needed stimulus to domestic demand; unemployment has assumed crisis proportions, especially among the majority black segment of the population; inflationary expectations have become embedded; inflation differentials with partner countries have emerged, causing the real exchange rate to appreciate significantly, thus reducing external competitiveness; and the external position has been seriously compromised, because the deleterious repercussions of foreign disinvestment have resulted in an external debt moratorium.

Moreover, the medium-term outlook points to several disquieting features that are, if anything, likely to exacerbate the difficult position confronting the South African authorities. These include particularly serious effects on growth from the projected slowing of internal demand caused by persistent capital exports, as well as the inadequacy of domestic savings for financing even a modest growth in investment, which is itself primarily determined by noneconomic factors. Of course, the political environment remains extremely tense with serious repercussions both internally and in neighboring countries.

I will now comment on the two illustrative scenarios discussed on pages 28 and 29 of the staff report. Efforts to stimulate growth in output through increasing the expansion of domestic demand will, in the present environment of considerable uncertainty, end up further imperiling the current account balance and the external reserve position. However one evaluates the validity of the baseline scenario, the staff's alternative scenario seems somewhat unrealistic, simulating a virtual doubling of the growth rates of output and domestic demand while the real effective exchange rate remains unchanged. This is unrealistic because it implies severely restrictive demand-management policies to eliminate inertial components of inflation--a policy option that is clearly not feasible in the prevailing environment.

Against this background, the staff has valiantly attempted to identify the building blocks of a credible adjustment strategy for the South African authorities to pursue. It advocates a more balanced and integrated policy strategy, involving increased public support for capital formation and other growth-promoting outlays directed toward what are euphemistically called "low-income groups," especially in the areas of housing and human capital; a less accommodative financial policy; the avoidance of further losses in external competitiveness; and stepped-up deregulation in labor and output markets.

This strategy is reasonable up to a point, but the staff appraisal failed to emphasize sufficiently the fundamental importance of the causes of the prevailing sociopolitical rigidities and uncertainties in the South African economy. Since our previous discussion, the perceptions of both domestic and external observers have, if anything, hardened considerably, reflected in growing manifestations of domestic unrest and the intensification of foreign disinvestment, the interruption of external credits, and the imposition of limited trade sanctions against the Republic. In the face of these developments, the authorities have only grudgingly taken some partial measures to improve the plight of the majority population with respect to the labor market. According to Mr. Links, "if they have not reversed the trend,...they have at least contained the size of the problem thus far." More could have been done if expenditures on public order and security did not constitute such a high and growing component of the budget. In this connection, we agree with the staff about the spin-off effects of restricting government expenditure so as to strengthen effective demand in the low-income sector of society, and note with concern that there has been a sharp curtailment in the level of capital expenditures for development assistance, and for the housing, small business, and informal sectors. In addition, the staff has acknowledged that the process of sociopolitical development can be greatly stimulated by raising expenditures in those areas in which they have been curtailed, and by expanding education and training facilities. Moreover, restrictions on labor market mobility--in particular, the odious Group Areas Act--still remain in force, while the severity of the Act's provisions is mitigated only in some individual cases.

Data for Namibia remain a problem, and should be disaggregated from the national statistics. Once again, there are no data on energy imports and consumption. It is absolutely necessary that both sets of data be provided to the Fund in order for a fuller assessment to be made of the performance of the South African economy.

I started by quoting the Governor of the Reserve Bank of South Africa on the nature of the problems confronting his country. I will end with a quotation from the Nobel Economics Prize lecture of James Buchanan which, although made in a different context, has a deeper connotation for the situation in South Africa: "Economists should cease proffering policy advice as if they were employed by a benevolent despot, and they should look to the structure within which political decisions are made." The Fund staff should keep this advice constantly in mind as it evaluates economic and financial developments in this deeply divided nation.

Mr. Bertuch-Samuels made the following statement:

Both the papers before us and Mr. Links's statement reveal a number of encouraging aspects both with respect to recent economic developments--i.e., the external accounts, recent capital outflows, increases in reserves, structural reforms--and to prospects for the future. In this latter regard, I noted in particular the authorities' rather realistic assessment of the difficult tasks that lie ahead, including their acknowledgment of the importance of the existing sociopolitical environment and of consumer and investor confidence for economic activity. However, I was struck by the statement that "there is little that monetary and fiscal policies can do" in the present circumstances to influence economic decisions. This statement reveals an unduly pessimistic view of the authorities' room for maneuver. Indeed, the staff has made a compelling case that financial policies do matter, as these policies affect expectations, savings, and investment and exert a divisive influence on the growth prospects of the country. And those prospects are in turn an important factor in determining the scope for improving the socioeconomic and sociopolitical environment.

This environment can of course be influenced in a more direct and certainly more effective manner through structural reforms. I am therefore pleased to note that the potential impact of such reform policies seems increasingly to be recognized by the authorities, as reflected by, inter alia, recent developments in labor market legislation and human capital investment. At the same time, however, I agree with the staff that "much more needs to be done" in the area of structural reform. In view of the substantive benefits at stake, I am somewhat concerned about the rather sketchy information provided both in the staff papers and in Mr. Links's statement on the authorities' future reform intentions. Accordingly, I urge them to adopt a more forceful and integrated approach to structural reform.

As regards specific policy measures, I broadly agree with the staff appraisal. I wish to emphasize that I share the staff's concern about the present expansionary stance of financial policies, and in particular the possibility that the authorities might introduce additional fiscal stimulus were output growth to fall short of expectations. Clearly, this policy stance carries the risk of exacerbating inflationary pressures and destabilizing the external accounts--which would, of course, be bound to undermine the authorities' growth objectives. Such a growth-inhibiting process already seems under way, as indicated by the persistent high inflation rates and the most recent information provided in the supplementary paper's description of investment activity. In this context, I noted Mr. Links's observation that "interest rates and the exchange rate should be allowed to adjust to changes underlying demand/supply conditions."

While in general I have no quarrel with this observation, I strongly feel that allowing those rates to become negative in real terms--or to undermine external competitiveness--would definitely lead in the wrong direction. Nonetheless, the staff's advice that the nominal effective exchange rate should, at a minimum, fall in line with the inflation differential must not be misunderstood as an invitation to pursue an accommodating exchange rate policy.

There seems a clear need for a more resolute and comprehensive approach integrating both bold structural reform measures and more stability-oriented macropolicies. In the framework of such an approach, economic prospects could be substantially improved by the adoption of a credible medium-term program of adjustment and reform that would dissipate the existing uncertainties about the authorities' policy intentions.

Mr. Massé made the following statement:

I share the staff's analysis and conclusions. I would like to encourage further analysis of the linkage between the South African economy and neighboring countries which are highly dependent upon South Africa. Future staff work could perhaps deal more explicitly with this regional dimension.

During past discussions on South Africa, this chair has focused on the serious structural distortions arising from South Africa's regulatory and social policies. These concerns remain very important to us. However, there is also now cause for concern about the present course of South African macroeconomic policy. The South African Government is maintaining a social system which is out of step with the world beyond its borders, and the authorities seem also to have now adopted a macroeconomic stance which has already been tried and rejected elsewhere.

In the short term, the authorities hope that fiscal stimulus and an accommodating monetary policy will increase domestic demand, employment, and growth. To be effective, however, this strategy must have a positive influence on domestic confidence, as reflected both in consumer demand and in investment. It would also have to lead to higher rates of domestic savings, so that South Africa could rely less on external sources, and more on domestic sources of savings. To date, there is little evidence that the present strategy has had any impact on these fundamentals.

The supplement to the staff report suggests that output growth for 1987 and 1988 may now be weaker than originally expected, partly because of the continuing low confidence of domestic consumers and investors. If confidence--rather than the level of interest rates or the level of domestic demand--is now the key factor for restoring strong growth, the present stimulatory policy mix may produce none of the desired benefits. In fact, short-term demand stimulus and monetary accommodation may heighten the risk of current account deterioration, lead to entrenched inflation of 15 percent or higher, and may reduce the Government's capacity to shift public resources toward investment in social and human capital.

The recent strengthening of the rand poses an additional dilemma for macroeconomic management. The authorities are fully aware that external demand has been the dominant source of growth in recent years, and have stated that maintenance of a realistic exchange rate is essential for strengthening export growth. However, the recent appreciation of the rand raises doubts about the commitment to maintaining adequate competitiveness, and may well contribute to a weakening of the current account surplus.

In short, there are considerable risks to the current macroeconomic strategy. Stronger macroeconomic policies are needed, including exchange rate management centered on maintaining external competitiveness, an end to monetary accommodation, the restoration of positive real interest rates, and a fiscal policy based on greater investment in social goods and a stronger, less distorted revenue base.

My second point of emphasis has attracted considerable attention during previous consultations: the barriers to access and mobility of labor which have been erected and reinforced in South Africa. Mr. Links has noted a number of areas where there have been improvements in labor market flexibility and in the mobility of labor. However, although necessary, these measures are completely inadequate to address the economic needs and aspirations of the vast majority of South Africa's population. Quite apart from the unacceptable social consequences of the existing manpower and labor policies, these policies continue to exact a tremendous economic cost upon the South African economy. They effectively lower the economy's growth by artificially limiting the pool of available skilled labor and by reducing the economy's capacity to create new jobs.

Furthermore, as the staff emphasizes, market limitations in South Africa extend beyond the labor market and reduce the degree of competition in other markets throughout the economy. Under these circumstances, it is not surprising that the conditions for dynamic growth remain elusive, and that South Africa's growth potential is so low.

Therefore, I strongly agree with the staff that comprehensive and systematic policy reform is needed at both the structural and macroeconomic levels. Only by creating conditions which permit the free flow of labor and goods, ensure the competitiveness of South African exports, and match aggregate demand to the economy's supply capacity, will sustainable economic growth be made possible.

I fully subscribe to the views set out in the last paragraph of Mr. Links's statement. I sincerely hope that policies can be found which benefit all the people of South Africa.

Mr. Ovi said that the South African economy faced considerable problems, whose roots lay in the apartheid policy and in the resultant uncertainty regarding future developments. The problems had been made worse by the economic policies pursued by the authorities, and by the lack of confidence in those policies. Abolition of the apartheid system remained a crucial precondition for stabilizing and restoring the South African economy.

The drastic decline in investment in recent years was a clear symptom of the problems, Mr. Ovi continued. Other symptoms included the large exchange rate fluctuations, and the swing to a considerable capital outflow. In the medium term, both insufficient expansion of productive potential and the external constraint would pose serious problems.

The South African authorities' attempts to induce economic growth via expansive monetary and fiscal policies had proved untenable, Mr. Ovi considered. Developments had been characterized by high rates of inflation, an increasing public sector deficit, and falling investment. There were no prospects for a lasting improvement in economic growth, and unemployment was unacceptably high in the poorest population brackets.

Attempts to increase the level of investment through negative real interest rates and favorable depreciation allowances had created rather than solved problems, as shifts in relative factor prices had reduced incentives to utilize and develop the considerable--but underutilized--manpower resources of South Africa, Mr. Ovi noted. Economic policy should primarily be directed toward the improved use of manpower resources. That effort would imply the dismantling of numerous restrictions--particularly restrictions on labor mobility. In addition, considerable additional--rather than reduced--financial resources would have to be earmarked for the development of human capital in low-income groups through, inter alia, education and improved and better located housing.

There seemed to be room for increasing such expenditures even at a time of a general tightening of fiscal policy, Mr. Ovi concluded. The tax base could be broadened, and there would seem to be wide scope for redefining priorities within the existing budget, as the outlays for public order and security alone constituted about 20 percent of the central government budget. Considerable welfare gains would also be realized through improved utilization of human capital.

Mrs. Ploix made the following statement:

I broadly agree with most conclusions in the staff report. The greatest challenge facing the South African economy is the need to achieve a strong rate of growth in output to support the rapidly expanding population. However, despite some recovery after a serious recession, and despite the authorities' forecast for 1987-88, the growth rate will be well below the level required to make such an improvement.

Furthermore, the authorities' forecasts seem to us optimistic. In fact, the present policies are based on the increase of internal demand and are exacerbating inflationary pressures. As stated by the staff, the present strategy might run counter to the external constraint, and might put a premature end to the recovery. We urge the authorities to review their policies toward encouraging the diversification of exports and increasing labor productivity.

I will now emphasize some aspects of South Africa's economic policy which are not likely to help the recovery of growth.

Fiscal policy remains a cause for serious concern. The budget deficit, which is already high, is expected to increase in the next few years. The Central Government's current expenditures have continued to increase to the detriment of human and fixed capital expenditures. Investment in human and fixed capital is, however, the most appropriate means to promote a more balanced and sustained growth pattern.

Therefore, we urge the South African authorities to greatly increase capital expenditures, especially in the areas of development assistance, housing, and education for the lowest income section of the population. In order not to increase the budget deficit, a substantial restructuring of government expenditures and a simultaneous broadening of the public revenue base will be indispensable.

With regard to monetary policy, I would stress the negative effects of low interest rates.

Indeed, the decline in interest rates has not influenced investment but it has weakened the incentive to save at a time when reliance on domestic resources for financing investments is crucial. Moreover, negative real interest rates favor inefficient investments and encourage intensive capital investment at the expense of employment. It is also clear that such a policy can only exacerbate inflationary pressures. Monetary policy must therefore be tightened to contain demand and inflation, and must be complemented by a severe wage control policy, particularly in the public sector.

> I wish to emphasize the structural rigidities which still bear on South Africa's economy, especially with regard to the labor market. I welcome the recent progress in deregulating the labor market, but I would note that important limitations on labor mobility still remain, particularly because of the Group Areas Act which restricts the housing of the nonwhite population. We are concerned that there is a high level of unemployment among the black population while there are shortages of skilled labor. We urge the authorities to continue tackling these rigidities. Such a reform process is the only way to foster accelerated growth, greater competitiveness, and the creation of more jobs. My authorities hope that such reforms will be implemented as soon as possible.

Mr. Salehkhou said that the South African economy continued to be characterized by low growth and high unemployment rates, capital shortages, shrinking gross fixed investment, low savings, increased capital flight, and high inflation rates. Although those problems were unfortunately common to many other developing countries, the root causes were unique in the case of South Africa. Thus, while in other developing countries such problems could be addressed in several ways, the task was complicated in South Africa by the prevailing strong sociopolitical rigidities and uncertainties, and by the Government's dogmatic views and primitive attitudes.

He was greatly surprised that the authorities sought commendation for attracting almost half a million immigrant workers to South Africa's mines--a process described by the authorities as a significant contribution to the economies of the neighboring states. That call for approval signaled the most profound failure of the international economic and monetary system, a system which had created such appalling conditions for the peoples of the states bordering South Africa that those people were willing to enter South Africa to earn a minimal living. Such commendation would also imply Fund approval of an inhumane means of subjugating the people of South Africa--the importation of workers from impoverished countries to keep the wages of South African workers at unacceptably low levels. Such commendation would also support the practice whereby a majority of South Africans were deprived of their own wealth and basic human rights by the ruling minority.

The views of his chair on South African economic management had been detailed on past occasions, and--as expected--the situation seemed to have deteriorated, Mr. Salehkhou continued. While he concurred with the staff view that "any assessment of the economic situation in South Africa cannot be divorced from macroeconomic considerations," South Africa's present economic imbalances would not be corrected unless the sociopolitical rigidities and discriminations that existed under the apartheid system were eliminated. Recent developments, however, indicated that such a possibility remained remote, given the prevailing dogmatic views of the authorities.

Mr. Fernando said that he agreed with the staff appraisal. When a resource-rich economy with a diversified production base experienced serious constraints to growth, the focus of attention must inevitably be on economic policy. Past consultations--and the papers before the Board--stressed that the structural rigidities of the economic system were clearly due to sociopolitical factors. Consequently, macroeconomic policy reviews aimed at addressing the problems of slow growth and imbalances could moderate the symptoms but could not attack the root causes of the problems. The impact of low confidence and high uncertainty regarding the future were most clearly revealed in the depressed state of investment, which existed despite plentiful liquidity in the system and negative real rates of interest.

The medium-term projections of the staff were more realistic than those of the authorities, Mr. Fernando continued. The budgetary situation and the accommodating monetary policy both limited the possibility of reviving growth through domestic demand stimulation, and increased the real possibility of accelerating the rate of inflation. The recent appreciation of the exchange rate was likely to place more impediments in the way of export-led growth. Export competitiveness was affected by sanctions and boycotts in foreign markets as well as by the real effective exchange rate. The question therefore remained whether the private sector could take investment decisions on exports in the confidence that their market access would be no less than that available to their competitors.

The situation with respect to investment was also complicated, Mr. Fernando noted. Capital outflows with their well-known implications, were an ever-present threat despite the possibility of administrative controls. Moreover, domestic savings were low, incentives to save were limited, and debt servicing would continue, for some years, to claim a part of savings to the detriment of investment.

Mr. Links's statement mentioned a number of measures taken to reduce rigidities in the labor market, increase labor mobility, reduce disparities in wages, and improve social welfare, Mr. Fernando commented. He wished to emphasize the critical importance of the development of human capital skills, the contribution of equal opportunities to labor productivity was as important as a reduction of the disparities within segments of the labor market. With such a large labor force, South Africa's comparative advantage lay in maximizing the labor content of production and growth. Even though South Africa had provided a market for labor from neighboring countries, he wondered whether it would not have been better to provide work for its own labor force. As the Governor of the Reserve Bank of South Africa had noted, "There is little that monetary and fiscal policies can do to extricate economic decisions from the political considerations with which they are currently entwined." He encouraged the authorities to make speedy progress toward reaching the necessary sociopolitical consensus.

Ms. Bush said that the weak performance of the South African economy in recent years--as evidenced by developments in GNP growth, real investment spending, inflation, and unemployment--suggested that the obstacles to sustained noninflationary growth were fundamental and not transitory. That economic peformance had of course been costly to South Africa's population.

She shared the staff's concern that the authorities had been too little concerned about inflation, Ms. Bush confirmed. South Africa's financial sector was modern and sophisticated, resembling that of many OECD countries. Despite the potential to maintain effective monetary control, South Africa's inflation rate in the 1980s had been high relative to that of OECD countries.

There was a substantial risk of fueling inflation in maintaining nominal interest rates so low that estimated real rates had been negative since mid-1985, Ms. Bush considered. In addition, low or negative real interest rates discouraged much needed private sector saving, and encouraged capital outflows as asset holders sought higher returns--and overly capital-intensive modes of production. The high rate of growth of M3 in 1983 and 1984 seemed to have contributed--with a lag--to the higher rate of inflation; indeed, excessive monetary growth could have been a key factor in explaining the acceleration in inflation.

Given the need both for substantial increases in outlays for education, housing, health, and development assistance--as recognized by the authorities' own plans--and to control overall expenditure, less urgent activities would probably have to be curtailed, Ms. Bush noted. Failure to do so would call into question the authorities' commitments. On page 5 of the staff report, the staff drew attention to the curtailment of capital transfers to the National Housing Trust and to the Small Business Development Corporation. Was that consistent with the seeming agreement in South Africa that economic reform could be stimulated through expenditures in those areas? She certainly welcomed Mr. Links's statement on the disaggregation of educational spending, the heavier weighting of expenditures for the black population, and greater equity in the allocation of resources for housing. All these measures were very important because of the critical role of the further development of human capital in South Africa in the future performance of the economy.

It would be interesting to hear more about the Margo Commission's recommendations from Mr. Links and the staff, Ms. Bush remarked. The staff had given some indications of the reform that was being suggested, but it would be helpful to have information on the overall goal of the reform and its potential impact on business, individuals, and productivity.

Her authorities were pleased with the attention given in the staff report to structural matters, Ms. Bush said. They welcomed the repeal of residual job reservation restrictions in the mining sector in August 1987, following the earlier elimination of influx controls and improved black property rights. However, as the staff observed, the major restraints on labor market mobility remained--including the Group Areas Act--in addition to pervasive restraints on business activity by nonwhite entrepreneurs. In those areas, too, in addition to further action, the authorities needed to ensure that the prescribed deregulation policies were faithfully implemented.

The marketing boards--which set quantities and prices--were most likely obstacles to free economic activities, Ms. Bush noted. Her authorities were further concerned about the extent of the access of the nonwhite population--particularly the black population--to capital markets. Perhaps the Small Business Development Corporation could be appropriately utilized to encourage capital availability across the population. That effort could also be important in connection with privatization and with the encouragement of the private sector goals that the authorities had suggested were important to them. Further structural reform was most assuredly the key to growth and to improved economic conditions in South Africa. Without it, other policies could have only a very limited impact. With it, the large and growing labor force could be used much more effectively. It was therefore important that the authorities quickly address those areas of needed structural reform, including labor mobility, capital availability, and opportunities for business development for all sectors of the population.

Mr. Finaish said that he shared the concerns expressed by other speakers regarding the various distortions in the South African economy, particularly the severe structural problems caused by the policy of apartheid. The pervasive barriers against a majority of the population prevented, in a direct way, greater productivity and greater employment of the black population. The significant rigidities in the labor market had constrained the growth of the economy and had caused a shortage of skilled labor that had intensified inflationary pressures. Government policies had caused marked differences in the levels of education of different racial groups and, together with limited labor mobility with respect to both occupations and geographic areas, had led to wide disparities in wage rates and a highly skewed income distribution. Those policies had also resulted in a costly misallocation of resources, and there was an urgent need for structural changes--such as the removal of restrictions on labor mobility, the elimination of restrictions on trading and other business activities by blacks, and an expansion of government programs in education and training of the black population. It was disappointing that hardly any progress had been made in those areas, and that the system remained essentially unchanged with respect not only to labor mobility and the large gap in educational opportunities, but also other economic welfare indicators such as health and housing standards for the black community. He urged the staff to continue and to extend their analysis of labor market policies and structural distortions in the economy, as they were the most serious impediments to the economic development of the country.

Mr. Hogeweg stated that he agreed with most of the staff recommendations. The staff had correctly emphasized that its various recommendations should be part of a new policy package.

The authorities might have some room for fiscal stimulation at present, Mr. Hogeweg continued: the size of the public debt was not large, and the current account was in surplus. However, structural rigidities prevented the economy from responding to demand management, and a stimulating stance would soon run into external constraints. Attention should be focused on restructuring government expenditure to unlock the vast potential of South Africa's human capital. The supply-side effect of that change, coupled with the new market that it represented, would do much more for economic growth than shortsighted budgetary stimulus. The Government should also be aware of the likely upward pressure on expenditures in the future, and should prepare itself for that eventuality by creating sufficient revenue sources.

The same principle applied to monetary policy, Mr. Hogeweg remarked. The economy did not respond sufficiently to monetary stimulus because of rigidities and uncertainties, while low interest rates ran counter to the need for higher savings both to increase the growth potential and to prevent balance of payments problems. A considerable tightening of monetary policy was therefore clearly required.

The somewhat erratic behavior of the exchange rate observed in the past was not helpful, Mr. Hogeweg considered. Evidently nongold exports did respond to increases in competitiveness; therefore, the staff advocated a depreciation to make up for inflation differentials with trading partners. Greater emphasis should however be placed on the containment of domestic prices, which would allow the exchange rate to act--to some extent--as a nominal anchor and disciplining device rather than as an infinitely malleable instrument.

The staff representative from the Fiscal Affairs Department said that the staff had pressed the authorities for better data on the balance of payments and to provide disaggregated data on Namibia. The authorities had explained that energy data were not published for security reasons and were therefore unavailable. Separate data on Namibia were not released by the authorities, and despite the staff's requests, no data were made available beyond those contained in the background paper and the staff report.

The continuing high inflation rate had resulted in part from exogenous shocks, price shocks, the confidence related depreciation of the exchange rate, and the agricultural drought, the staff representative considered. All those developments had on the whole been accommodated by an easy monetary policy. There had been a rise in inflationary expectations which were firmly entrenched in the economy. As real wages had fallen heavily during 1985/86 and as profit margins had remained relatively stable, the staff considered that inflation was essentially a monetary phenomenon rather than the result of autonomous domestic cost pressures.

The South African economy was an immensely important engine of economic activity in southern Africa, and the linkages extended far to the north in complex ways--through distribution channels, forwarding agency arrangements, and the actual ownership of assets, the staff representative noted. The next staff report would examine the question of regional linkages in more detail. If the reform advocated in the Margo Commission Report was carried out by the authorities, it would have a major impact not only on the South African economy, but also on neighboring economies as well. One of the reports' recommendations was for a renegotiation of the South African Customs Union, which affected Botswana, Lesotho, and Swaziland. That renegotiation, according to the Margo Commission, would involve some favorable developments for neighboring countries--such as speedier transfer payments--and some less favorable developments, such as a change in the coefficient of 0.42 which was applied to all the payments made under the Customs Union. Those payments were described in the Report as being basically aid, and the Report suggested that that support should be made overtly in the form of assigned aid. The Report also suggested that the formula for the Customs Agreement should be changed so that the total pool of resources would be allocated by the formula to all parties and South Africa would no longer be a residual recipient of the remaining resources. Such changes would clearly have major consequences for other countries in the area.

The sharp cuts in the funds allocated to the Small Business Development Corporation and to the Housing Corporation in the current fiscal year did seem to go directly against the declared aims of the authorities to expand activities in the informal area, the staff representative from the Fiscal Affairs Department said. Those cuts were indeed substantial. Of the R 55 million that had been received by the Small Business Development Corporation in the previous fiscal year, only R 5 million had been allocated directly in the budget, while R 50 million had been the supplementary package allocated to the Corporation as part of a general stimulatory budget package. Similarly, almost half of the expenditure on housing aid was part of the June 1986 stimulatory package. The authorities thus viewed the allocations made last year as being a short-term stabilization measure that could be implemented according to the level of domestic demand. That approach might indeed not be the most desirable way to infuse resources into the informal economy, either in housing or in small business development. The uncertainty involved--especially in business development--was certainly undesirable.

Mr. Links said that there was clearly a growing concern among Directors about the underlying structure of the economy of South Africa. That concern reflected the increasing emphasis of the Fund on the need for appropriate policies over the medium and long run. That shift of emphasis by the Fund in dealing with adjustment problems was by no means unique to its dealing with South Africa; it had become a general theme of the Fund over the past few years--as had been clearly indicated by the numerous references to and discussions of the structural adjustment facility during the 1987 Annual Meetings. His authorities had come to align themselves with that new approach, acknowledging that until the proper socioeconomic structure was in place, the most ambitious and well-intended fine-tuning of monetary and fiscal variables would not bring forth the desired results in the economy. There was a realization in South Africa that there were underlying structural determinants of unemployment, inflation, and the lack of real growth as well as of the overall "weariness" in the various sectors of the economy. The Fund's message and Directors' comments had not gone unheeded.

His authorities were also aware that policies should also recognize changes in the structure of the economy in an appropriate way, Mr. Links continued. Hence, the piecemeal adjustments that had been made to the tax system over the past decade would have to be replaced by a coherent and comprehensive overhaul of the whole tax system, to take account of that structural change in the economy. The Margo Commission had also taken the long view, refraining from making any recommendations to tinker with the tax structure through ad hoc attempts to accommodate economic problems in the short run.

A further example of social change in the country was the development of social expenditures, Mr. Links noted. By ordinary budgetary standards the Government was actually dissaving to the extent that its current expenditure far exceeded its current income. But expenditures on education, health, and general improvement were regarded as essential to distribute the human capital formation process more evenly across the population. Those expenditures had enormous implications for the labor market in general and for the supply and productivity of labor in particular. Such expenditures could however be increased only within the bounds of an acceptable fiscal deficit in the first instance, and within the constraints imposed by the effects of such long-term investment on the inflation rate. Given those "negative externalities," the solutions suggested were not without their problems.

He fully recognized Directors' concern over the rigidities of the South African economy, Mr. Links said. But although the argument had often been made that not enough was being done quickly, the formal removal of impediments did not always lead to the desired results, at least not instantaneously, as the experiences of many other countries had shown. It was simplistic to expect that the repeal of discriminatory legislation in South Africa would normalize the labor market within just one year. Furthermore, social expenditure--educational expenditure, for example--to correct the present position, would only affect the supply of labor only over the longer term. Given the long-term character of human capital formation, the alleviation of unemployment in the interim was being promoted on various fronts.

The Chairman made the following summing up:

> In concluding the 1987 Article IV consultation with South Africa, Directors expressed broad agreement with the thrust of the staff appraisal. They noted that the recovery in output growth, evident since mid-1986, continued to be hesitant, while unemployment continued to rise, especially among the black segment of the population. Directors felt that the expansionary

fiscal and monetary policies pursued since mid-1985 had been largely ineffective in stimulating gross fixed investment, owing to the low level of confidence prevailing in the private sector. That underscored, in their view, the difficulty of influencing the economic fundamentals through macroeconomic policies alone when the present economic difficulties also had important non-economic causes. Directors believed that the expansionary financial policies, and most notably the low interest rate policy, risked exacerbating inflationary pressures and had encouraged a major shift of resources from liquid assets into equities and real assets. Directors concurred with the judgment that a preferable approach would involve a more restrictive financial policy stance, accompanied by a restoration of incentives to save, stepped-up deregulation of labor and output markets, increased reliance on export-led growth through the maintenance of an appropriate level of competitiveness, and a restructuring of public sector spending toward growth-promoting outlays, especially on labor-intensive activities. Those activities included, it was stressed by all who spoke, a reversal of recent cutbacks in the funds made available to the Small Business Development Corporation.

Directors recognized that the authorities' commitments to raising the standards of housing, education, health, and welfare of the lowest income sections of the society implied sharply increased demands on public sector resources. To accommodate those demands, while at the same time containing the upward pressures on total public sector spending, Directors urged the authorities to restrain the growth in other current public spending and, in particular, public sector employment, and to significantly strengthen expenditure control procedures. Directors also noted that, as reducing the budget deficit from the present high level remained an important policy objective, the room for lowering the overall tax burden was very limited. Instead, the tax base needed to be expanded and tax distortions corrected. In that regard, Directors welcomed the completion of a major inquiry into the tax structure of South Africa, and the authorities' intention to announce their tax reform decisions in next year's budget. Directors also noted the likely impact of any tax reform on South Africa's neighbors given the regional linkages.

On monetary policy, Directors stressed the importance of adopting a more restrictive stance in the immediate future and of framing policy over the medium term in a way that was consistent with the objectives of curbing inflation and restoring appropriate incentives for savings and investment. To that end, positive real interest rates needed to be restored.

Directors emphasized that on present policies the achievement of the authorities' modest growth target of about 3 percent per annum over the next three to four years, besides falling significantly short of the rate required to stabilize, let alone reduce, unemployment, was likely to run into an external constraint. Most Directors therefore expressed concern about the marked real effective appreciation of the rand that had taken place since late 1986, and stressed the need to, as a minimum, avoid further losses in competitiveness. That implied allowing the nominal effective exchange rate to slide in line with the inflation differential vis-à-vis partner countries.

Directors underscored the importance of accelerating structural reform and enhancing efficiency and competition in the economy. To that end, Directors called on the authorities to step up the deregulation of economic activity in support of small businesses and the informal sector of the economy. Such measures would, inter alia, tend to increase the labor content of growth and accelerate employment creation. With regard to labor market reform, Directors noted the progress made so far but stressed that much more needed to be done to improve further the geographical and occupational mobility of labor, achieve wage parity between racial groups, and unlock in general the potential contribution to growth that could be made by low-income groups.

The authorities were also urged to improve the quality, accuracy, and availability of geographical data on the balance of payments, and energy imports and consumption.

It is expected that the next Article IV consultation with South Africa will be held in accordance with 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/87/143 (10/7/87) and EBM/87/144 (10/9/87).

3. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/87/214 (10/5/87).

Adopted October 7, 1987

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 87/42 and 87/43 are approved. (EBD/87/248, 10/1/87)

Adopted October 7, 1987

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/87/215 (10/6/87) is approved.

APPROVED: May 16, 1988

LEO VAN HOUTVEN
Secretary