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04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/155

3:00 p.m., September 12, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	M. K. Bush
	G. Seyler, Temporary
	A. H. Mustafa, Temporary
	T. Morita, Temporary
	B. Goos
	Yang W.
J. E. Ismael	
	H. A. Arias
	M. Foot
	R. Fox, Temporary
	H. Fugmann
M. Massé	L. Leonard
	A. Abdallah
	M. A. Weitz, Temporary
Y. A. Nimatallah	
	J. E. Rodríguez, Temporary
H. Ploix	
J. J. Polak	
C. R. Rye	
G. Salehkhou	
	A. Vasudevan, Temporary
	N. Kyriazidis

L. Van Houtven, Secretary
K. S. Friedman, Assistant

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2. South Africa - 1986 Article IV Consultation . . . . Page 14

Also Present

IBRD: A. C. Tsantis, South Asia Regional Office. A. H. Peacey, Principal Resident Representative for South Africa; E. Matthee, Assistant. African Department: D. T. S. Ballali. Asian Department: P. R. Narvekar, Director; S. Ishii, S. Kohsaka, B. P. Pande, D. M. Ripley, A. Salehizadeh, S. Shah, D. Villanueva, R. C. Williams. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; U. Dell'Anno, H. B. Junz, J. S. Van 't dack, H. Vittas. Exchange and Trade Relations Department: J. T. Boorman, E. H. Brau. IMF Institute: J. R. S. Bohra, Participant. Legal Department: J. G. Evans, Jr., Deputy General Counsel; A. O. Liuksila, J. M. Ogoola, J. K. Oh. Research Department: D. Folkerts-Landau. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: W.-R. Bengs, L. P. Ebrill, S. Ganjarerndee, G. D. Hodgson, G. Nguyen, J.-C. Obame, A. Ouanes, R. Valladares. Assistants to Executive Directors: O. S.-M. Bethel, W. N. Engert, V. Govindarajan, G. K. Hodges, O. Isleifsson, Z. b. Ismail, M. Lundsager, W. K. Parmena, G. Schurr, S. Simonsen, H. van der Burg.

1. NEPAL - STAND-BY ARRANGEMENT - REVIEW AND MODIFICATION

The Executive Directors continued from the previous meeting (EBM/86/154, 9/12/86) their consideration of a staff paper on the review under the stand-by arrangement for Nepal approved on December 23, 1985 and requests to extend the expiration date of the stand-by arrangement for three months and to waive the application of the performance criteria for July 15, 1986 (EBS/86/182, 8/11/86; and Sup. 1, 9/8/86).

Mr. Fox said that, as many speakers had noted, Nepal had made progress in a number of areas under its first stand-by arrangement with the Fund. However, there had also been problems, most notably the persistent difficulty in keeping to the program's credit ceilings. Recent preliminary information indicated that the performance criteria on net domestic assets and net credit to the Government had been breached in July, for the third consecutive review period. He therefore supported the staff's recommendation that technical assistance should be provided in that area. However, he also wondered whether it was normal to test compliance with a program before complete information was available.

It was also worrying that the performance criteria had been breached in July, after net domestic assets had been put back on track in June, Mr. Fox continued. Perhaps monetary policy was not tight enough, even after the significant recent tightening, to achieve the performance criteria set for the remainder of the program. Since the authorities had asked for the program to be extended by three months and since the present review was only two months behind schedule, the Board should possibly have waited for an additional month's data, which hopefully would have provided an indication that the program was back on track before considering the request for a waiver.

Throughout the program, credit to the Government had been better controlled than credit to either the private sector or nonfinancial public enterprises, Mr. Fox went on. Poor monitoring had been one problem, but there had been important and welcome improvements on that front, and after the tightening of credit guidelines in April and May, credit to the private sector had come under better control. Unfortunately, the authorities had needed to rely on direct controls. However, the recent reform of interest rates, with the freeing of a number of deposit and lending rates, was welcome, and he urged the authorities to follow through by freeing up treasury bill rates and the central bank overdraft rate on lending to the Government--measures that would increase the influence of market mechanisms.

The breaches of indicative ceilings on credit to nonfinancial public enterprises had also been persistent and increasing, Mr. Fox noted. Indeed, they had been breached by 25 percent in the latest performance period. While ceilings on nonfinancial public enterprises were not performance criteria, the authorities should tighten up in that area for the remainder of the program. He would welcome staff comment on any measures that were planned to improve the performance of those enterprises.

The merits of the request for a waiver depended on an understanding of precisely why the credit ceilings had been continually overshot, Mr. Fox remarked. The processes at work in Nepal appeared to be complex. The staff report explained that the demand for money had been higher than assumed, partly because of higher than expected inflation, but also because of the unexpected size of the shift from Indian rupees into Nepalese rupees. He wondered if the main counterpart of that development had been the higher bank lending or greater external inflows. Elsewhere in its report, the staff explained that banks had been reluctant to curtail their lending in the face of an increasing deposit base under the influence of a faster than anticipated balance of payments turnaround. Whatever the reason, there were grounds for arguing that the program's problems had been caused by problems of design as much as of implementation in a country in which the Fund had had only limited experience. He would be interested in staff comment on that issue.

In the light of those considerations and in recognition of the authorities' cooperation with the Fund and their major efforts to comply with the program by introducing timely corrective measures, he was willing to go along with the waiver and the release of one further purchase, albeit a little reluctantly, Mr. Fox continued. In that light, he welcomed the additional program review that had been scheduled.

Improved domestic resource mobilization was essential, both to achieve the program's fiscal objectives and to ensure the availability of counterpart funds for foreign aid, Mr. Fox said. The measures on the revenue and expenditure sides were welcome because they further reduced the domestic financing of the overall budget deficit. However, the authorities should stand ready to introduce additional measures should slippages begin to occur. On the revenue side, the decision to implement most of the staff's recommendations were particularly welcome, given the low tax to GDP ratio in Nepal. On the expenditure side, continued efforts would be needed to restrain regular expenditures. The standstill on the civil service wage bill, which was planned to be continued the current year, was welcome, as was the review of development expenditures.

The failure of the planned sale of shares in some public enterprises was disappointing and gave cause to wonder whether private savings were adequate to support that objective, Mr. Fox noted. Although the legal problems cited as a reason for that failure should be solved in the current fiscal year, it might be necessary to effect some fundamental internal reforms of the enterprises in order to make them sufficiently attractive to potential buyers. He would welcome some further comment from the staff on that issue. At any rate, he would certainly join the staff in urging a major review of the finances of the public enterprises with a view to reducing subsidies substantially.

On external policy, the first steps toward import liberalization were welcome, and he urged the authorities to formulate a medium-term program for reducing quantitative import restrictions and replacing them where necessary with tariffs, Mr. Fox remarked.

The medium-term scenarios indicated that continued adjustment measures, including structural adjustment, would be needed beyond the life of the current program if a sustainably higher growth rate was to be achieved, Mr. Fox noted. Therefore, he welcomed the preliminary discussions with the World Bank on a structural adjustment loan and the close coordination with the World Bank on the current stand-by arrangement. He would also be interested to know about the plans for a structural adjustment arrangement with the Fund.

Ms. Lundsager made the following statement:

> Under this first stand-by arrangement that Nepal has had with the Fund, the authorities have made some progress in implementing the elements of the program. For a number of reasons, however, difficulties have arisen in managing monetary policy, and performance criteria have not been met since Board approval last December, despite the fact that overall fiscal and current account targets were met in the fiscal year just ended. In fact, the implementation of the program apparently has restored some measure of confidence in the Nepalese economy, as shown by the sharp increase in private capital inflows this year. It was also encouraging to see the higher rate of growth and the recovery in foreign exchange reserves from their low levels at the end of 1985.
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> A number of structural or supply-side measures were implemented this year in conjunction with the program under the stand-by arrangement, as well as the programs of the World Bank and Asian Development Bank. The measures included some crucial adjustments in input prices, particularly fertilizer, which were aimed at encouraging more rational use of these resources while reducing the budgetary burden of subsidies. Another important step was the expansion in commercial bank branches in the rural areas, which we view as critical to monetizing the rural sector and encouraging production at greater than subsistence levels. We welcome the assistance that the World Bank is providing to the industrial sector, including an emphasis on import liberalization--substituting tariffs for quantitative restrictions--and export promotion. We would appreciate any details the World Bank representative could provide on the export promotion measures. Regarding exports of jute, with the developments in world markets and the large losses incurred by the domestic jute corporation recently, we wonder if the authorities have reached a conclusion as to the appropriate course of action in this sector?
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> Finally, the most important export promotion measure is the flexible management of the exchange rate, which is central to providing adequate incentives. We noted though that there is a suggestion in the staff paper, and in the medium-term scenarios, that continued implementation of the structural adjustment program would imply that additional real exchange rate depreciation would

not be necessary. We would be interested in further staff comment on this, in light of the need for a broader and stronger growth in exports. Also, in our view these scenarios are extremely useful in pointing out that the high growth scenario, with balance of payments viability, requires continued structural adjustment, with the emphasis on adequate domestic resource mobilization for development purposes. Clearly, higher growth without structural adjustment is not sustainable. One final point on the medium-term scenarios, we noted that Nepal's overall debt servicing burden should remain manageable, and in that regard we would urge the authorities to place emphasis on securing concessional financing from sources such as bilateral donors, the Fund's structural adjustment facility, and the World Bank/IDA structural adjustment loans.

The overall fiscal deficit was lower than programmed despite the shortfalls in revenue that materialized. Expenditures were kept below levels expected in the program. The authorities are maintaining controls over current expenditures, with no general wage increase last year and none budgeted this year. An important effort is being made to provide adequate resources for the domestic component of development expenditures, although this may require additional constraints on current expenditures. The budget for next year is expected to generate a higher deficit, which we normally might view with some concern. However, current expenditures will grow only modestly, and the bulk of that higher spending relates to development expenditures. Efforts to improve aid utilization are particularly welcome. Furthermore, foreign financing is expected to increase, leading to a smaller net domestic financing need. I support Mr. Govindarajan's suggestion that the authorities prioritize their system of subsidies in order to attain their social goals within the resource constraints facing Nepal.

One disappointment was the lack of progress in selling public enterprises, reportedly owing to legal problems and a lack of buyers for some of the weaker entities. Efforts apparently will be made this year to improve these entities' marketability by continuing to emphasize appropriate price adjustments, but we wonder if the authorities should consider closing some entities in light of their very weak performance.

The primary area of difficulty under the program has been control over credit expansion. It is disturbing that while credit expansion guidelines were issued by the central bank, they were not passed down to the commercial bank branches, leading to an excessive expansion of domestic credit. Also, the authorities did not sell government securities as planned last year, leading to a larger than programmed use of credit by the Government. One problem appears to be the low rate of interest paid on these securities. We are also concerned that the system of automatic refinancing could lead to excessive credit expansion again. We would welcome speedy adoption by the authorities of the additional reforms recommended in the staff paper, which would broaden the set of monetary policy tools and enable a reduced dependence on credit ceilings. Perhaps such reforms could be part of a structural adjustment facility loan. Regarding interest rates, the decontrol of interest rates is especially welcome, although we are uncertain whether interest rates on deposits are in fact positive in real terms, given that the rate of inflation is about 15 percent.

These problems with the management of monetary policy led to the unfortunate result that performance criteria on net domestic assets and net credit to the Government were breached in January and April. We are therefore reluctant to be releasing a purchase at this time, especially in light of the information provided in the supplement, which shows that mid-July ceilings were also missed. We recognize that the program period is being extended by one quarter, with purchases rephased, and that a second review has been added prior to release of the final purchase. We hope that that review will put particular emphasis on progress in monetary policy management and public enterprise reform. Furthermore, in May and June several measures were implemented that appear to enhance the prospects for better results this fiscal year. In that regard, we must stress the importance of meeting the next set of performance criteria, in order to indicate that credit expansion is clearly under control.

In sum, while it is unusual to release a purchase following a period of missed performance criteria, the Nepalese authorities have performed fairly well in other areas--particularly, on the fiscal and external fronts--as was noted earlier. In that regard, it appears that meeting these targets is perhaps equally important to meeting the performance criteria on credit expansion; thus, we emphasize including these measures in performance clauses. Finally, attainment of these targets and the comments made by Mr. Ismael provide the assurance that the authorities are committed, cooperating with the Fund, and making substantial efforts to achieve the goals of the program. For these reasons, we can go along with the proposed decision, although still with some reluctance.

Mr. Goos made the following statement:

Overall, we share the favorable assessment of Nepal's recent economic performance, as expressed by previous speakers and by Mr. Ismael. Indeed, performance in many important respects has actually been better than required by the program targets, notably in the areas of the external current account and overall growth. This commendable progress can be largely attributed to economic policies that were broadly in line with the thrust of the program, notwithstanding the considerable complications resulting from the stronger than expected deterioration in the terms of trade, the large fiscal revenue shortfall, and the problems in the first quarter of fiscal year 1985/86 in the conduct of monetary policy. In general, I feel that the authorities have reacted to those complications in quite an impressive and decisive manner, in particular, by timely and sizable cuts in government expenditure and by adjustment in monetary policy. While this latter adjustment did not succeed in bringing the credit program fully back on track by the middle of this year, I can support the proposed waiver considering the relatively small deviations from the respective performance criteria and the apparent strong commitment of the authorities to comply with the program targets. I also feel that the proposed extension of the program period, including rephasing, is appropriate.

However, the slippages that occurred in fiscal and monetary policy clearly suggest that the authorities will have to increase their efforts in these areas. In fiscal policy, there seems to be an urgent need to strengthen budgetary procedures and tax administration, the latter because the specific measures employed to compensate for the recent revenue shortfall can hardly be repeated in the future, considering in particular the sizable cuts that had to be effected in domestically financed development expenditure. Moreover, I was somewhat disappointed to note that the program for 1986/87 envisages only a moderate improvement in the overall fiscal balance in terms of GDP--excluding grants--compared with last year's program target. Actually, it envisages a substantive increase in the deficit compared with the actual outcome for 1985/86. I recognize the points made by Ms. Lundsager in that regard but feel that the authorities should stand ready to take additional steps if new slippages should occur.

In addition, monetary policy needs to be strengthened and especially the monitoring capability of the Central Bank. While welcoming the steps undertaken in this regard, as well as a most commendable interest rate reform, one has to note that monetary expansion so far has been contained mainly by quantitative credit controls, and hence by measures that are anything but conducive to efficient allocation of resources, adversely affecting the profit situation of commercial banks. I therefore strongly support the advice of the staff and other speakers that the authorities create the necessary conditions in which monetary and credit policy can be conducted effectively through the use of interest rates and instruments for more direct liquidity control. I found the specific recommendations made by the staff in that regard most appropriate. Indeed, decisive and timely progress in this area would appear crucial to the ability to mobilize efficient domestic resources in order to support the development effort, including alleviating the considerable burden of recurrent expenditure associated with investment projects, while securing a viable balance of payments position.

Against this background, the staff's indication that "early action was not necessarily being contemplated" is quite disappointing. I would only hope that the authorities would reconsider that attitude. Early action regarding monetary policy would also be appropriate in view of the slippages that occurred in the inflation target. While I welcome the fact that the inflation rate is expected to be cut by roughly one third in the coming fiscal year, the prospective rate of 10 percent would clearly remain on the high side. Also, I found the objective embedded in the medium-term projections of only reducing the inflation rate to 5 percent by 1990/91 rather unambitious. To my mind, the authorities would be well advised to aim at a more forceful stabilization of inflation.

With these reservations in mind, I support the adjustment targets and policies envisaged for this fiscal year. Since I agree with the staff's analysis and recommendations in that regard, I will restrict myself to supporting only the staff's appraisal and the proposed decision.

The staff representative from the Asian Department stated that there would not be a retrenchment in aid utilization in the coming period. Aid utilization in the form of grants and net foreign loans had totaled SDR 168 million in 1985/86--a level that was approximately 14 percent higher than the previous year--and was projected to increase by 17 percent, to SDR 197 million, in 1986/87. The staff felt that that projection was feasible in part because of actions that were being taken with the assistance of the World Bank, the Asian Development Bank, and numerous donors to ensure more rapid disbursement of aid. In that regard, an important new element of foreign aid would be the prospective World Bank structural adjustment loan for the equivalent of $50 million to be disbursed over a period of 18 months. In addition, there were plans for the establishment of an investment program on the public sector side that would enhance supervisory skills and give more autonomy to project management--developments that would enhance aid utilization over the longer term. The staff's estimate for aid was lower than the authorities' budgeted number, which remained on the high side. Nevertheless, in local currency terms, there would be an increase in development expenditure on the order of 30 percent for 1986/87, which would indicate significant progress.

A question had been raised as to whether the persistent difficulties with the credit ceilings were due to problems of program design or of program implementation, the staff representative went on. The excess credit expansion had taken place in the period through October 15, 1985, before the program had come into effect, and the authorities had been unable to make up for that excess in subsequent months. The expansion of net domestic assets in the nine-month period ended July 1986 was estimated at NRs 1,448 million, compared with the program assumption of NRs 1,450 million for that period. There had been a tremendous amount of pressure on the balance of payments not only in 1984/85 but also in the first few months of 1985/86, and it had seemed appropriate to try to tighten credit as much as possible early in the program period.

A number of Directors had questioned the credibility of the July estimates of credit expansion and the implementation of the program in that area, the staff representative noted. However, substantial progress had been made in obtaining the estimates for July with a much shorter lag than in the past. It should be remembered that Nepal was a country with only five commercial banks, one of which was a newly established joint venture bank. Two of the banks were large government banks, and the Central Bank was represented on their Board of Directors for the purpose of reviewing loans. There was direct and indirect control over monetary policy, but even with direct guidelines, communication was poor. Indeed, the head office and the branch office communicated by shortwave radio, which was frequently interrupted. Often, currency was physically transported from one place to another around the country. Given those problems, the authorities had done a remarkably good job. The preliminary June figure for net domestic assets of NRs 12,960 million had recently been revised--by only NRs 42 million--to NRs 12,918 million. The authorities would benefit from additional technical assistance in compiling those statistics.

A number of questions had been asked about why credit to the public enterprises had expanded so rapidly, the staff representative remarked. The issue was not a question of monetary policy in one sense, because once the Government made a decision to finance a public enterprise, the Central Bank could do little to stand against it. For example, at the urging of various international institutions, the Nepalese authorities had tried to promote production of various cash crops, including jute. One of the techniques was to introduce a suitable minimum support price. That minimum support price had turned out to be very much on the high side in the light of developments in world jute markets. Consequently, the jute corporation had ended up with 15,000 tons of jute that could not be exported and which had had to be financed. Each of the public enterprise problems was different, and the authorities were looking into them individually.

As for the program of privatization, the Government's stated policy was, first, that there would be no new public enterprises, the staff representative indicated. Furthermore, the authorities were attempting to push the privatization program as fast as possible in the current year, although they did not expect the kind of progress that might have been expected a year earlier. All the public enterprises faced legal problems, and some of them were inefficiently operated and poorly managed. Indeed, no one wanted to buy shares in most of them. However, the authorities were beginning to face the issues of how and when to close each operation and would consider those questions further in the context of the Bank's structural adjustment loan and the arrangement that would eventually be proposed under the structural adjustment facility.

Other public enterprises, which were not included in the privatization program, tended to place the largest drain on the budget and the banking system, the staff representative noted. The reform of those enterprises would be implemented under the structural adjustment loan. The Agricultural Input Corporation and the Nepal Food Corporation carried out social functions and could not be expected to be managed as commercial ventures. However, the Agricultural Input Corporation, which sold subsidized seeds and fertilizers, had improved its financial position.

One Director had questioned whether a more aggressive real depreciation of the exchange rate would be helpful, the staff representative recalled. The staff was cautious in the area of the exchange rate in Nepal because it was a very open economy, especially to India. Furthermore, a major exchange rate adjustment had been made in late November 1985, and domestic prices had risen significantly. The devaluation had been effective in the sense that the index of traded goods prices had risen much more rapidly than the index of nontraded goods prices, benefiting the traded goods sector substantially. The Nepalese rupee had continued to depreciate significantly against the SDR and the improved overall competitiveness achieved at the time of the devaluation had been virtually maintained in real effective terms. The staff believed that the exchange rate was compatible with the achievement of the balance of payments objectives and the objective of strengthening the accounts over the period ahead as other structural measures were taken, assuming that the financial programs were implemented.

On structural measures, a first step had been taken toward import liberalization of all inputs for the industrial sector, the staff representative stated. Import licenses for nonaid imports were projected to increase over the previous year by 30-40 percent. Under the proposed system, each industrial enterprise would obtain a passbook on the basis of documentation of its import requirements for 1985/86, estimated in the light of its past experience and its production capacity. Once that amount was established, the company could import freely up to its entitlement.

Some Directors had expressed disappointment about the extent of the projected improvement in the overall budget deficit, the staff representative went on. The staff had emphasized the need to ensure that the domestically financed portion of the budget deficit was limited to make certain that it was compatible with the resource availabilities and the need to make credit available to the private sector. In the short term, there was also a need to enhance aid utilization. Development expenditures and imports were expected to rise in line with that increase in aid. Consequently, the extent to which the authorities were successful in utilizing aid more rapidly was going to be reflected in the overall current account deficit of the balance of payments and in the overall budget deficit. The ratio of the domestically financed budget to GDP, and the portion to be financed through the banking system in relation to GDP would, however, decline in the same period.

Finally, on technical assistance, the staff of the Fund and the World Bank would be discussing with the authorities at the time of the Annual Meetings the possibility of technical assistance in the area of budgetary management and monetary statistics.

The staff representative from the Exchange and Trade Relations Department noted that a question had been asked on the legitimacy of concluding the review and allowing Nepal to make a purchase, even though the final data regarding observance of some performance criteria were not yet available. Technically the decision would not constitute a waiver, as the precise amount of the breach of the performance criteria was not yet known. Although it was unusual for the staff to recommend such a decision in the absence of final data, it had felt that there was justification in the case of Nepal because the staff was fairly confident that the final data would be close to the preliminary data, which were favorable. Basically, the staff felt justified in making the recommendation to the Board because the authorities had taken strong measures to bring the program back on track. It was important to the authorities that the Board review and endorse those measures to maintain the momentum and the confidence that they would need to continue implementing the program.

The staff representative from the World Bank said that the proposed structural adjustment loan with Nepal would be the first such arrangement with the country. The Bank staff was in the process of submitting the documentation to the Bank loan committee requesting approval for appraisal. It had discussed with the authorities a number of areas which could be effectively covered in the context of a structural adjustment loan. The staff had focused on a number of areas that had not been effectively addressed in the past in the context of project lending and conditionality.

That first structural adjustment loan would focus on agriculture, industry, and the development expenditure process--selection of projects, auditing, and accounting, the staff representative commented. The Bank staff would also consider Nepal's macroeconomic framework in coordination with the Fund. The World Bank staff would also be discussing a number of measures in the industrial sector.

Mr. Ismael made the following statement:

> The Nepalese authorities are fully committed to pursuing vigorously the adjustment efforts. In this connection, they have implemented almost all policy measures agreed under the stand-by arrangement, including the introduction of a flexible exchange rate system, interest rate reform, the liberalization of imports, increases in administered prices of public enterprises, and a reduction in government expenditure and the budget deficit. In addition, the 1986/87 budget has also incorporated the agreed upon tax proposals. As a result, substantial progress was made in policy formulation and in achieving the program's objectives in respect of the balance of payments and economic growth. This,

however, is not to discount the departures from some of the quantitative policy limits of the program in 1985/86 and the fact that some adjustment measures were implemented more slowly than originally envisaged. These weaknesses are now being rectified.

For 1986/87, the authorities will implement measures that will consolidate the gains achieved in 1985/86. But the latest report that I have received from the authorities indicates that the production of paddy is likely to decline by 28 percent, as a result of drought in the food producing tarai zones. This will have implications for the management of the economy. Already, the donor agencies have been informed about the situation. The authorities are still working on the estimated shortfall in paddy production, and they will communicate this latest information as soon as it is known. In this connection, the three-month extension of the stand-by arrangement would definitely help the authorities in the orderly adjustment of the economy.

The Chairman said that he had been interested in the medium-term prospects of the Nepalese economy. It was obvious from the scenarios presented in the staff report that a small change in the distribution of public expenditure--mainly from current expenditure to development expenditure--and a modest increase in public revenue could altogether change the outlook for growth. In one scenario, growth was estimated to be 4.5 percent in 1987/88, whereas under the other scenario, growth was projected to be only 1 percent. Thus, it was important to have adjustment policies in place, and he hoped that the authorities would pursue the course outlined in the first of those two scenarios.

The Executive Board then took the following decision:

1. Nepal has consulted with the Fund in accordance with paragraph 3 of the stand-by arrangement for Nepal (EBS/85/264, Sup. 2, 12/26/85) and paragraph 3 of the letter dated December 3, 1985 from the Minister of Finance of Nepal, in order to review the progress made by Nepal in implementing the program supported by the arrangement and to establish suitable performance criteria for the remaining period of the arrangement and has requested an extension of the period of the arrangement to April 22, 1987.

2. The letter dated September 8, 1986 together with the technical memorandum from the Minister of State for Finance and Industry of Nepal shall be attached to the stand-by arrangement and the letter dated December 3, 1985 with annexed memoranda shall be read as supplemented and modified by the letter of September 8, 1986 together with the technical memorandum.

3. Accordingly,

(a) the period of the stand-by arrangement is extended to April 22, 1987;

(b) purchases under the arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 12.35 million until December 15, 1986 and the equivalent of SDR 15.5 million until March 15, 1987;

(c) Nepal will not make purchases under the arrangement that would increase the Fund's holdings of Nepal's currency in the credit tranches beyond 25 percent of quota:

(i) during any period in which the data at the end of the preceding period indicate that the quarterly limit on net domestic assets of the banking system or the quarterly limit on net bank claims on the Government set out in the technical memorandum attached to the letter of September 8, 1986 is not observed; or

(ii) if Nepal fails to observe the limit on the contracting or guaranteeing of new nonconcessional foreign indebtedness set out in paragraph 22 of the letter of September 8, 1986; or

(iii) during any period after March 15, 1987 until the review of the progress of Nepal in implementing the program supported by the arrangement, contemplated in paragraph 23 of the letter of September 8, 1986, has been completed.

4. The Fund decides that the review contemplated in paragraph 3 of the stand-by arrangement is completed and that Nepal may proceed to make purchases under the arrangement.

Decision No. 8391-(86/155), adopted
September 12, 1986

2. SOUTH AFRICA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with South Africa (SM/86/185, 7/30/86; and Sup. 1, 9/9/86). They also had before them a background paper on recent economic developments in South Africa (SM/86/217, 8/28/86; and Cor. 1, 9/5/86).

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

Mr. Peacey made the following statement:

In examining the particular aspects of the South African economy highlighted during the course of Article IV consultations in June 1985, the most useful discussions with the staff in May and June this year focused on the need for firm medium-term stabilization policies and structural adjustments aimed at enhancing domestic growth and engendering improvements in the overall balance of payments position of the country.

My authorities noted with deep gratitude the considerable efforts of the staff, evidenced for instance by the voluminous information set out in SM/86/217 to come to grips with the complexities characterizing socioeconomic conditions in my country. In view of the uncertain dynamics of current economic prospects, I wish to express, furthermore, appreciation to staff for the supplementary report (SM/86/185, Sup. 1) on the trend of events subsequent to those covered by their earlier comments.

Taking all these observations into account, my authorities are in accord with the broad thrust of the analysis in SM/86/185.

Given the detailed update provided by staff, I shall confine my own comments to a few broader issues emanating from these staff reports.

Long-term developments

For decades, my authorities have been promoting domestic economic growth by encouraging the unrestricted competitive exploitation and exportation of the country's extensive natural resources by local and foreign entrepreneurs. As international commodity and financial markets provided a propitious environment for the pursuit of this policy, these endeavors were highly successful. In keeping with long-term global cyclical trends, South Africa experienced unprecedented, largely inflation-free expansion--at an average annual real GDP growth rate of some 4.9 percent--between 1946 and 1974.

The relative slowdown since 1974 in South Africa's export growth and the weakening of the terms of trade--apart from the "gold bonanza" period of international financial instability from 1978 to 1980--are naturally also related to the leveling out of world production and changes in the pattern of global economic activity associated with the rise of service and high-technology industries.

On the other hand, the expansion of a wide-ranging and far-flung mining industry necessitated the establishment of an extensive physical infrastructure, stimulating the development of a specialized and diversified supportive secondary industry and related technology and services. As a result, the country was increasingly identified as an industrial country, so that by 1984, 68 percent of South Africa's foreign liabilities were related to the pursuit of manufacturing, trading, and business servicing activities; 17 percent to transport, communications, and energy; and scarcely 14 percent to agriculture, construction, social services, and the mining industry.

What has increasingly distinguished South Africa from the industrial countries, however, is the rapidly growing black population reflecting sub-Saharan demographic characteristics.

In keeping with prevalent problems worldwide, it was virtually inevitable that the set-off of flagging world absorption against the population explosion in an open economy, at a time of ratcheted welfare expectations and lagging and unbalanced supply-side capabilities, would engender rising inflation and unemployment.

My authorities have for some time recognized that in such circumstances policy dictates must obviously provide for a multifaceted long-term development program addressing market imbalances in accordance with causal constraints and impediments. Numerous far-reaching structural changes in keeping with Fund surveillance guidelines and globally accepted development policies have therefore been introduced, with the passage of time and after comprehensive investigation, as will be evident from a comparative study of staff reports on South Africa.

Moreover, as indicated in my statement on June 6, 1985, the State President's Committee on National Priorities has been engaged in efforts, first, to reduce the level of government involvement in the economy and, second, to restructure public sector expenditure priorities in line with longer-term economic development and social restructuring objectives, addressing in the process the questions of privatization and deregulation.

Short-term developments

As is now evident, the economy reached the lower turning point of the business cycle in about mid-1985, i.e., at about the time of the Board's last Article IV meeting on South Africa. The restrictive fiscal and monetary policies of the preceding year had by the first quarter of 1985 eliminated excess consumption demand, transforming the current account of the balance of payments into a large surplus and enhancing the repayment of substantial amounts of foreign short-term debt.

After declining by 1 percent in 1985, given current uncertainties, gross domestic product is not expected to increase by more than 1-2 percent in 1986, hardly a sufficient stimulant of consumption or an inducement to invest, despite increasing liquidity as evidenced by steadily declining interest rates.

With the current account of the balance of payments continuing to show a large surplus and while credit utilization, investment, inflationary pressures, and per capita real income continue to decline, rising unemployment and surplus capacity have made it increasingly imperative from the welfare point of view, particularly as regards the lower-income section of the population, that monetary and fiscal policy should not only not inhibit growth in the short term, but also, on the contrary, be moderately expansionary.

The budget proposed by my authorities in March this year was thus most significant in two respects. First, in the structural sense, it placed a new emphasis on the supply side of the economy by concentrating on the upgrading of the socioeconomic infrastructure and related services. Second, in the cyclical sense, it pursued the mildly expansionary trend identified in September 1985 by providing, inter alia, on the revenue side, for reductions in income tax rates and, on the expenditure side, for the alleviation of social distress, drought relief, labor training, the promotion of small business enterprises, constitutional, economic and social development affecting both rural and urban areas.

These measures were followed by the Finance Minister's announcement--during the parliamentary 1986/87 budget debate--in June 1986 of a further R 1,200 million--the major portion of which possibly will be spent in the current financial year--stimulatory "package" at a time when it was widely feared that the mild upswing that was developing during the last quarter of 1985 had lost momentum during the first quarter of 1986. The package included the early repayment of loan levies, abolition of the import surcharge on certain categories of imports, as well as rebates on excise duties payable on motor vehicles.

Giving effect to a provision of some R 750 million for low-cost housing, which also formed part of the package announced in June 1986, the establishment of a housing trust fund in the private sector was announced last month. R 400 million will be made available to the trust fund to enable unemployed people to acquire homes under a self-build scheme. The remaining R 350 million will be spent on housing and labor projects identified by the public sector with a view to immediate implementation.

Since our consultations last year, however, one further development has had an impact on the economic situation, namely, the change in the attitudes of foreign lenders with financial exposure to South Africa, as a result of distorted perceptions with respect to the evolving dynamics of the sociopolitical dispensation.

As the authorities of a country with significant international commercial interest, my Government, while recognizing and continuing to pursue the benefits of international trade and finance, must take note of the longer-term effects of the rising tide of protectionism in many industrial countries. They have not been slow to note, for instance, the observation contained in the World Development Report 1986 that "protectionism in industrial countries on average has intensified, and nontariff barriers to trade--as opposed to tariffs--have proliferated in markets that are of present or potential interest to developing countries--such as textiles and clothing, steel, and agricultural products."

Medium-term objectives

My authorities readily concede the importance of a frequently stated contention that, given present uncertain circumstances surrounding the future evolution of the economy, it is highly necessary for them to enunciate and explain the medium-term economic implications of the Government's objectives for structural change and, in the process, to cost out clearly stated priorities and policy intentions. However, it would also be apposite to make a few observations in this regard.

First, generally speaking, the South African economy, having been committed to a system of private ownership and private sector initiative, is essentially reliant on efficient markets. It is the explicit and continuing objective of the Government to effect improvements to the extent that markets fall short of this dictum. It is, therefore, most unfortunate that the pursuit of this philosophy is to an increasing extent being impeded by external actions motivated by noneconomic objectives. Despite these developments, however, it remains the objective of the Government to continue as far as possible to manage and provide guidance to the economy through resort to market mechanisms.

Second, as far as structural changes are concerned, it is important to recognize and acknowledge that: the sociopolitical changes that are taking place in the country have an important effect on economic development; the urbanization program could become a major incentive for further economic growth; in view of changed external financial relations, South Africa is forced to rely more on its own sources of finance and this has important implications for priorities for both current government expenditure and all capital projects of the public sector; and that the greater emphasis on social upliftment, education, and housing will strongly affect the nature of government expenditure in future.

Consequently, third, having already recognized the wisdom of the continued pursuit of conventional monetary and fiscal policies propagated by the Fund, my authorities are at this time even more committed by circumstance to the imposition of greater discipline by such means as money supply targeting, the setting of priorities for reduced government expenditure as a percentage of total expenditure, privatization, and deregulation.

The imminent outcome of the Commission of Enquiry into the Tax Structure of the Republic of South Africa--Margo Commission--will also be thoroughly assessed in the light both of the evolving constitutional situation and the changing economic circumstances as outlined above with a view to optimizing the impact of the ensuing redistribution of income.

Finally, I wish to emphasize the recurrent theme of the economic policy embraced by my authorities with respect to the critical role of the individual entrepreneur in promoting economic growth. Responding in July this year to the recommendations of the Committee for Economic Affairs of the President's Council on a strategy for the development of small business and deregulation, the Government is, inter alia, giving effect to the deregulation guideline that all businessmen in South Africa should "operate their businesses in terms of procedures and subject to standards which are in all respects equivalent, provided that existing alternative standards which are less costly and more simple should be retained without distinction on the basis of race to take into account the needs of developing communities in South Africa."

Mr. Foot said that the South African authorities' policy stance in 1986 could be seen as an attempt to boost growth--largely because of the serious unemployment problem--and to maintain a substantial balance of payments surplus. The attempts to boost growth ran along fairly orthodox Keynesian lines. As the latest staff supplement demonstrated, the budget deficit was likely to be substantially higher in 1986/87 than was originally planned, partly because of developments in the first four months of fiscal year 1986, when expenditure ran 20 percent higher than the previous year, while revenue was only 16 percent higher. It was also expected to be higher because of the likely impact in the remainder of the year of the reflationary package announced in June.

Thus far, the policy stance appeared to have helped to produce a modest revival in activity, Mr. Foot continued. Some of the measures announced, especially those relating to the expansion of low-cost housing, were likely to be labor intensive in areas of the economy with high unemployment. Therefore, they should have little direct adverse effect in terms of their impact on prices and wages. However, over the longer term, there remained the more open question of how the increased public sector deficit would be financed. The authorities had secured the financing for the current year largely by, as the staff put it, "overborrowing on the capital market." However, that approach would take care of the current year only. The longer-term implications, especially for the cost of government borrowing, remained to be reckoned with. Furthermore, if the Government's long-term objectives in areas such as education were to be realized--and with them a significant advance was to be made in tackling structural weaknesses in the South African economy--then the tax base undoubtedly needed widening.

In the short term, the authorities' desire for faster growth was presumably boosted by the recent strength of gold and platinum prices, Mr. Foot went on. He wondered whether the staff had any rough estimates of the effects that development might have had on the fiscal position, current account, and growth prospects, assuming that the current prices of those commodities persisted through the coming fiscal year.

Another question in determining the likely persistence of renewed growth was how far the depreciation of the rand was likely to boost industries relevant to import substitution, Mr. Foot considered. The staff had appropriately noted that export-led growth was unlikely to follow from the decline in the value of the rand, but import substitution was perhaps a more meaningful area for discussion.

As for monetary policy, it would appear reasonable that the authorities should continue to focus on a range of monetary indicators rather than on any particular one, Mr. Foot remarked. However, the most difficult thing to assess would be the interrelationship between the apparent buildup of liquidity in South Africa--which presumably could be augmented in the short run if mining companies' profits rose on the back of higher commodity prices--and the need to limit both capital flight and a resurgence of inflationary expectations. He would appreciate any staff comments on those issues. Finally, on the external side, the key issue was clearly the adequacy of the current account surplus and credit to meet the financing need generated by South Africa's external debt.

Mr. Fugmann made the following statement:

> We are in broad agreement with the appraisal and with the staff's critical assessment of South Africa's economic policies. As pointed out by the staff, no assessment of the economic situation in South Africa can be divorced from what it calls sociopolitical considerations. The economy is characterized by difficult structural problems that, for the most part, are rooted, in our view, in the apartheid policy.
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> The reduced confidence of the outside world, particularly foreign enterprises and banks, is, of course, explained primarily by the unstable political and social situation. Without an inflow of foreign capital, it is not possible to attain the growth that is needed, among other things, to reduce unemployment. South Africa's current difficulties in obtaining external borrowing are well known; therefore, in order to re-establish creditworthiness, a fundamental change in attitude by the authorities toward the real problems in the economy is needed.

The staff refers particularly to unemployment and the underemployment of labor resources as being among the most serious problems that policies have wrought. According to the staff, the unemployment rate among blacks is roughly estimated to be between 30 and 50 percent, while, for a long time, there has been a lack of skilled labor. Productivity of a large portion of the labor force is hampered by the forced, unreasonable travel time between home and work.

In order to create a sufficient number of jobs, massive efforts regarding infrastructure, housing, and education are needed. We concur with the staff that the efforts now planned for this purpose are insufficient. Instead, enormous resources are now tied up in a bureaucracy, which monitors various rules and regulations of apartheid and, as a consequence, an economically destructive panoply of controls.

The attempts that are now being made to stimulate the domestic economy and that are, in themselves, characterized by irregularity, are only artificial. This is also evident in the projections for the rate of growth. Investment is decreasing, and the balance of payments surplus has to be used to meet foreign creditors' demands for decreased exposure. At the same time, unemployment and the rate of inflation are rising. On the whole, developments are affected by the lack of confidence that the Government's policy faces domestically and abroad.

We agree that the choice of a "siege economy" option should be eschewed, as this would only worsen the ineffective allocation of resources and lead to still higher administrative costs. In the medium term, such a strategy will be self-defeating as the economic and political tensions would be destructive.

It is our view that, in order to bring about stabilization and a recovery in the South African economy, basic changes designed to lead to the abolition of the system of apartheid are needed. The measures that have already been taken, or are on the horizon, neither change the foundations of that system, nor, consequently, the preconditions of the country's social and economic development.

Mr. Abdallah made the following statement:

When one reads and reflects on what has been happening in the Republic of South Africa during the last 12 months or so, it is impossible to avoid the conclusion that sociopolitical tensions of monumental proportions are unfolding there that impinge on all aspects of life not only within the Republic itself but also over a large part of the African continent as far away as the equator.

Tensions of such intensity clearly have implications for international economic cooperation and world peace, and, because of this, they have inevitably attracted considerable external interest and generated international concern. One manifestation of this concern took the form of a special mission to South Africa which was agreed upon by Commonwealth leaders in October 1985 and was dispatched at the beginning of this year. The mission's report is essential reading for anyone who is interested in the welfare of Africa and begins in these words: "None of us was fully prepared for the full reality of apartheid. As a consequence of social engineering, it is awesome in its cruelty. It is achieved and sustained only through force, creating human misery and deprivation and blighting the lives of millions."

The staff report, with whose analysis and appraisal I am in broad agreement, could not help being affected by the electric atmosphere that now pervades the whole country. It departs somewhat from the neutral terminology that usually characterizes Fund documents, which can clearly be seen from the first paragraph on page 2, which reads as follows:

> Economic, financial and sociopolitical conditions in South Africa came under increasing strain in 1985 and 1986 as political unrest at home and pressures abroad for a significant reduction of political and social inequalities interacted. The consequent erosion of confidence has prolonged the cyclical downturn of 1984 and has frustrated policy attempts to engineer a recovery. Whereas political uncertainties play a major role in the apparent unresponsiveness of the economy to easier demand management policies, the slowness with which policies addressed the aftermath of the commodity boom of the 1970s, together with the rigidities imparted largely by the apartheid laws, are important elements as well.

I have examined the statement of Mr. Peacey with great care to see if it could shed any light on how his authorities propose to reduce the existing tensions, stabilize the economy, and promote social equality and genuine political cooperation within the country. I regret to say that I have not seen anything to give me even temporary comfort. He has made allusions to "longer term economic development and social restructuring objectives" and to the need to reduce unemployment "from the welfare point of view, particularly as regards the lower income section of the population." There is acknowledgement on page 4 of his statement that "the sociopolitical changes that are taking place in the country have an important effect on economic development" and also that greater "emphasis on social upliftment, education, and housing will strongly affect the nature of government expenditure in future." On page 5 he speaks of "the evolving constitutional situation," without stating the ultimate objective of that evolution.

These allusions are not clear enough, nor do they amount to the bold and comprehensive statement of policy that is urgently required to deal with the explosive situation. That some institutional changes are being effected cannot be denied, particularly in opening up public amenities like hotels, cinemas, parks, and libraries. There is increasing desegregation in work places, the Mixed Marriages Act has been replaced, and so have the pass laws. More changes have been promised.

But the fundamental question is this: do such changes have a real impact on the lives of the black people? The finding of the Commonwealth Mission is that they are not meaningful because apartheid in its "essential elements" remains "very much intact." Mr. Peacey will no doubt disagree with this finding, probably regarding it as arising from "distorted perceptions." After all, those words are how his own authorities described the actions of foreign lenders who refused to renew credit lines to South African banks in September last year.

Having given this essentially political perspective to the discussion, let me now turn to some economic issues where performance has been less than expected. The first such issue concerns monetary policy, which has appeared insufficiently defined to the extent that while short-term interest rates have been held low, long-term rates have remained very high, underlining strong inflationary expectations among economic agents. With renewed pressures on the domestic capital market, interest rates are bound to rise in the short term as well as in the long term.

So far as fiscal performance is concerned, I must say, as in the past, that the staff papers would have been more useful had they presented a consolidation of the entire public sector since the operations of public enterprises are significant and generate deficits of their own that sometimes amount to as much as 6-8 percent of GDP. In any case, the Central Government itself has continued to grow unchecked relative to GDP, as its expenditures reached 26.9 percent of GDP in 1985/86. Most of the budget is nontransparent, as the staff pointed out, largely because most expenditures go to buttress the threatened apartheid system, in such items as the maintenance of "homelands" and other transfer payments. The combined deficits of the parastatals, together with that of the Central Government, amount to about 10 percent of GDP. Considering the fact that access to external finance is now no longer available to South Africa, deficits of this magnitude are not sustainable and will have serious consequences for inflation and interest rates.

The potential repercussions of these policies are not limited to South Africa but impinge on neighboring countries represented by this chair because of the close economic ties that South Africa has deliberately forged with its neighbors as a means of ensuring their dependence on it. Indeed, the prevailing high levels of inflation, at about 18 percent, induced primarily by the depreciation of the rand, have already caused the Rand Monetary Area to be abandoned and new arrangements to be created, as explained in Appendix II of the staff report.

I am pleased to note from the staff report and from Mr. Peacy's statement that the authorities are fully aware that the apartheid laws do not allow the labor market to function properly. At the same time, however, I cannot help noting that the authorities' declaration to increase employment opportunities and raise the quality of black labor are full of contradictions and lack credibility. There are numerous impediments to geographical mobility that deliberately fragment the labor market. I find even the estimate of 50 percent unemployment among the black population to be on the lower side. One indication that these figures show suppressed levels is to be found on page 13 of the staff paper on recent economic developments where it is noted that "in anticipation of the lifting of the influx control laws, there was a large inflow of people from the rural areas into selected metropolitan areas in search of work. While no formal count has been made, it is believed that several hundreds of thousands converged in locations close to metropolitan centers." This is surely a clear indication that if there were free mobility and full registration of the unemployed in South Africa, the numbers of unemployed black people would be staggeringly higher.

The question of education and training, and the consequent narrowing of wage differentials, is another aspect of social policy that the Government says it intends to modify. So far, no detailed policies have been announced to back up the intention. In the nonagricultural sector, the average wage of a black worker is only 26 percent of that of a comparably employed white. With a view to eliminating the productivity gap, the Government has stated its intention to upgrade housing, education, and health for blacks. The intention is to achieve parity in per capita expenditures on education and health in about 10 years. However, as the staff has demonstrated in Appendix III of the staff report, this is not realistic in view of the level of resources that would be required or income redistribution that would have to be effected in order to attain the goal. In fact, current policies do not indicate any serious effort in that direction, especially if one takes into account the present gap, in which expenditure on a white student is more than five times that on a black student. Indeed, the little information we get from the media indicates that black schools have even been closed down since the state of emergency was declared a second time. As regards training programs, we note without surprise that the number of people who have undergone such training fell in 1985 compared to 1984.

Let me finally turn to the question of data under which I wish to raise two questions. The first concerns data for Namibia. In the past, this chair has stressed the desirability of disaggregating data of this special territory from that of South Africa, and I would appreciate staff comment concerning progress in this respect. Such disaggregation is absolutely essential to safeguard the mineral wealth of this forcibly administered country from unethical exploitation of its resources, which, I understand, is now going on.

The second question concerns data on energy availability and consumption in South Africa itself. It is noted that South Africa continues to withhold all data on energy imports and consumption contrary to the provisions of the Articles of Agreement of this institution. This information is essential not only for the comprehensive analysis of the South African economy but also for the appraisal of the economies of neighboring countries that are members of the Customs Union with the Republic of South Africa. On these two matters--namely, separate data for Namibia and full information on energy supplies and consumption within South Africa--the authorities are not collaborating fully with the Fund. I would appreciate staff comment on what action the Fund proposes to take to ensure compliance as soon as possible.

Mrs. Ploix made the following statement:

Like other Directors, I share most of the staff's analyses and recommendations. Therefore, I will limit my remarks to the following issues: fiscal policy, monetary policy, unemployment, and the debt situation.

With regard to fiscal policy, the useful information given by the staff in Supplement 1 to SM/86/185 clearly shows a continued deterioration. The budget deficit, which is almost double that of the original estimate, is now expected to reach 4 1/2 percent of GDP, owing to expenditure overruns and the adoption of stimulatory measures. The staff states that the authorities have already secured most, if not all, of the additional required borrowing by overborrowing on the capital market. I would appreciate some further elaboration on the sources of financing this deficit.

In this context, monetary policy will bear the brunt of the adjustment, and it is therefore important not to relax the restrictive stance, especially given the worrisome and increasing rate of inflation, as shown by the chart of page 6 of the supplement to the staff report. This is all the more worrisome as a pickup in income streams is forecast, and expectations are unfavorable. The staff seems uneasy with the present monetary stance. I would appreciate staff comments on the current situation. Because negative interest rates favor capital-intensive investment, I wonder whether a change of policy on real interest rates is not warranted.

The policies so far implemented do not seem to fully address the situation, especially at a time when the country is facing a formidable unemployment problem. I would appreciate staff elaboration on its assessment that "the authorities, so far, have been unable to set the economy on a positive course through the application of traditional demand management tools."

The current level of unemployment, 2 million people, is cause for concern. The growth rate that would allow a stabilization of this figure--3.5 percent, according to the authorities--appears out of reach: maintaining the present level of activity is already optimistic. As a matter of fact, as suggested by the staff, unemployment in South Africa is due to considerable structural rigidities such as constraints on the mobility of manpower, unequal and insufficient access to education and vocational training, and wage differentiation not based on market principles. We urge the authorities to tackle these rigidities.

I would like to touch upon the problem of the debt situation by welcoming the decision taken by the South African authorities to solve, through contractual negotiations, the difficulties linked to their external debt servicing. The staff has presented in Appendix III of the staff report a useful table. Some explanation would be helpful on the underlying assumptions beyond 1987.

To conclude, the case before us is undoubtedly a very difficult and complex one. As rightly put by the staff, "any assessment of the economic situation in South Africa cannot be divorced from noneconomic considerations. In any context, the task facing economic policy is a formidable one, as it involves a program of fundamental social change with far-reaching implications for the longer-term growth and employment pattern of the economy." My authorities do hope that appropriate solutions will be found as soon as possible.

Mr. Massé made the following statement:

I broadly agree with the staff's analysis and recommendations; so I will confine my comments to two areas that I would like to emphasize: the need for a more credible, consistent approach to macroeconomic policy in South Africa; and the urgent need for structural change, particularly in the labor market.

Developments in the South African economy over the past few years have been very disappointing. To a degree, part of South Africa's difficulties result from adverse external developments. However, as the staff paper makes clear, South African economic policy has left much to be desired. In fact, the difficult external aspects, particularly the cessation of new credit to South African residents and the required repayment of principal, are a response to conditions in South Africa that have been engineered largely by South African policy.

As the staff points out, the current macroeconomic strategy in South Africa is characterized by a conflict between short-term and long-term objectives. Faced with weak economic activity and faltering demand, the authorities have introduced fiscal stimulus and an accommodative monetary policy in the hope of reversing recent adverse developments. However, this approach is inconsistent with the authorities' stated medium-term objectives. And, it is an example of a disturbing tendency to fashion piecemeal policy responses to fundamental problems.

The South African authorities' approach to macroeconomic policy is a good example of time-inconsistent policy: that is, the policy stance is clearly not appropriate for a medium-term horizon, although it appears to be expedient for the short run, and therefore attractive. However, as many members of the Fund have learned in the last two decades, such an approach to demand management is not helpful, is ultimately counterproductive, and can be very costly. This may be especially so in South Africa's case, where the fundamental difficulty is the tremendous uncertainty facing the country, the lack of demonstrated credibility in economic management, and the lack of confidence that has resulted, both internationally and domestically. Therefore, I would urge the authorities to adopt a macroeconomic policy approach that is more consistent, credible, and sustainable. And, I strongly agree with the staff that the South African authorities must announce and explain the economic implications of their medium-term objectives, including structural objectives.

My second point is an equally fundamental one. On other occasions, this chair has noted the serious structural distortions in South Africa imposed by South African regulatory and social policy. In this connection, I am surprised that the South African authorities view their policy orientation as consistent with the principles of a market economy.

It is hard to take this view seriously in the face of the overwhelming barriers to access and mobility which have been erected and repeatedly reinforced within the South African economy. The most pervasive and notable example of such distorting policies are South Africa's labor and manpower policies. Quite apart from the repugnant social consequences that South Africa's manpower and labor policies have, these have also exacted a tremendous economic cost independent of the effect of sanctions that such policies attract. By impeding the geographical, occupational and social mobility of the majority of the work force, South African policy has diminished the pool of available skilled labor and diminished its capability to create employment and generate income.

While the South African authorities apparently acknowledge these severe economic costs and recognize that a considerable part of South Africa's poor productivity performance has derived from the apartheid laws, they have been painfully slow in removing the extreme barriers within their society. Some efforts are being made to remove legal constraints on the mobility of labor, and the authorities apparently have undertaken to redress the imbalances in social expenditures across various groups of the population, but this policy response is minute in comparison to the magnitude of change which the situation demands.

I sincerely hope that the South African authorities will be seized of the need for further fundamental changes and adjustments in national policies in a timely fashion so that the economy can grow to the benefit of all the people of South Africa.

Mr. Goos made the following statement:

South Africa is undoubtedly facing extremely difficult problems, which culminated most obviously last year in the imposition of the debt standstill. Given the magnitude of those problems, one has to recognize that the authorities have been quite successful in containing domestic and external financial imbalances so far as a result of generally appropriate economic policies. I also welcome their apparent commitment and effort to regularize their financial relations with external creditors.

Now, in assessing the present economic situation, like previous speakers, I also feel that the staff is right in stressing that such an assessment "cannot be divorced from noneconomic considerations"--considerations, I might add, that directly lead to the root of the existing difficulties. Indeed, it appears that without early and forceful progress on the socioeconomic front, the situation would deteriorate even further as a result of the already low and declining confidence and the adverse repercussions on the availability of savings and on investment activity. Compared with those problems, stimulatory measures like the fiscal policy package adopted recently and the expansionary monetary stance, as also mentioned in Mr. Peacey's helpful statement, appear of little avail. The likelihood is even greater that they will aggravate the situation by accelerating inflation and inducing additional capital outflow.

Against this background, the structural reform measures described in the staff report are undoubtedly important steps in the right direction, most notably the efforts to eliminate the existing impediments to geographical and occupational labor mobility and those directed toward increasing the resource flow into social and infrastructural investment, benefiting hitherto disadvantaged population groups, notably the black community.

Nevertheless, it appears that more needs to be done to stabilize the social and economic situation, and I say this in full recognition of the enormous difficulties the authorities are confronted with in tackling the deep-seated structural distortions. But there is compelling evidence that time is running short. In this context it is noteworthy that, according to the staff report, the authorities themselves "acknowledged that a considerable part of the poor productivity performance derived from the apartheid laws." Since poor productivity and resulting high unemployment lie at the heart of the economic problem, vigorous progress in abolishing those laws would clearly be called for on merely economic grounds. Such an approach--if forcefully designed, widely publicized, and supplemented by a convincing strategy on how the authorities intend to deal with medium-term economic implications--should go a long way toward rectifying what Mr. Peacey describes as "distorted perceptions with respect to the evolving dynamics of the sociopolitical dispensations." In any event, like others, I feel that such a policy would be critical to restoring domestic and international confidence in the prospects of the country, and hence to the mobilization of the financial resources that are badly needed--not least from abroad--to solve the enormous task of integrating the unemployed and growing labor force into productive activity.

Mr. Kyriazidis made the following statement:

The South African situation is a most extraordinary one from the Fund's point of view. As we all know, it is the cause of grave concern to the international community as a whole. The situation is such that economic developments and policies in *South Africa cannot be constructively discussed except in the* light of progress toward achievement of consensus about fundamental changes in the political and social structure of the country that constitute the major prerequisite for the elimination of the existing explosive and severe domestic and international tensions, restoration of confidence, and the resumption of a process of economic growth that will benefit the entire population of South Africa.

The staff is aware of these wider aspects and, in fact, references to them are a recurring theme in the report, which at times is somewhat bewildering reading. If I have caught the main thread of the argument in the report, it would seem to be that noneconomic factors--namely, the explosive tensions that have developed in the last few years and the attendant justified reactions of the international community--have become important determinants of economic behavior and major impediments to the effective administration of policies. If this interpretation is correct, one may be justified in having some difficulty in assessing the relevance of the more detailed analyses and recommendations in the report. For example, I have no quarrel at all--in fact, I agree fully--with the analysis and assessment of demand management policies of the Government. I might even add, together with Mr. Goos, that it would perhaps be advisable for the South African authorities not to persist in applying fiscal and monetary stimulus that is obviously ineffective and may eventually lead to an intensification of inflationary pressures and an acceleration of capital flight. The crucial question, however, is whether demand management policies can overcome the effects of a strongly adverse climate created by noneconomic factors. The answer is realistically provided in the last sentence of page 24: "the lack of resilience finds its roots in the lack of confidence that pervades the private sector and is likely to persist until a consensus for sociopolitical change can be achieved." This is a very serious, important condition.

Neither can one have any objections about the staff's recommendations regarding external policies, namely, the need for export-oriented growth, the maintenance of competitiveness, and flexible exchange rate policies. But how practical or relevant these policy recommendations are clearly depends on highly uncertain assumptions related to the same noneconomic factors, particularly the strong socioeconomic structural changes that are required within the economy.

Similar considerations apply to the analysis of fiscal policy. One cannot easily be convinced, given all the elements in the situation, such as the transparency in the budgeting process, that improved control of public expenditures and better coordination between expenditure and revenue policies are likely to overcome the effects of the pervasive uncertainty caused by other factors. I do not wish to minimize the need for proper fiscal management in all circumstances, but I do believe, with the staff, that in order to play a proper role in the special circumstances of South Africa, overall fiscal policy needs to be set in a "credible medium-term framework" that "will need to specify a set of policy priorities that is perceived to be consistent with the external, financial, and domestic sociopolitical constraints and around which a social consensus can be forged." I will not touch upon other aspects of the report--such as manpower and education policies or the required structural changes in the pattern of investment--because they are even more intimately linked to noneconomic factors that are appropriately excluded from discussion in this institution but outside of which discussion would be meaningless.

My remarks have not been meant as a criticism of the staff or the report. On the contrary, as I said at the beginning, I sincerely admire the staff's work, given the very serious constraints under which it had to operate.

My remarks have their roots in a very acute feeling of discomfort caused by the realization that normal consultation procedures are being applied to an extraordinarily abnormal situation. Whatever aspects of the economic situation of South Africa we touch upon, we come up against fundamental problems that lie outside the scope of this institution. The pervasive effects of these problems are bound to lend an aura of unreality to, and reduce the validity of, discussions on the subjects that constitute the main object of interest of the Fund--such as effectiveness or appropriateness of macroeconomic policies, exchange rate policies, or structural adjustments. The main purpose of consultations is to enhance the pursuit of realistic and effective economic policies that are designed to promote domestic and external economic stability and growth in a framework of free multilateral trade. I would hesitate to state unequivocally that South Africa can be usefully and constructively treated within this framework, both for the people of South Africa and the international community of which this institution is a part.

Ms. Bush made the following statement:

At our last Board discussion of the South African economy, we addressed two principal problem areas. These were the current imbalances in the economy at that time and the need for basic structural changes to improve growth and employment potential through the full and efficient utilization of South Africa's human, natural, and capital resources. In the interim, current imbalances have generally worsened. But, more important, the urgency of addressing structural problems has become even more acute.

Economic developments in 1985 and the outlook for this year are, in general, less favorable than a year ago. Real GDP fell by 1 percent last year and may not grow at all this year; in 1985, gross fixed investment fell for the fourth year in a row; inflation accelerated, and further acceleration is occurring this year; the unemployment rate rose last year; the current account of the balance of payments moved into large surplus, partly reflecting a drop in the volume of imports by nearly 16 percent; the overall balance was in deficit by $1.3 billion; and international reserves fell to only about two months of imports. Faced with weak growth and rising unemployment, the authorities began in 1985 to shift their policy stance toward more relaxed fiscal and monetary policies in an attempt to stimulate the economy. Under the circumstances, these measures are understandable, but they carry the risk of feeding inflation and of weakening the balance of payments; they also imply that the authorities will continue to focus on the short-term rather than on the more lastingly beneficial structural changes that are of utmost importance. In that regard, a more fundamental reassessment of South Africa's medium-term economic strategy should receive top priority.

I agree with the staff and other Directors that it is very difficult to divorce the economic outlook for South Africa from its present very difficult sociopolitical situation. This leads us to support the emphasis in the staff report on the need for the formulation of a medium-term economic policy framework based on a sociopolitical consensus about where the economy should be headed. We would envisage a strategy aimed at maximizing growth, job creation, and financial stability and at achieving a sustainable external position, with all elements of society participating in the planning and carrying out of such an economic development effort, and all sharing equitably in its benefits. In addition to policies aimed at creating a stable financial environment, the heart of such a program would clearly be structural reforms. Major elements should include restructuring and shifting of public expenditures to make room for increased spending on areas such as education, training, housing, and health--items that are designed to increase the productivity of the labor force. In the past, South Africa's spending on the development of its mining sector has led to that sector being well developed and has resulted in substantial benefits to the economy. The state of development of this sector now leaves room for increased spending in the areas just mentioned. Tax reform is necessary to maximize incentives for domestic savings and investment and to facilitate efficient forms of financial intermediation. Wage and interest rate policies are needed that will lead to realistic pricing of capital and labor so as to reduce the capital-intensive investment characteristic of past endeavors and foster job creation. Also, prompt removal of legal impediments to the geographical and occupational mobility of labor is called for, as well as deregulation of business activities, especially for small business.

Sustainable growth and job creation are needed to absorb the unemployed, underemployed, and new entrants into the rapidly growing labor force. The pressing need for this is already clear in view of the large number of unemployed and underemployed blacks. Moreover, the fall off in growth and lack of buoyancy in the economy and the accompanying effects on employment are having a negative impact on the whole population, as unemployment in 1985 rose for all groups and real wages have declined for all groups. It is difficult to avoid the conclusion that unless there is further moderation in the growth of real wages, employment growth objectives probably cannot be achieved. Therefore, while increases in real wages will need to be more moderate in the short term, this should be accompanied by the removal of restraints on labor mobility and by substantially enhanced opportunities for blacks to obtain the education and technical training necessary to raise their skill levels, thereby permitting their full participation in the labor force, including the highly skilled segments of the labor force. Such education and training and the resulting higher levels of skill will boost the productivity of labor and help to justify a return to higher real wages. This should be accomplished in the context of the operation of free market competitive forces, which has not been the case in the past, as shortages of skilled labor have helped to push real wages up while there existed, at the same time, a large untrained and therefore unskilled segment of the labor force.

One of the many challenges that we see in view of the need to moderate real wage rate growth is that more progress is necessary in reducing disparities in the wage rates. This can be helped along even more as productivity improves. But in the meantime, we encourage the authorities to continue the movement that they have made in this regard.

It is also essential that labor market rigidities be removed through eliminating barriers to labor and occupational mobility. I know that some steps have been taken in this regard, with some legal impediments removed; but impediments to mobility remain in the form of "job reservations," "employee ratios," and restrictions on trade and business activity. In the mining industry, it is important that the authorities press for agreement on the removal of job reservations, and we urge speedy action on the legislation that the Government contemplates to remove the remaining restrictions and the speedup of negotiatfons among business management and labor unions so that success in eliminating the restrictions will be realized forthwith.

We also hope to see fast elimination of the regulations hindering the start up of business. It is my understanding that some legislation is under consideration or has recently passed empowering the State President to streamline and reduce the preponderance of regulations in this area. Perhaps Mr. Peacey could provide some additional information on this. A further elaboration also on the activities of the Small Business Development Corporation, mentioned on page 14 of SM/86/216, would be appreciated.

The reduction of the barriers to business activity and encouragement of private sector development is extremely important to the needed growth and expansion of the economy. We welcome the authorities' view, as reflected in Mr. Peacey's statement, that the South African Government is committed to private ownership and initiative, and to market mechanisms. And we encourage greater efforts on their part to encourage such initiative but note once again that the barriers to such initiative and private sector activity facing some groups must be effectively removed in order for this philosophy to be reflected in actual circumstances.

In the fiscal area, I concur with the authorities that any fiscal stimulus must be part of a broader strategy in order to have a lasting effect. The R 1.2 billion announced package for housing, job creation, and training can fit well in a strategy designed to have the needed lasting effects. Unfortunately, the fiscal base is not particularly strong, with a central government deficit in FY 1986/87 now expected to reach about 4 1/2 percent of GDP, a general government deficit of about 5 1/2 percent, and a public sector deficit of about 8 1/2 percent. The staff report suggests that in order to achieve the goal of equal per capita expenditures for all population groups on health and education by 1996/97, a "quantum jump" in social expenditures would be required, with a rise in the tax burden on persons actually paying tax. However, the extent of the increase in overall expenditures would depend on whether or not the authorities succeed in reducing other forms of expenditure and on whether the tax base were expanded. These fiscal realities point to the urgent need for private sector involvement in the socioeconomic efforts. Reductions of barriers to business development will be helpful in this regard.

Also of importance is the issue of tax reform. We are glad to see that a commission is now studying this question. We would be interested in additional information about the possible timing and content of tax reform. As the authorities consider tax reform, we hope they will bear in mind that the tax base can automatically be broadened as more people are brought into the productive work force as employees or as new business owners. A broadening of the tax base through this kind of development should also help to make way for some relief in the high degree of progressivity of the tax structure on the present taxable income base.

Turning to monetary policy, I note the recent adoption of monetary targeting, which is probably a useful but not an adequate guide in the short run. It might also be a useful component of a medium-term strategy, which needs to be adopted. Interest rate policy will also be important, both in terms of domestic savings and investment and with regard to the international capital flows. The recent sharp cuts in short-term interest rates have made such rates rather strongly negative in real terms. Perhaps the staff would care to comment on the relationship between the monetary targets that have been adopted and the level of real interest rates, as well as the general revisions in management of the money supply in view of conclusions reached by the commission that completed its study of the monetary system in 1985.

With regard to the negative real interest rates, we must note that apart from the risks of increased inflationary pressures and capital outflows, the underpricing of capital has also discouraged the substitution of labor for capital that is needed to reduce unemployment.

Further, in the money and banking area, I welcome the Financial Institutions Amendment Act, which has grown, in part, out of the commission's recommendations, as this Act is leading to the redesigning of capital requirements of commercial banks so as to relate capital to assets rather than to liabilities and to take account of portfolio risk and off-balance sheet exposure. In addition, the better asset/liability structure that is resulting from a closer matching of maturities of assets and liabilities is a prudent development in the banking system.

Turning to the external accounts, I note that there has been a sharp shift in the current account balance from a deficit of $1.0 billion in 1984 to a surplus of $2.6 billion in 1985, and a surplus this year probably exceeding $2.0 billion. Yet, this is not a very healthy sign, since it largely reflects import compression and the decline in South Africa's access to foreign capital. The continued evidence of an outflow of capital is another symptom of confidence problems. To some extent, the sharp decline in the real effective exchange rate--nearly 46 percent between its peak in the third quarter of 1983 and June 1986--can help to contain capital flight, and it has also contributed to the strengthening of the current account, along with the rise in the price of gold. Continued exchange rate flexibility will also be needed over the longer term.

In sum, the South African authorities face some immediate problems of economic management, but the more basic challenge is the fundamental need to form a sociopolitical consensus to give impetus to upgrading the socioeconomic infrastructure and for the development of a workable economic strategy. The success of such a consensus and the success of the development efforts--which should now be substantially reoriented toward the development of human capital and toward full participation in the economy by all population groups--can be helped along by the participation by all groups in such a consensus. As staff notes, the authorities have not been able to set the economy on a positive course using typical demand management tools. In our view, such tools are not sufficient in South Africa; major structural reform is needed on an urgent basis. I have already mentioned many areas that need attention, but I will briefly recount some. There is the need for greatly stepped-up training and education that focuses on the black population; increased levels of work skills; removal of barriers to entry to certain jobs and occupations; removal of barriers of entry to business formation; some shifting from capital investment to investment in the development of human capital; allowing the appropriate market price of capital, which should further shift emphasis to labor; and, in general, allowing competitive free market mechanisms to actually operate within the economy by removing regulations, restrictions, and barriers.

Private sector confidence must be restored in order to stimulate growth and expansion, and that confidence is dependent upon the socioeconomic inequities being tackled and corrected and upon allowing a socioeconomic consensus to form. The negative effects of labor and capital market rigidities and highly restrictive laws regarding business activity on the economy and its potential are becoming more evident for the entire economy as growth has slowed and the overall economy has weakened, and continues to weaken, as evidenced by many factors already cited. We urge the authorities to address their pressing problems effectively and forthwith.

Mr. Salehkhou made the following statement:

As anticipated, apartheid has continued to impose a heavy burden on the South African economy. It is discouraging to note that no progress was made toward improving the labor market, and despite persistent recommendations by the Executive Board in previous meetings, the authorities failed to implement the necessary adjustment in the socioeconomic and political system of the country. This, apart from the structural adjustment problems and the cyclical downturn--that started from the second half of 1984--has resulted in a disappointing overall economic performance of South Africa in 1985. As unemployment increased further, the double-digit rate of inflation continued to rise, and real output fell below the level of the previous year. This trend intensified the problems of job creation and increased savings capacity at a time when foreign savings were disappearing and uncertainties in the economy increasing.

The stubborn pursuit of apartheid by the minority Government in South Africa led the Nonaligned Movement, in its recent meeting, to seek to intensify the imposition of international economic sanctions against this country and to join with the Organization of African Unity in calling for a meeting of the Security Council of the United Nations to consider comprehensive mandatory sanctions against South Africa under the United Nations Charter, which empowers the world organization to call for mandatory action against a country considered a threat to world peace. The country's other major trading partners are also seeking various ways and means to press South Africa to take positive action in removing the racial discrimination policy. Given the cooperative nature of the Fund and its valued recommendations to members in order to help facilitate the expansion and balanced growth of international trade, I wonder whether under the present circumstances these recommendations would not indirectly help South Africa to preserve an economy with severe and fundamental structural deficiencies based on the apartheid system. Furthermore, would not the Fund's positive recommendations undermine the commendable efforts being undertaken by the international community, including the United Nations General Assembly, in calling for further economic pressures to force South Africa to change its sociopolitical system that is, to say the least, immoral? I believe that any sympathetic gesture of the Fund toward this country would give the wrong signal to the world community about the compatibility of the Fund's policies with the will of the international community. In this respect, a rejection by the Managing Director of South Africa's request for the designation by him, when requested of the President of an Arbitral Tribunal--as set forth in SM/86/236, 9/9/86--appears to be in order.

The inconsistency in decision making that has led to a stop-go pattern of policies over a number of years, and the implementation of ad hoc measures mainly reflect the authorities' failure to remove the increasing deep-rooted imbalances of the economy and the existing racial disparities among population groups. As well elaborated by the staff, recommendations for implementation of traditional management policies--without recommendations for taking appropriate action to remove disparities--would not help abate inflation and unemployment. The country has considerable potential for growth, manpower, and population, but policies that impede the geographical and occupational mobility of the majority of the work force continue to have a negative impact on employment and output.

In 1985, there was a substantial rise in unemployment among nonblacks--a doubling, from 1.4 to 2.8 percent of the labor force. However, the unemployment rate among blacks in some areas exceeded 50 percent, and their real pay declined by 1.5 percent. The depreciation of the rand and the increases in administered prices overshadowed the wage moderation and led to a sizable increase in the rate of inflation from 11.7 percent in 1984 to 16.2 percent in 1985. The ad hoc measures taken by the minority Government to combat the inflationary pressures and to contain the unemployment rate were offset by the external financial pressures, domestic social unrest, and growing uncertainties facing the private sector.

In concluding, I fully agree with the staff comment that "any assessment of the economic situation in South Africa cannot be divorced from noneconomic considerations." I would also like to express my serious doubts regarding South Africa's intention to achieve parity in terms of per capita expenditures on education and health for all population groups. The medium-term scenarios prepared by the authorities would not bring about the massive needed changes in this regard.

Finally, I wish to hear the staff's comments regarding UN Resolution A/40/53, on the relations of the Fund with South Africa, which was adopted by 126 UN members and which is contained in SM/86/2 (1/7/86). Paragraph 21 of the resolution "reiterates its proposal, under Article III of the Agreement between the United Nations and the International Monetary Fund, for the urgent inclusion in the agenda of the Board of Governors of the Fund of an item dealing with the relationship between the Fund and South Africa and further reiterates its proposal that, in pursuance of Article II of the Agreement, the relevant organs of the United Nations should participate in any meeting of the Board of Governors called by the Fund for the purpose of discussing the item, and urges the Fund to discuss its relationship with South Africa at its annual meeting, in compliance with the above-mentioned Agreement, and to report to the Secretary-General of the United Nations on the action taken." As all the countries of this constituency have voted in favor of this Resolution, I wonder what action was taken or is contemplated in fulfillment of its recommendation.

Mr. Polak made the following statement:

As the staff states, the assessment of the economic situation in South Africa cannot be divorced from noneconomic considerations. The excellent staff paper before us makes a strong attempt, however, to discern the areas where economic policy can make a difference to the outcome and, indeed, contains valuable pointers to the contribution that constructive medium-term economic policies can--or at least could--make to the political situation in which South Africa finds itself.

The evidence from the paper is, however, that financial policy has not been guided by a firm hand toward certain clearly perceived medium-term goals; on the contrary, it has consisted of rapidly suggested and inconsistent responses to emerging difficulties. As a result, economic agents have been faced in recent years with domestic policy uncertainty that compounded the political and external uncertainties, including the gold price and the exchange rate. The staff paper abounds with examples. Sensible medium-term goals--to contain inflation, to reduce the share of government, and to give more room to market forces--were set aside in order to try to stimulate the economy by opposite measures. Expenditure cuts have been legislated, and then were not fully implemented or were negated year after year by large overruns. Monetary policy, far from supporting an anti-inflationary objective, has been greatly loosened in part by the poor choice of the monetary target variable. Also, the authorities, after first planning to eliminate subsidized forward cover for exchange transactions by August 1986, have reversed that decision as well.

Although there are of course abundant other reasons for entrepreneurial confidence in South Africa to be at a low ebb, I believe the staff is right in pointing out the negative effect on confidence that these policy reversals and inconsistencies must exercise. In these circumstances, the benefits that can be expected from Keynesian-type fiscal or monetary policies must at best be ephemeral and are easily outweighed by the negative effects over the slightly longer run. Accordingly, I doubt whether the recent bursts of consumer spending can be interpreted as symptoms of a cyclical recovery.

In the monetary policy area, I believe the authorities rely too much on M3 as a target. The slow growth of nominal money--10 percent or even less according to the latest information--relative to the target--16-20 percent--is the main reason for the latest reductions in interest rates, which are now negative in real terms. The staff has given us some very convincing reasons why M3 is, in present circumstances, not a suitable money supply target.

The negative real interest rates encourage inflationary pressures and hamper growth and structural adjustment. As the staff demonstrates, the demographic tendencies of the country imply an urgent necessity over the long run to lower the cost of labor compared with that of capital; but the current monetary policy is doing the opposite. At the same time, negative real interest rates discourage private saving and encourage capital outflows. On a more theoretical--but at the same time very practical--level, it should be said about South Africa's monetary policy that a country that has to contend with a persistent balance of payments problem--including the prevention of capital flight--should not target a money supply variable but should focus on a target for domestic credit. To make these comments on monetary or fiscal policies is not to imply that the problems of South Africa can be solved by measures in these areas. But these are the areas of most direct concern to the Fund, and they are of relevance to the outcome of events in South Africa.

Beyond these areas--yet still within the field of economic policy--there is, as the staff rightly states, a need for large budgetary expansion to build up the infrastructure and improve the housing, education, and training available to the black population, so as to raise their productivity and make possible a large increase in their employment. I was particularly interested in the staff's calculations of the medium-term implications of prospective measures on the finances of the Central Government, as shown in Appendix I of the background paper. These calculations should be of great interest to the authorities, among other things because they make it very clear that in this area too there is a need for the authorities to sort out priorities in order to arrive at consistent and sustainable policy approaches.

Ultimately, however, nothing short of far-ranging political changes will make possible sustained growth in output and employment. In a direct way, the policy of apartheid is, as the authorities recognize, a bar to greater productivity and, hence, greater employability of the black population. More broadly, the unsettled political situation will continue to create uncertainty, which will take away the incentives to long-term investment and dry up the capital needed for this investment. These reactions are now obvious on the part of both foreign and domestic potential investors; indeed, both groups are engaged in taking capital out of South Africa. Perhaps a final word of caution is not amiss: while political change is now a necessary condition for prosperity to return to South Africa, whether it will also be a sufficient condition will depend geatly on the nature of that change.

Mr. Vasudevan made the following statement:

During the discussion on the 1985 Article IV consultation report, this chair held the view that deep-seated structural problems have been afflicting the South African economy, especially in the labor market, leading to a serious misallocation of resources and making macroeconomic management extremely difficult. We also noted that if the authorities genuinely believed that these rigidities are not holding back economic progress, the Fund should prepare medium-term scenarios simulating the outcome of the alternative policies to demonstrate to the authorities the usefulness and practicality of reducing or eliminating those rigidities.

In the staff report before us today, a beginning has been made in Appendix I in terms of providing medium-term scenarios that highlight the effort involved if social expenditures--on education, health, and housing--are raised, under certain assumptions, inter alia, about the real growth rate, the labor force, and real wage increases over a ten-year period. The results are not difficult to anticipate. The requisite resources for making such social expenditures are very large and have implications for the growth rate and income distribution.

The incompatibility of the authorities' projections is noted by the staff. However, the staff analysis is couched in a language that is too refined. This is understandable, since a long period--

one does not normally associate the medium term with ten years--is not ideal for projections to be operationally helpful. One has necessarily to make broad judgments about the likely evolution of the factors concerned when the time frame is so long. However, one could think of quantification for a subperiod within the long-term period that is taken as the framework in which to effect social expenditures. However, the medium-term debt situation described in Appendix III to the background paper--covering the five years up to 1991--is more amenable to quantification, although even there assumptions have to be made with considerable caution. The staff itself has pointed out that projections would be more tentative than usual, South Africa's inability to repay maturing debt in a timely fashion. The scenarios tried are indicative and to that extent useful, but more sophisticated techniques may have to be tried to make matters a little more detailed and explicit.

The report gives a useful background to the current policy issues facing the authorities. The report shows how during the 1980s frequent policy shifts and accommodating financial policies contributed to the inflationary environment and slowing of economic growth. Inflation and the burden of taxation have eroded the propensity of households to save. The pattern of output and savings has been increasingly inadequate to meet the needs of employment. The labor force has been growing at about 2.5 percent a year. Unemployment among blacks has been phenomenally high--50 percent of the labor force in some areas. But the scarcity of skilled labor still poses an important bottleneck. There has also been a tendency to substitute capital for labor. This has gone hand in hand with increases in the cost of labor and relatively cheap capital. Consumption seems to be saturated, and investment activity has declined sharply from about 32 percent of GDP at the beginning of the 1980s to 22 percent in 1985.

These structural problems have been serious and have to be met by policies for structural change. The official response, however, as seen in demand management policies, focuses on short-run considerations. The easing of fiscal and monetary policies since about the middle of 1985 is an example. As a result, the fiscal deficit is higher than before; the staff puts it at 4.5 percent of GDP in 1986-87. The fundamental fiscal base is weak and cannot be sustained if fiscal expenditures continue to grow. The short-term interest rates have been pushed down, apparently in response to the slowdown in M3 growth, but long-term interest rates have stayed at relatively high levels. As the staff has pointed out, this policy has little credibility and could be counterproductive. This policy would not help, and has not helped, to restore business confidence.

There is a need for the Government to set aside short-run considerations and to work out a medium-term economic strategy. Its focal point has to be concentrated on massive job creation. While this would entail an examination of labor costs, capital/labor ratios and productivity performance, there should be an array of structural changes and demand management policies to support the policy of job creation--more specifically, upgrading the skills of the black labor force, eliminating black-white wage gaps, removing the payroll tax, pursuing a more appropriate interest rate policy, eliminating all impediments to geographical and occupational labor mobility, removing restrictions on trading and other business activities by nonwhite population groups in areas where they are now forbidden, upgrading housing, education, and health standards for the black community, and providing incentives and opportunities for small business. These measures should form the basic elements of any social and economic policy in South Africa.

In this context, the staff report mentions the authorities' conclusion that growth rate of 3-3.5 percent a year is needed to stabilize unemployment, and the authorities' calculation that a 4.5-5 percent growth rate a year over a sustained period would help absorb the large existing reservoir of unemployed labor as well. The authorities consider that a 5 percent annual growth rate would not be possible without renewed access to foreign savings. The staff hints that the required savings effort to achieve the desired growth rate to absorb the existing reservoir of the unemployed would be possible if domestic savings are promoted, the pattern of investment is encouraged, tax policies are revised, and the regulatory framework governing financial institutions is eliminated. But we are not sure of the staff's stand, since the the staff also mentions, without going into detail, that with appropriate incentives, the existing level of investment--22 percent of GDP--could go a considerable way toward meeting current and prospective needs.

The linkages between South Africa and the neighboring states shown in Appendix II of the background paper provide an interesting account of the tensions and hardships that could be caused by South Africa's external policies. These have a number of implications for regional surveillance--surveillance of the effects of the policies of a large country on small neighboring countries, particularly those that have or have recently had Fund-supported programs--that need to be carefully looked into. An example is the imposition of the cash deposit requirement in rand on imports destined for Zambia that move through South African territory. We would encourage the staff to monitor the administration of the mechanism and to assess its effects.

In sum, we would like the medium-term strategy to focus on job creation and high growth rates through the implementation--not mere enunciation--of structural policies and more rational and consistent financial policies than hitherto.

The staff representative from the European Department said that the staff, unlike the South African authorities, did not hold the perception that current indicators were pointing to a recovery. Since mid-1985, episodes of incipient revival of domestic demand had followed either an injection of fiscal stimulus or some relaxation of monetary policy or some injection of liquidity through the current account surplus. The staff's view of why those developments did not lead to full recovery had to do with the abrupt changes in the stance of policy of the Reserve Bank and the pervasive lack of confidence in the private sector in response to noncyclical elements. Therefore, the most recent data, which indicated once again some consumption expenditure increases in both the private and the public sector, might indeed give an upward push to GDP but could be as short lived as the earlier ones. For that reason, the staff did not believe that it should revise its forecast for the current calendar year; its forecast covered the entire year, and there might be a pause in positive developments in the second half of the year. It was for that same reason, as a number of speakers had observed, that the staff disagreed with the authorities about the wisdom of a highly accommodative monetary policy stance.

It was true that the recent sharp decline in long-term interest rates had produced a somewhat more traditional yield curve, but short-term interest rates had also fallen quite sharply, the staff representative continued. Therefore, the gap had not been reduced greatly. Apparently long-term rates were more or less the same as the prime rate--about 14.5 percent--but it was not clear how much business was actually being done at the prime rate. In reality, the decline in the long-term rates was related to the rise in the price of gold and platinum, which had injected unexpected liquidity into the economy through the current account. However, that liquidity was related even more to the continuing decline in domestic demand, as corporations were spending less than the cash flow they generated internally. Further, household savings were being accumulated mainly through contractual arrangements--namely, through the institutional investors, insurance companies, and pension funds--all of which were flush with liquidity, had no new paper to invest in, and were no longer making investments in construction or other real estate projects. All of that money flooded basically into the financial assets market, and from there mainly into the public sector paper market. Consequently, what one was seeing was a process of excess supply of liquidity rather than an indication of genuine changes in inflation expectations--a view probably not shared by the authorities.

The staff did not think that M3 was at present necessarily the most appropriate indicator, particularly because of the financial and institutional changes that were occurring in the economy, and because of the unusual liquidity situation, the staff representative went on. In the past, the traditional mechanism with which the Reserve Bank curtailed liquidity was selling foreign exchange in the market; however, that path was not open to the authorities at present because of the paucity of foreign exchange reserves. Indeed, the inability to take liquidity out of the market did not warrant an accommodative posture, nor should it encourage the buildup of liquidity in the market.

A question had been asked about the effect of the increases in the prices of gold and platinum on the current account, liquidity, and government revenues, the staff representative remarked. If the price of gold were to stay in the $400 per fine ounce range and if the price of platinum were to stay in the $650 per fine ounce range, enough increased income would be generated for the mining companies to allow a reduction in the central government budget deficit equivalent to about 1 percent of GDP for the financial year ending in March 1987. For the current calendar year, the result could be an addition of $500-750 million to the current account surplus, which would the bring staff's estimates closer to those of the authorities and the commercial banks. However, if lower gold and platinum prices were assumed, there would be a current account surplus of about $2.75 billion in CY 1986.

A question had been raised as to why the staff had not focused more on the consolidated public sector accounts in the staff papers, the staff representative stated. In fact, there was a chart in the staff report and a table in the paper on recent economic developments on the consolidated public sector accounts, but the staff had not focused its discussion on the consolidated public sector deficit mainly because the fiscal dynamics were concentrated in the Central Government. Because of the cuts in investment expenditure, the parastatals were not likely to have the same impact on the deficit for the public sector as a whole as they had had in previous years. Consequently, it might be possible to see a reduction, as a percentage of GDP, in the recourse of the public sector to capital markets compared with preceding years. Nevertheless, there were concerns about the effect that continuing recourse of that sort might have on the capital markets. The problem on the liquidity side and the lack of options in portfolio patterns and investment in general for institutional investors and others indicated that one could not easily finance large budget deficits if there was a shift in credit demand to the private sector.

On the issue of data for Namibia, the same situation prevailed as the previous year, the staff representative noted. Data were being collected on trade between Namibia and the rest of the world other than South Africa. Bilateral data were currently not available to the staff. Similarly, there were no hard data on oil imports and inventories, which was true for some other members as well.

On the question of the pace of structural change, the staff representative remarked that it was important to have an orderly short-term policy stance to hold onto when moving toward structural change that would contain the buildup in inflationary pressures and prevent greater distortions, particularly given the scarcity of resources. Therefore, there was a connection between short-term demand management and medium-term requirements. All the medium-term questions that had been raised had to do with how to better use South Africa's greatest resource--its population. Currently, there were slightly more than 3 million taxpayers in South Africa out of a population of 31 million. Integrating the remainder of the population into the economic process would provide more sustainable means of meeting the social needs of the population at large. At the beginning of that process, the financing burdens on the smaller part of the population must clearly be higher than they were at present. As to the wage gap between black workers and other population groups, the gap was not in terms of comparable work but rather average wages of the groups. Therefore, the relevant figures reflected the lack of training and the different occupational problems that affected the groups.

The issue of population as a resource linked up to the question asked by Ms. Bush on elements of tax reform and the role of the Small Business Development Corporation, the staff representative commented. It was an important issue because the authorities looked to the informal sector as a source of social change; and the Small Business Development Corporation had been charged with fueling the growth of the informal sector. Over the previous 18 months, some 46,000 jobs had been created through the Small Business Administration, and some 25,000 jobs had been saved--a relatively small amount given the enormous needs.

The staff did not have much information on tax reform, the staff representative went on. The Margo Commission on Tax Reform was to report to the Government in early 1987, and the staff had not been informed on the likely recommendations. It was to be hoped, however, that matters were moving in the right direction, including a value-added tax, changes in investment allowances, less subsidization of investment, and possibly some change in the incentives to move to less capital-intensive investment.

A question was raised regarding the debt scenarios put forward by the staff, the staff representative from the European Department recalled. More sophisticated analytical methods would not have aided the staff in the scenario exercise, as the staff did not know what the international financial community might have had in mind in terms of reaching agreement on the refinancing of the debt, which in terms of its maturity structure was clearly unmanageable. The tables provided by the staff indicated that in 1987 $17 billion would mature.

The Deputy General Counsel noted that a question had been asked regarding placing an item on South Africa on the agenda of the Annual Meeting of the Board of Governors. Under the Fund's agreement with the United Nations, each organization had to give due consideration to proposals by the other to place items on the agenda of the other institution. The General Assembly had asked annually over a period of several years for the Fund to place South Africa on the agenda of the Fund's Annual Meeting. The matter had been brought to the attention of the Executive

Board in the report of the Special Representative to the United Nations on the 40th Session of the General Assembly (SM/86/2, 1/7/86). The agenda was prepared by the Managing Director under the direction of the Executive Board, and his proposed agenda for the Board of Governors for the upcoming meeting referred specifically to the report of the Special Representative to the United Nations and the inclusion of the agenda item that had been proposed. However, the actual proposed agenda had not included that item; and the proposed agenda had been adopted on a lapse of time basis in August.

Mr. Kyriazidis said that if the staff was recommending the maintenance of orderly short-term conditions in the perspective of long-term structural change and a social consensus, he would be entirely in agreement. However, his reading of the staff report was somewhat different. Structural change in the framework of a social consensus was a prerequisite for the maintenance of orderly conditions. In fact, the main question was whether confidence could be encouraged by interest rate policy while explosive political conditions persisted as the result of the application of apartheid rules.

Mr. Vasudevan said that he wondered whether in the circumstances described by the staff there was need for a medium-term debt projection. If such a scenario must be so tentative, then one should not attempt it.

Mr. Peacey made the following statement:

My authorities will examine the outcome of today's deliberations with great care in order to ascertain how the Board applies the international lessons learned from the adjustment process in many developing countries to the South African context. May I at the outset deal with references to apartheid and therewith dispose of the matter in one stroke--and in this respect, I reflect the attitude of my highest authority. When South Africa and "apartheid" are mentioned, common sense disappears. The issue has caused many normally rational and logical people to lose perspective in matters relating to South Africa. I do not believe that the use of terminology enhances the analytical accuracy of the economic situation of my country.

During the past year, the South African economy has been made painfully aware of the costs of the international adjustment process, despite which, I may add, South Africa has met its not insignificant commitments to the Fund promptly. Like many other countries, South Africa has not escaped a decline in per capita income, growing unemployment and, unfortunately, as a result, rising sociopolitical tensions. It was naturally to be expected that these conditions would create a severe measure of uncertainty and confusion about the factors underlying the trend of current events, but with the passage of time, the nature of the required adjustments in the South African economy has become increasingly evident, and my authorities have responded accordingly.

Fortunately, despite the decline in domestic investment, the country has come through the experience with the economic infrastructure intact, a very important factor in the African context. This is an often overlooked positive augur for the future. It enables the economy to proceed into a gradual upswing without having to retrace its steps unduly, so to speak. Moreover, significant changes have already been effected in such diverse spheres of the economy as, for instance, those relating to labor relations--following the execution of recommendations of the Wiehahn Commission made in the previous decade--and to the money market in giving effect to the then ongoing recommendations of the De Kock Commission. My authorities have for some time recognized that the removal, as rapidly as possible, of many structural impediments hindering the efficient operation of the market system could make an important contribution to the economy's emergence from the postrecessionary slump. I believe it would be useful, therefore, if I noted a few further pragmatic steps taken along this road. If it is true that structural problems have blunted the responsiveness of the economy to demand management policies, then it should be equally evident that the removal of these impediments should strengthen the effect of such policies. Mention has been made in the papers prepared for this meeting of initiatives in, for instance, the educational and housing fields, but I feel that these selected observations should be considered in context.

First, I wish to reiterate that all legislation pertaining to domestic influx control has been abrogated. Moreover, there are no legislative impediments to occupational mobility in my country, save one, which relates to sensitive work situations thousands of meters, in fact kilometers, below the surface of the ground, and in that case, my authorities have complied by undertaking to introduce legislation in Parliament. The matter is now on the table of a standing committee of Parliament. The abrogation of influx control legislation has shifted the whole thrust of policy attention to the need for a strategy for planned, positive urbanization. This strategy was set out in a Government White Paper on Urbanization published earlier this year in response to the findings of a President's Council investigation of the matter. I think it useful to highlight very briefly one or two financial observations of this White Paper.

The Government accepts as policy that all possible sources of revenue be exploited and used primarily for the acquisition of land for urban development. Regarding the private sector, it is accepted that special measures are needed to make it possible for this sector to participate increasingly in financing the acquisition of land and urban development for the lower-income groups, an extremely important factor in the African environment. The Government has consulted with the private sector in order to find better ways of achieving this goal. However, the possible effects of this initiative on the Government's monetary and fiscal policy and aims in this regard must be taken into consideration. The Government has therefore directed the relevant government departments and administration, in consultation with the Department of Finance, to undertake such an investigation and to establish the necessary liaison with the private sector.

As far as the Government's role in finance is concerned, the Central Economic Advisory Service has already been instructed to investigate and conduct research into the establishment of a more reliable basis for the preparation of long-term forecasts of the basic requirement for state funds to this end. This will also serve as an input to the State President's Priorities Committee.

The Government accepts as a point of departure that services and housing provided by the state should be supplied on a recoverable basis, and I mention this because there should be no misunderstanding on what basis the housing initiative is being expanded. Consequently, the relevant standards should, where possible, be brought into direct relationship with the needs and financial means of the inhabitants. In this context, let me immediately say that there is a constant reference to differentiations between black and white people in my country. It is irrelevant whether they are pink or brown. I would interpose instead of the words black and white, the term first and third world, in which case one might come to a somewhat different conclusion. The Government is, as far as circumstances permit, in favor of a system whereby property rates in all black townships are based on the market value of the property concerned.

The Margo Commission has been requested to give attention to the question of the extent to which differentiated tax systems can be applied in the process of planned urbanization, with a particular view to effecting an improved distribution of population concentrations.

Third, and I am now getting closer to responding to the request of Ms. Bush, legislation entitled "The Temporary Removal of Restrictions on Economic Activities Act" was adopted by Parliament a few days ago and will empower the State President to deregulate by means of proclamation. This will enable the State President to remove undue restrictions on economic activities caused by laws, regulations, and directives at all government and semigovernment levels. More specifically, these matters relate to the registration and licensing of businesses, the use of land and premises for business purposes, health requirements with respect to business premises, the erection of homes and business premises, the conveyance of people and goods, town planning and establishment, conditions of service and working and business hours, and the supervision and use of machines. It is expected that, in cooperation with the Competition Board, the

Government will give priority to those aspects having the potential to draw in new entrepreneurs over a short period of time and with little, or relatively low, public spending--for example, the opening up of all proclaimed industrial areas to entrepreneurs of all races, authorization of small enterprises, such as hawking, within certain residential areas, and licensing of business in general.

In this context, one must not overlook the important institutional initiatives that are under way to augment the activities of the substantial private financial services structure already in place. I mention this again in the African context. In the first instance, I should refer to the work of the Small Business Development Corporation, which promotes the interests of all small businessmen and propagates their interests at the highest level of authority. For instance, the Small Business Development Corporation provides finance for small businesses through loans, equity participation, installment sale, leasing, and financial guarantees in various ways: it provides small loans of up to R 5,000 for infant enterprises, in the formal or semiformal stages of development, whose requirements are urgent, short-term, and repetitive; the Comprehensive Assistance Program assists infant enterprises that are developing into more stable, formal businesses, but which need assistance in managing their growth, and the minimum loan is R 30,000; short-term bridging finance, of up to R 50,000, is available for viable small businesses experiencing short-term financial problems as a result of adverse economic conditions; loans of up to R 300,000 on extremely favorable terms are made to new small businesses to help them to get a good start; and bridging finance is available to small builders unable to get finance on the open market. I would refer here to another factor that we have to bear in mind and that is South Africa, although demographically predominantly a developing country, does not have access to concessionary funds from abroad. One has to bear this structural factor in mind when considering the impact of monetary, particularly interest rate, policies. The Entrepreneurship Training and Development Program is used to encourage potential entrepreneurs to start their own businesses by making available to them equipped workshops and a variety of other services. Bank Indemnity Schemes provide the participating banks with guarantees for up to a maximum 80 percent of the money they loan to small entrepreneurs.

The Small Business Development Corporation also provides business premises, including industrial parks, factory units, workshops, market stalls, and shopping centers. Again, with respect to special problems, one of the most outstanding characteristics of the South African economic system is that 70 percent of the GDP region accrues in the four big metropolitan areas. Against this background and with the aim of regional cooperation, the countries of Transkei, Bophuthatswana, Venda and Ciskei and

South Africa, including the self-governing states, agreed back in 1981 on a regional development policy. A feature of this policy was the identification of economic development regions disregarding political borders between the countries and states involved and the establishment of consultative structures between the independent countries on matters pertaining to agriculture, industries, commerce and tourism, transport, posts and telecommunications, health and welfare, manpower and education, urban development and housing, juridical matters, financial relations, and regional cooperation.

To promote this regional policy, the Development Bank of South Africa opened its doors on September 1, 1984. The activities of the Bank are directed to promoting a dynamic economic development process in South Africa, inter alia, by the coordination and programming of development activities and expenditure; the identification of priority development projects and the planning, implementation, management, and maintenance of such projects; the establishment of an effective and efficient institutional structure within participating states and development regions with the capacity to carry out the above functions; the creation of a positive climate and opportunities for the private sector to invest successfully, the application of sound economic policies, and by the creation of an environment of stability and order. On March 3, 1986, almost 39 percent of all projects of the Development Bank were in the negotiation and implementation phases--fixed commitments. This represented projects with a total loan commitment by the Bank of R 836 million, indicating that significant capital investment has occurred and can still occur as a result of the operations of the Bank since 1984.

The point that I am trying to make is that my authorities are not simply throwing money in laissez-faire fashion at the country's development problems. On the contrary, the whole South African economy is rapidly being converted into, what seems to me, to be a massive coordinated development project of great significance to the rest of Africa. These initiatives are starting to galvanize the South African entrepreneur to his newly directed socioeconomic future.

There are also various other factors, technical and otherwise, which encourage my authorities to believe that business sentiment has shifted and is shifting for the better. For instance, after almost five months of rising consumer expenditure, it looks as if we are settling into a period of steady consumer-led expansion. This is a welcome change. But it is still too early to talk about recovery. Encouraging news is confined to consumer expenditure, but this should absorb surplus capacity and work through to stimulate investment.

Obviously, as is common at this stage of cyclical development, there are mixed signals, and my authorities are under no illusion that their initiatives to date should be regarded as a panacea. Moreover, I should emphasize that although they are of necessity pragmatically flexible with respect to current fiscal and monetary policy, my authorities have not and will not set aside their medium-term goals, including the continued battle against inflation. Indeed, the measures I have just mentioned should be seen as part and parcel of this battle even if they bring additional pressure to bear on the budget in the meantime while there is still substantial surplus capacity in the economy. This is, unfortunately, one of these contradictions we have to face, and we have to seek balance in this respect. However, it should be acknowledged that we are engaged in a pioneering venture in development--I would say an exciting pioneering venture in development--the very assumptions of which can only be tentative. A healthier external climate, reducing the transfer of resources away from this South African development scene, would do much to promote these self-supporting endeavors to the benefit of all southern Africa and sub-Saharan Africa, benefits that can only impact favorably on many other aspects of the daily lives of the developing communities of this region, particularly on the chances to achieve sociopolitical consensus in South Africa.

The Chairman then made the following summing up:

In concluding the 1986 Article IV consultation with South Africa, Directors expressed broad agreement with the thrust of the staff appraisal. In particular, they noted the current apparent lack of response of the South African economy to traditional demand management stimuli and identified various explanatory factors. Directors referred specifically to the impact of the worsening sociopolitical and external climate on economic developments in general, and on consumer and investor confidence in particular, and stressed the relationship between the hesitancy of the present upturn and structural problems. In this regard, Directors concurred with the staff that a medium-term strategy directed toward accelerated growth and job creation would have to be geared toward gaining greater competitiveness and reorienting the production process toward more labor-intensive methods. They stressed that this orientation would have little chance of success without a reversal of the loss of economic efficiency inherent in the apartheid laws.

Directors noted with concern the high level of unemployment among the black population, while at the same time there were shortages of skilled labor. Steps taken thus far represented but a first attempt toward removing the impediments to geographical and occupational mobility. Moreover, these measures would yield little benefit unless they were accompanied by strides toward improving productivity, which would require a significant upgrading of the skills and educational and general welfare standards of the majority of the population, an opening of access to educational and vocational programs for all segments of the population, as well as a rapid reduction in the major disparities in wages among the population groups, in line with productivity developments. In this connection, some Directors urged the authorities to clearly spell out the medium-term costs of alternative social adjustment programs. They also urged the authorities to eliminate all remaining administrative controls and restrictions that impede the development of small and medium-sized businesses.

Directors emphasized that financial policies should be formulated in terms of a medium-term strategy to eliminate inflation, restore fiscal balance, restore confidence, and accelerate job creation. They further underscored the importance of making these policies more predictable and transparent.

Directors noted the rapid growth of central government spending and were concerned that expenditure overruns threatened once again to inflate the budget deficit well beyond the original estimate to the equivalent of some 4 percent to 5 percent of GDP. The budget deficit threatened to become unsustainable, Directors stressed, and they urged the authorities to scale it down to a size that could be soundly financed without further adding to inflationary pressures and capital outflows. They also encouraged the authorities to broaden the tax base, to strengthen fiscal incentives for domestic savings and investment, and to improve financial control over expenditure programs.

With regard to monetary policy, Directors welcomed the introduction of monetary targeting in guiding monetary policy. They warned, however, that the adopted target range for the growth of the broad aggregate M3 might be too high in view of the recent portfolio shifts in the economy. Directors, therefore, felt that the target range should be scaled down and questioned the appropriateness of reductions in short-term interest rates in present circumstances, which may well have contributed to the outflow of private sector capital.

Directors noted the almost continuous slide of the exchange rate of the rand since mid-1983 and observed that this depreciation had helped to strengthen the competitive position of the South African economy, to limit recourse to protective trade measures, and to facilitate meeting the external financial obligations of the country.

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

The Deputy Managing Director then took the chair.

Mr. Salehkhou recalled that he had asked a legal question by quoting from a resolution of the General Assembly of the United Nations in which it had requested the inclusion of an item regarding South Africa on the agenda of the Annual Meetings. To the best of his recollection he did not recall seeing the item on the agenda that was proposed to the Board for approval on a lapse of time basis. He wondered whether it had been proposed and then rejected. He assumed that it had been rejected, but the resolution had contained two parts. In the second part, it was requested that, in compliance with the UN resolution, there would be a report back to the Secretary-General of the United Nations on the action taken. He wondered if the decision had been reported back to the Secretary-General and, if so, what had been the text of the communication.

The Deputy General Counsel remarked that in accordance with the By-Laws, the Managing Director had to propose the agenda 42 days before the opening of the Annual Meetings. The procedure within the Fund was for the Managing Director to circulate his proposal for the agenda to the Executive Directors for their consideration. The Managing Director had circulated the proposal (EBD/86/209, 7/28/86). It contained his memorandum to the Board, explaining what the By-Laws required him to do with respect to the agenda and the calling of the meeting, and a cover note, which said: "There is attached for consideration by the Executive Directors a memorandum from the Managing Director with a draft formal notice and brief agenda for the 1986 Annual Meetings. In this connection, Executive Directors will recall the proposal of an agenda item by the UN General Assembly which was noted in SM/86/2 (1/7/86)." The cover note proposed the adoption of the agenda on a lapse of time basis by the close of business Wednesday, August 6, 1986 (see EBM/86/133, 8/8/86). The memorandum and the proposal for the agenda were the same item.

The Executive Directors concluded their discussion.

APPROVED: May 22, 1987

LEO VAN HOUTVEN
Secretary