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CONFIDENTIAL - PRELIMINARY DRAFT - NOT YET CLEARED BY EXECUTIVE DIRECTORS

DRAFT

EBM/82/140 - 11/3/82 a.m.

1. EXECUTIVE DIRECTORS

The Chairman welcomed Mr. Alfidja, Mr. Donoso, Mr.Salehkhou, Mr. Sangare, and Mr. Senior as Executive Directors, and Mr. Feito as Alternate to Mr. Senior.

2. EXECUTIVE BOARD

The Secretary said that on November 2, 1982 he had circulated to Executive Directors a proposed seating chart for the Executive Board meetingroom. As he had promised at EBM/82/139 (10/30/82) he had consulted Executive Directors about Mr. de Groote's proposals that the alphabetical seating should begin on the Chairman's left rather than, as usual, on his right, and that there should be separate smoking and non-smoking sections. A majority of the Executive Directors did not have a preference one way or another with respect to Mr. de Groote's first proposal, but those who had expressed a preference clearly favored the traditional seating arrangement. As for the second proposal, the Executive Directors were almost evenly divided among those who favored separate sections for smokers and non-

smokers, those who preferred the present arrangement, and those who did not have a preference one way or another. Executive Directors who did not wish to introduce separate sections for smokers and non-smokers had noted that the smoking habits of Executive Directors might well differ from those of their alternates, Advisors and technical assistants; and as the persons in each Executive Director's office might well change during a Director's two-year term, division of the meeting room into sections for smokers and non-smokers could create difficulties for newcomers. In the circumstances, it seemed best to retain the traditional seating order, and the seating at the present meeting was based on that order. The seat for Mr. Supinit had been placed according to the name of the sole nominee to succeed the late Mr. Kharmawan in the by-election that was to be completed later in the week, and Mr. Nimatallah's location reflected his wish, which he had communicated to Executive Directors, to remain in the seat that he had occupied in the past.

Mr. Prowse considered that it would be useful to canvass Executive Directors for their opinion concerning the possible prohibition of smoking in the Executive Board meetingroom.

The Chairman noted that the World Health Organization planned to send to all UN agencies and other interested organizations its recently completed report on the effect of smoking on non-smokers. The proposal

that Mr. Prowse had made should certainly be looked at and could perhaps be considered in the context of the examination of the new WHO report.

3. REPORT BY MANAGING DIRECTOR - MEETING WITH REPRESENTATIVES OF THE SPECIAL COMMITTEE AGAINST APARTHEID

The Chairman made the following statement:

(to be inserted in final draft minutes)

4. SOUTH AFRICA - STAND-BY ARRANGEMENT AND PURCHASE TRANSACTION--COMPENSATORY FINANCING FACILITY

The Executive Directors considered requests by South Africa for a stand-by arrangement (EBS/82/173, 10/4/82; and Cor. 1, 10/7/82) and a purchase equivalent to SDR 636 million under the compensatory financing facility (EBS/82/174, 10/4/82; and Sup. 1, 11/1/82).

Mr. Brand made the following statement:

(Buff 82/ to be inserted in final draft minutes)

Mr. Finaish said that at the meeting of the G-9 on November 2, 1982 a number of Executive Directors had said that they hoped that the Executive Board's discussion of South Africa's request for a stand-by arrangement and purchase transaction would be postponed for for an appropriate period. As the Chairman of the G-9, he had been asked to convey that wish to the Executive Board. The members of the G-9 felt that a postponement was warranted for a number of reasons. First, the case was controversial, and there had been significant developments since the distribution of the staff papers. Second, several Executive Directors were new to the Executive Board and needed more time to reflect on the complexities of South Africa's requests. Third, because of inevitable delays in communications, more time was needed by many Executive Directors to consult their

authorities, particularly about the relevant recent developments.

Mr. de Groote considered that the division of opinion among Executive Directors on the substance of South Africa's request was not a sufficient reason for postponing the discussion. All the established procedures with respect to the provision of information to the Executive Board had been followed, and the Executive Directors had had a full month to examine the staff reports. The discussion should be postponed only if new information pertaining in a substantive way to the technical elements of the requests had just been provided. No information on South Africa's requests was lacking in EBS/82/173 and EBS/82/174, and the proposal for postponing the discussion should not be approved.

Mr. Erb said that he agreed with Mr. de Groote that, unless the economic circumstances bearing on South Africa's case had changed enough to influence significantly the discussion and judgment on the economic merits of the case, a postponement would not be warranted.

Mr Laske, Mr. Anson, Mr. de Vries, Mr. Lovato and Mr. Casey stated that they agreed with Mr. de Groote.

The Chairman commented that there had been no change in the technical elements of the staff papers on South Africa's requests.

Mr. Nimatallah said that the fact that there were a number of new Executive Directors who needed more time to reflect on the issues involved in South Africa's request was sufficient ground for postponing the discussion.

Mr. Alfidja commented that he fully understood and supported the implications of the Chairman's statement to the representatives of the UN Special Committee against Apartheid. While the principle that any member country's request to use Fund resources should be discussed promptly and on its own merits was important and should be maintained, he had been unable to consult all his authorities about the requests and would have to reserve his position on them if they were taken up at the present meeting.

Mr. Jayawardena remarked that Executive Directors would be better informed if the discussion on South Africa was postponed for a few days. Executive Directors had not had sufficient time to study the staff papers, and there had been certain relevant extraordinary developments in the United Nations and elsewhere since the distribution of the papers. Indeed, various institutions had been in contact with the countries in his constituency about the matters

at hand as recently as the previous day.

Mr. Sangare said that he had not had sufficient time to consult all his authorities and would not be able to take a position on the proposed decisions if they were discussed at the present meeting. Postponing the discussion would not detract from the principle of dealing promptly with member countries' requests to use Fund resources.

Mr. Senior remarked that he too had had difficulty in consulting his authorities in time for a discussion at the present meeting, and he hoped that the discussion would be postponed.

Mr. Tai stated that he accepted the proposal for postponing the discussion for the reasons that previous speakers had mentioned.

Mr. de Maulde said that he fully sympathized with Executive Directors who had had difficulties in consulting their authorities in time; in future, that problem should be kept in mind in scheduling matters for the agenda of a new Executive Board. Nevertheless, the Fund had an overwhelming duty to handle promptly member countries' requests to use its resources, and the discussion on South Africa should not be postponed.

Mr. Salehkhou said that he too wished to have more time to consider the matters at hand and accepted the proposal for postponing the discussion.

Mr. Kafka stated that he would not object to a brief delay of the discussion.

The Chairman remarked that the sense of the meeting was that the discussion should be held as scheduled.

Mr. Erb said that he broadly agreed with the staff appraisals. The proposed stabilization program, the measures already in place, and the authorities' commitments to act further as necessary appeared to be broadly appropriate. He agreed with the staff that the request to use the compensatory financing facility appeared to meet all the requirements, and he accepted both draft decisions.

Although it was generally well understood by the Executive Board, Mr. Erb remarked, and the Chairman had elaborated on the point in his statement on his meeting with the representatives of the UN Special Committee against Apartheid, it was sometimes not as fully understood outside the Executive Board that the support of the

United States of the proposed decisions was based solely on his authorities' judgment that the requests met the economic and financial criteria that the Fund applied to all member countries' requests to use its resources. His position should not be interpreted in any way as an indication of the views of his Government on other matters related to South Africa. Those views had been clearly expressed in the appropriate fora and would be publicly re-stated by his authorities following the completion of the present discussion. His position on the proposed decisions indicated no change in the opposition of the United States both to apartheid and to the use of force to resolve political differences in Southern Africa.

Commenting on the proposed adjustment program, Mr. Erb said that the demand management policies, together with other measures, seemed to be a broadly appropriate response to the need to achieve the desired large degree of adjustment in the 1983 current account of the balance of payments. The staff had noted that the authorities' objective was to achieve a sustainable external position in 1983. Although delays in the implementation of adjustment policies in 1981 had apparently contributed to the deterioration in the external accounts, the restrictive thrust of policy had been in place for several months and there were signs that adjustment was taking place. In addition, the conservative assumptions underlying the program--and particularly the conservative gold price assumption and the automatic

downward adjustment in the credit ceilings should the gold price assumption prove to be too high--provided added safeguards for the adjustment effort.

He agreed with the staff, Mr. Erb went on, that the more flexible interest rate policy that the authorities had maintained in recent months, together with the other measures introduced to strengthen the control over the monetary aggregates, were in the right direction and should contribute importantly to the adjustment program. The authorities were also to be commended for tightening fiscal policy, although action in that area could have appropriately been adopted at an earlier stage. The authorities' fiscal policy stance, including the commitment to avoid any net recourse by the Government to the banking system in either FY 1983 or FY 1984, was a reflection of their apparent determination to solve the payment problems facing South Africa. He was pleased that the authorities were phasing out the 10 per cent surcharge on non-oil non-government imports. As he had noted during the discussion of the staff report for the 1982 Article IV consultation with South Africa, if additional revenues were needed, measures that did not discriminate against trade flows would be preferable to the import surcharge.

In the past, Mr. Erb recalled, South Africa had experienced cyclical swings in its export receipts. The surges in export receipts had caused a temporary relaxation of the external constraints on the economy and had often encouraged the authorities to adopt excessively

expansionary domestic policies. The authorities should be strongly encouraged to take whatever steps might be necessary to avoid a repetition of that mistake when exports prices picked up in the future. It would be useful to have a further comment on the possible ways in which that mistake could be avoided. Other member countries also had to deal with similar export surges and shortfalls.

In its report for the 1982 Article IV consultation with South Africa and in EBS/82/173, Mr. Erb noted, the staff had clearly shown that the shortages of skilled labor in South Africa had become a constraint during cyclical upswings, increasing labor costs and hampering the efficient expansion of production. The authorities should be encouraged to utilize the country's labor resources effectively, avoid labor supply bottlenecks, and expand the pool of skilled labor through appropriate training and education programs. He was pleased that such programs were not being cut back during the present fiscal austerity, as they could ease the rigidities in the labor market, thereby helping to establish the basis for long-term growth through a balanced expansion of all factors of production.

He had no major difficulty in accepting the proposed purchase under the compensatory financing facility, Mr. Erb said. The calculated shortfall was much larger than the proposed purchase. However, he was concerned about the fact that gold production in South Africa had been relatively low in the five-year period that had been used for the calculation of the export shortfall. He wondered to what extent

the mining of lower quality ore--which in itself lowered the level of production--had contributed to the export shortfall, although he understood that the amount of the export shortfall would exceed the amount of the proposed purchase even if gold exports were excluded from the calculation.

The staff felt that some diamond stockpiling might have been taking place, Mr. Erb remarked. No adjustment was made for it because data on stockpiling were not available. In the future, the Executive Board should consider ways of adjusting for stockpiling when precise data were not available.

As he had stated on previous occasions, Mr. Erb said, as a general rule member countries should take advantage of their access to private capital markets borrowing before making substantial use of Fund resources, depending, of course, on a number of factors, including each country's external debt situation. The staff felt that South Africa's potential for further borrowing and swaps in the short term was very limited and it had noted that South Africa's debt had grown by 55 per cent in 1981. Still, if South Africa's external position improved more rapidly than was now anticipated, South Africa should be expected to effect an early repurchase.

Mr. Nimatallah noted that under the proposed decisions South Africa would be able to draw immediately SDR 800 million of the Fund's ordinary resources. The staff had noted that the demand management

policies that the authorities had maintained in the previous two years had been a major factor in the deterioration in the balance of payments, and that the value of merchandise imports had doubled in the period 1979-81. In its report on the request for a stand-by arrangement, the staff had concluded that South Africa was maintaining adjustment policies designed to correct the present difficulties, but he failed to see where the adjustment was to be made.

The usual expectation under a fiscal adjustment program was that there would be a decline in the ratio of the budget deficit to GDP, Mr. Nimatallah went on; if GDP rose, the ratio could decline even though the absolute size of the budget deficit remained the same or even increased. However, Table 4 in EBS/82/173 showed that in South Africa the ratio of the budget deficit to GDP in 1982/83, the year of fiscal adjustment, would be the same as in 1981/82, the year without adjustment. Hence, it seemed incorrect to conclude that the proposed program called for adjustment on the fiscal front.

In his opening statement, Mr. Nimatallah continued, Mr. Brand had noted that the large sales of government stock in open market operations to the non-bank private sector represented a positive element of policy, as they permitted the budget deficit to be financed outside the banking system. However, that argument missed the whole point of the need for achieving genuine fiscal adjustment;

what was required was a reduction in the size of the budget deficit itself rather than merely a shift in the means of financing it from the banking system to the non-bank sector. Resources were being misallocated by being diverted from the private sector to the public sector. Similarly, Table 5 showed that net credit to the Government in 1982 was to be permitted to expand by almost exactly the same amount (R2.03 billion) as in 1981 (R 2.06 billion). Hence, the amount of credit expansion to the Government in the year of adjustment was to be almost the same as that in the year in which the Government's policies clearly had not been designed to achieve adjustment.

Another cause for concern about South Africa's adjustment effort was the recent change in monetary policy, Mr. Nimatallah remarked. Mr. Brand had mentioned that the South Africa Reserve Bank had announced on September 27, 1982 that it was lowering its reserve requirements--a sophisticated tool that South Africa used to control the money supply--in order to prevent what Mr. Brand feared would be a further tightening of monetary conditions. Tight monetary policy was usually a major feature of an adjustment program, and the change in South Africa's reserve requirement policy together with the recent declines in interest rates raised doubts about the effectiveness of South Africa's adjustment program.

In addition, Mr. Nimatallah said, the proposed purchase schedule

under the stand-by arrangement was surprising. The suggested phasing of purchases would in fact retard the adjustment process in South Africa. Under the proposals, South Africa could immediately draw 44 per cent of the total amount of the stand-by arrangement plus an additional 11 per cent upon meeting the end-December 1982 credit ceilings, without making any tangible adjustment effort. There would probably be very little incentive for South Africa to maintain adjustment policies in 1983 after it made the first two purchases under the proposed decisions.

The staff papers completely ignored the important need for structural adjustment in South Africa, Mr. Nimatallah commented. In particular, the staff had said nothing about possible ways of dealing with the widespread shortages of skilled labor that pushed up labor costs, thereby fueling the inflation. It was wrong to conclude that structural adjustment should not be addressed because South Africa was requesting a stand-by arrangement rather than an extended arrangement. Structural adjustment in South Africa was particularly important because it could help to contain labor costs. Unless the labor supply bottlenecks were eliminated, South Africa would be unable to embark on a non-inflationary growth path. Removing the rigidities in the labor market should be part of the adjustment program.

Commenting on South Africa's balance of payments need to use Fund resources, Mr. Nimatallah said that, according to the staff, by August 1982 the potential for further short-term borrowing by South Africa had

been seen to be very limited. He wondered on what basis that assessment had been made. Had South Africa actually attempted further short-term borrowing and found that it could not do so? South Africa had the capacity to borrow further from the private capital markets--on both a short and long-term basis--without straining its economy, as its credit rating was favorable, its debt service burden remained very small, its reserve position was relatively strong, and its per capita income was relatively high. What factors were keeping South Africa from borrowing additional amounts in the private sector? Many developed and developing countries faced balance of payments problems, had adopted adjustment programs that were much stronger than South Africa's, and had not sought to use the Fund's resources. Instead, they had borrowed from the private capital markets; they had understood that the Fund's resources were under strain and they had unselfishly decided to leave the Fund's resources to the countries that had limited access to private capital markets. South Africa should have followed their example. In a sense, South Africa was taking advantage of the Fund's cheaper resources. In the latest issue of the Wall Street Journal it was said that South Africa should approach the capital markets and that it was not appropriate for U.S. tax payers to support South Africa through the Fund if South Africa could continue to borrow in the private market. He was worried that the U.S. Congress and European parliaments might find it difficult in the near future to legislate quota increases and other contributions

to Fund resources if the resources were channeled to countries that, like South Africa, could borrow in the commercial markets because of their continued economic strength and creditworthiness,

Given the weakness of the adjustment effort of South Africa and the country's continued access to private capital markets, Mr. Nimatallah considered, it would have been more appropriate for the authorities to have made only one request to use Fund resources, namely, a purchase equivalent to 50 per cent of quota under the compensatory financing facility. South Africa should use its own resources to finance its adjustment effort. He opposed both draft decisions.

Mr. Anson stated that he broadly agreed with the staff analysis and conclusions. Both requests appeared to be consistent with the Fund's general policies on the use of its resources, and he supported them on their economic merits. The wide range of adopted and proposed adjustment measures seemed well devised to tackle the problems facing the economy. The economic situation in South Africa had deteriorated significantly since 1980: real GDP growth had fallen sharply; the rate of inflation was high; and the current account of the balance of payments had moved into sizable deficit. The problems could be traced in part to weak export markets and to fluctuations in the price of gold but also, as the authorities had recognized, to over-expansionary domestic policies in 1980 and 1981. It was therefore

encouraging that a wide range of corrective measures had been adopted in recent months. Still, if the adjustment effort was to succeed, there would have to be greater fiscal and monetary restraint to bring the excess demand pressure under control. That restraint should be supported by a judicious blend of exchange rate and supply-side policies in order to ensure balanced economic growth over the medium term.

The proposed credit ceilings seemed appropriate, Mr. Anson considered, as they involved a significant tightening of the monetary stance. Moreover, the authorities' control over the monetary aggregates should be strengthened by the far-reaching institutional changes that had been recently introduced. The shift to positive real interest rates should make it easier to finance the fiscal deficit outside the banking system and should encourage capital inflows from abroad. Maintaining an appropriately firm monetary policy would probably do more to encourage exchange rate stability than the attempts at influencing the forward exchange rate on which the authorities had relied in the past.

Fiscal policy had also been tightened, Mr. Anson went on. The tax measures and reduction in real spending in the 1982-83 budget were clearly in the right direction. The increase in September 1982 in the general sales tax was evidence of the authorities' commitment to adhere to their fiscal targets. To adhere to their intention to avoid any net recourse to the domestic banking system for the financing of the

budget deficit in the coming two years, the authorities might need further fiscal measures in 1982; they would almost certainly be required in 1983. The objective of reducing the overall budget deficit to the equivalent of 2 per cent of GDP through further cuts in real expenditure was commendable.

On the external side, Mr. Anson said, the authorities should be able to rely less heavily on exchange rate adjustment in the coming months than they had in the past. The depreciation of the rand in 1981 and thus far in 1982 had had to be substantial because of the sharp deterioration in the terms of trade, the excessively expansionary fiscal and monetary policies, and the failure of interest rates to attract capital inflows. The underlying weakness of domestic policies was being reversed, but the recent developments in the South African economy had had widespread repercussions on other currencies in the region that should be considered during both the coming mid-year review and future Article IV consultations with South Africa. That the authorities' regarded the current level of the real effective exchange rate as broadly appropriate to safeguard the economy's competitive position was encouraging.

In the coming period, Mr. Anson continued, it would be appropriate to maintain some flexibility in the management of the exchange rate, but recent experience suggested that there were limits on the extent to which the exchange rate for the rand could serve as a primary instrument of adjustment policy. The short-run effect of the rand's deprecia-

tion on the current account in 1981 had been small. The continued deterioration in the balance of payments in the first half of 1982 had been due in part to the continued rise in import costs and to the factors mentioned on page 13 of EBS/82/173. The rise in import values, in rand terms, that had been caused by the further depreciation of the rand had more than offset the fall in import volume since the third quarter of 1981. As a result of that apparent J-curve effect, a completely flexible exchange rate regime could be unstable.

An improvement in the competitive position would not in itself ensure that the external objectives of the proposed program would be met, Mr. Anson considered, particularly if the response on the supply side was limited by infrastructural bottlenecks and by rigidities in the labor market. The authorities recognized that problem, and the proposed shift of resources, within the reduced budget, away from non-productive spending and toward infrastructure projects and training programs was very welcome. If growth was to be maintained in 1983, when imports were expected to fall sharply, a greater effort would have to be made to increase labor mobility, use more of the available labor resources, and enhance the supply of skilled labor through government and government-assisted training programs. As he had noted during the discussion on the staff report for the 1982 Article IV consultation with South Africa, efforts to increase the supply of skilled labor would help to ease an important constraint on the economy and, as the staff had noted, there was scope for considerable further progress in that area. He hoped that labor policy would be surveyed more fully during

the next Article IV consultation and would be addressed directly in any follow-up adjustment program.

The import surcharge had produced distortions in the trade account, Mr. Anson noted, and the authorities had wisely decided to phase it out. Their objective of unifying the dual exchange rate system was welcome, and it would be useful to know more about the factors governing the precise time schedule for the achievement of that goal.

The main objective of the proposed program, Mr. Anson observed, was to reduce the current account deficit to SDR 1.4 billion in 1983. The prospects of achieving that goal were very difficult to assess because of the uncertainties with respect to the price of gold and the volume of imports. The projected decline of 14 per cent in the volume of imports in 1983 seemed to be rather optimistic. If it was, and if the assumed average gold price of $315 per fine ounce was accurate, the current account deficit could be larger than was now expected. How did the authorities plan to cover any extra financing gap? On the other hand, the current account deficit could be smaller if, as was quite possible, the average price of gold exceeded $315 per fine ounce. On balance, South Africa had a balance of payments need sufficient to justify the drawings, especially when account was taken of the need to rebuild reserves, which had fallen to a low level in relation to imports.

The request to use the compensatory financing facility appeared to satisfy all the relevant criteria, Mr. Anson said. The calculation

of the export shortfall depended crucially on price forecasts for the coming two years, but the proposed purchase was considerably smaller than the calculated export shortfall.

Mr. Laske considered that the adjustment program that the authorities had already begun to implement reflected the Government's determination to deal with the problems facing the economy. The changes in monetary policy were particularly welcome, as they should improve control over the monetary aggregates. The intention of permitting domestic interest rates to be determined by market forces, so that interest rates in South Africa could encourage capital inflows, was very welcome. In the past, the balanced growth of the economy had been hampered by supply bottlenecks and by shortages of skilled labor. The authorities' intention of exercising restraint in fiscal expenditures was appropriate, but sufficient attention should be paid to the need to ease the supply constraints in order to build a solid foundation for an economic recovery and for economic stability. Given the considerable unemployment among the high and low-skilled portions of the labor force, there was a particularly urgent need to intensify training activities.

An important assumption underlying the proposed program, Mr. Laske noted, was that the average price of gold would be $315 per fine ounce. For some months, however, the price had been considerably above that level, and presumably there had been a corresponding improvement in the outlook for the balance of payments and the budget.

The calculated export shortfall, Mr. Laske remarked, was based on the expected upswing in economic activity in the industrial countries and on a corresponding increase in South Africa's exports in the two post-shortfall years. That expectation was certainly not unwarranted; there was widespread confidence that the world economy would revive in the relatively near future. However, the projected increase in South Africa's exports in the second post-shortfall year seemed rather large. Somewhat less optimistic projections would not have affected the size of the drawing to which South Africa was entitled. In any event, the requirement to make projections for a period two years into the future at a time when projections covering the coming 12 months were very hazardous to make, demonstrated the partly speculative nature of the formula used to determine export shortfalls. The formula should therefore not be sacrosanct and should be re-examined during the next review of the compensatory financing facility. The proposed adjustment program met all the Fund's standards, and the purchase request was fully consistent with the decision governing the compensatory financing facility. Both draft decisions should be approved.

Mr. de Maulde commented that the Government's delay in adjusting policies in 1981 and the continued world economic recession had compounded the problems caused by the decline in the price of gold. On balance, the proposed stand-by arrangement, which would reinforce the adjustment measures that had already been adopted, represented an

appropriate demand management response to the external imbalance. However, more attention could have been devoted to the supply side and to the medium-term prospects for achieving sustainable economic growth.

Given the excessive domestic credit expansion in 1981 and the large losses incurred on forward cover, Mr. de Maulde continued, the emphasis on monetary problems in the proposed program was warranted. The system of monetary control had apparently been significantly improved; the rate of expansion of broad money had already been substantially reduced. However, it would be useful to know whether the authorities had given some further thought to a possible reform of agricultural financing. In addition, the ceilings on net credit to the Government allowed only for forward exchange losses that might be incurred as a result of obligations that had already been undertaken. The authorities intended to use forward cover only in exceptional circumstances, and it would be useful to know why they had not decided to eliminate altogether the use of such cover.

The deficit under the 1981/82 budget was equivalent to 2.8 per cent of GDP, much smaller than the originally expected 3.6 per cent, Mr. de Maulde remarked. However, the factors that had caused that result were not likely to be repeated in the coming period, when a fall in domestic demand was expected. The intention of the authorities to hold the budget deficit in 1982/83 to the original estimate of 2.75 per cent of GDP despite the expenditure overruns at the beginning of the fiscal year was welcome. He agreed with Mr. Anson that the phased

reduction in the import surcharge should be seen as imperative even if the continued restraint on total expenditure proved to be more difficult to maintain than was expected. The planned reduction in the fiscal deficit did not seem to be over-ambitious; the deficit had risen slightly in FY 1983 and was expected to be curtailed to 2 per cent of GDP in FY 1984. Such a deficit was relatively small, but it was not fully consistent with the objective of maintaining fiscal austerity. The authorities should adhere to the target for 1983/84 of limiting the deficit to no more than 2 per cent of GDP.

He had no difficulty in accepting the proposed safeguard consisting of an automatic downward adjustment of the credit ceilings if the price of gold fell below $300 per fine ounce, Mr. de Maulde commented. However, the proposed performance criteria would not be of much significance if the price of gold exceeded the conservative assumption of $315 per ounce. As the staff had noted, a higher price would lower the forward losses--which were included under the credit ceilings--and would boost tax revenues. It might have been appropriate to give some thought to including a kind of review clause, on the basis of which further purchases would be made contingent, in the context of the coming consultation between the staff and the authorities on the 1983/84 budget. It would be a flexible way of correcting for the potential lacuna in the proposed performance criteria.

A somewhat more stringent approach to the phasing of the purchases would have been appropriate, Mr. de Maulde remarked. The first purchase under the proposed stand-by arrangement was a drawing in the first

credit tranche and was therefore not subject to phasing. However, it might have been appropriate to lessen the amount of the second purchase, which was to be available before the Fund would have full assurance about the outcome of the 1983-84 budget. The second proposed purchase would not present any difficulty if it was dependent upon the outcome of a review, but a smaller amount would be more appropriate in the absence of such a safeguard.

He deeply regretted that more attention had not been given to the longer-term prospects for the economy and to the supply-side aspects of the present economic difficulties facing South Africa, Mr. de Maulde commented. In SM/82/89 the staff had suggested that the authorities should establish a stabilization account to receive revenues arising from any unexpected increase in the gold price. Erratic price movements and a price in excess of $315 per ounce in 1983-84 could not be ruled out, and he had hoped that there would be some discussion between the staff and the authorities of the mechanism that the staff had recommended. A more important omission in the staff papers under discussion was the lack of a thorough examination of the greatly needed supply action in the labor market. In his summing up of the discussion on the staff report for the 1982 Article IV consultation with South Africa the Chairman had made the following statement:

Noting that domestic costs had been sharply increased by widespread shortages of skilled labor, Directors urged that training programs for upgrading the skill of the labor force be accelerated.

There were still striking imbalances in the labor market, including a high rate of unemployment--7.3 per cent--in the unskilled and semi-skilled labor force, and significant shortages of skilled labor. That situation clearly hampered output growth, increased production costs and delayed productivity gains. The existing training and infrastructural programs designed to ease the shortages of skilled labor had been partially exempted from the new budget cuts but, given the magnitude and duration of the labor-related problems and the persistence of the associated inflationary pressures, a much higher priority should be given to those programs. A limited reduction in the size of the fiscal deficit did not clearly require any cut in expenditures on training and infrastructural programs designed to ease the shortages of skilled labor; indeed, greater stringency in terms of the wage bill might even allow for some expansion of those programs.

The latest report on recent economic developments in South Africa, Mr. de Maulde noted, suggested that the incentives provided to the private sector to solve its manpower problems had not yet been successful, and some discussion of the matter—for instance, possible

ways of improving the incentives and the need for greater involvement of the public sector—in EBS/82/173 would have been useful. In addition, some discussion on the need to alleviate the external constraints on the economy by diversifying output for both the domestic and foreign markets would have been welcome. The openness of the economy and the variability of the price of gold underscored the need for a sustained effort to diversify output.

He had no difficulty in accepting the proposed purchase under the compensatory financing facility, which met all the necessary criteria, Mr. de Maulde stated. As had been the case in 1976, the present request appeared justified solely on the ground of non-gold exports; therefore, the Fund did not face the difficult task of forecasting the price of gold. It would be useful to know the staff view on the influence of the De Beers Company on the diamond market. Did the staff feel that the recent fluctuations in diamond exports had been beyond the control of South Africa?

Given the volatility of the price of gold and the dependence of South Africa on the world economy, Mr. de Maulde commented, the evolution of the current account in the coming period was very difficult to forecast. Under certain, perhaps, optimistic assumptions, the turnaround might well be faster and sharper than had been forecast, in which event South Africa would not necessarily have a balance of payments need throughout the period covered by the stand-by arrangement.

Mr. Finaish considered that the present staff reports and the

reports prepared for the 1982 Article IV consultation with South Africa clearly indicated that the authorities had maintained expansionary policies in the previous several years despite the evident deterioration in the terms of trade. The staff had concluded that "strong" adjustment measures had been introduced in early 1982, but it had made no convincing case for its contention that the present balance of payments and reserve problems could be solved only by resorting to the Fund. The case was weakened by the ample potential resources of South Africa and the limited effectiveness of the adjustment measures that the authorities had introduced in early 1982. Furthermore, the staff had paid insufficient attention to the unique features of South Africa's major structural problem--labor immobility--that was bound to impede any effort to achieve sustained development in the medium term.

According to the staff, Mr. Finaish continued, economic policy in South Africa had taken a sharp turn in 1982 in order to deal with the continued excess demand, rapid inflation, and deterioration in the current account. The several monetary and fiscal measures that had been adopted had affected interest rates, credit policy, the exchange rate, and government expenditures, and in its appraisal in SM/82/76 the staff had concluded that "the implementation of these policies will facilitate a rapid correction of the imbalance in the international payments position." Even the financing problem was not judged to be unsustainable. The staff had stated on page 11 of SM/82/76 that "the

financing requirement over the next year seems manageable, but a current deficit of such a large magnitude cannot be sustained over the medium term." On the basis of current policies and projections, a further improvement was expected in 1983. At present, however, the current account deficit was projected to fall sharply, from SDR 4 billion in 1982 to SDR 1.4 billion in 1983, the equivalent of 2 per cent of GDP; and the trade balance was expected to register a surplus of SDR 1.5 billion in 1983. That appraisal of the immediate prospects of the South African economy underscored the temporary nature of the present difficulties and cast serious doubt on South Africa's need for financing by the Fund, especially in the light of the assumption concerning the price of gold on which the present projections were based. On page 6 of EBS/82/173 the staff had indicated that "the entire financial program is based on an assumption of a weak gold market with an average price of $315 per fine ounce." Sufficient account apparently had not been taken of the possibility that the average price might not remain at that low level. Indeed, the staff, referring to recent developments in the market, had concluded on page 12 of EBS/82/173 that the price of gold "could well remain significantly above the level assumed for the program period."

One factor that had been of particular concern was the level of reserves, particularly in relation to merchandise imports, Mr. Finaish continued. In its reports the staff had highlighted the fall in

reserves at the end of 1981 to the equivalent of nine weeks of merchandise imports and had said on page 5 of EBS/82/173 that "the freedom of maneuver in financing the external deficit was perceived to be extremely small." That contention raised the problem of how to judge whether or not a certain level of reserves was sustainable. The staff had previously concluded that, given the favorable prospects for 1983, the level of reserves was manageable. In a paper entitled "Requirement of Need for the Use of Fund Resources and Special Drawings Rights" (SM/76/179, 9/17/76) the staff had mentioned on page 9 that "the question of what constitutes a weak reserve position becomes more difficult to answer--because it must be decided on judgmental considerations--when a use of Fund credit under tranche policies for special facilities is involved." Various judgmental considerations had been cited, including the role of foreign liabilities. In that respect, one element that could be considered was a member's access to market financing to deal with a short-term difficulty, thereby sparing Fund resources to meet the genuine needs of member countries, a factor that Mr. Nimatallah had usefully commented on.

The availability of market financing for South Africa, Mr. Finaish went on, could be gaged by, among other things, the debt service ratio, which was estimated at 7.9 per cent in 1982 and was expected to fall to 7 per cent in 1983. That ratio was much smaller than the ratios in member countries of similar size and with comparable resources. South Africa's reluctance to use the capital markets was apparently traceable

to the Government's present debt management policy, which restricted direct official borrowing, the aim being, as the staff had concluded on page 10 of EBS/82/173, to smooth out short-term fluctuations in official reserves and limit the issuance of guarantees to the financing of a small number of commercially viable projects. However, with a more flexible application of that policy, financing could easily be made available to deal with the present short-term problem. The same issue had been raised during Executive Board discussions of programs that had been submitted by member countries with a much greater need of assistance and which enjoyed much less potential access to the capital markets. During the discussion on India at EBM/81/139 (11/9/81) it had been stressed that there was a need to examine all the factors that influenced a country's debt service capacity, and the judgment that it would have been prudent for a member country to borrow in the markets rather than resort to the Fund had been considered one of the factors that justified withholding of Fund financing. That argument had recently been made even in connection with requests by poor developing countries to use Fund resources. The argument was even more relevant for the present case of South Africa, which was classified as a developing country but was in fact a fairly developed country with much better access to the capital markets than the poorer developing countries.

An important question was how far the proposed program could contribute to sustained growth of the South African economy, Mr. Finaish

remarked. In its appraisal in EBS/82/173 the staff had concluded that "South Africa's financial program through the end of 1983 is appropriate to the attainment of a sustainable external position and a sound basis for continued economic growth over the medium term." However, that judgment seemed to ignore the impact of South Africa's chronic structural constraints resulting from its labor policies. The adverse impact of those policies had been acknowledged in recent staff reports on South Africa. Unfortunately, however, the issue had never been fully analyzed in staff reports even though it dominated South Africa's economic and social development. Instead, it had been treated in the context of the need for more training; the main constraints on labor mobility resulting from the restrictive laws, regulations and practices had been ignored by the staff. In a rare reference to the issue the staff had mentioned on page 32 of SM/82/89 that in the mining sector "the movement of blacks into skilled positions had met with resistance by skilled trade unions." A recent issue of the Economist Intelligence Unit (third quarter 1982) reported that tighter controls over labor mobility were likely to result from a new draft bill entitled "Orderly Movement and Settlement of Black Persons."

A full assessment of the contribution of the new adjustment program to the attainment of sustained growth in South Africa must include a comprehensive appraisal of the structural constraint of labor immobility and of the administrative and budgetary costs of the resultant rigidities.

He agreed with Mr. Erb, who had mentioned during the previous discussion on South Africa (EBM/82/72, 5/26/82) that "it was doubtful that a sustained high level of output growth would be attainable in South Africa so long as higher demand was constrained by labor factor supply limits. The shortage of labor thus contributed to inflation and to the current account disequilibrium...." There was no clear evidence that that fundamental issue was being seriously addressed by the South African authorities. No convincing case had been made for the need of South Africa to drawn on Fund resources under either the compensatory financing facility or the proposed stand-by arrangement. He opposed both draft decisions.

Mr. Lovato said that he had strong reservations about the composition of the proposed package of assistance to South Africa. Of the total SDR 1.1 billion that had been requested, SDR 636 million would be available without conditions under the compensatory financing facility and only SDR 364 million would be subject to South Africa's adherence to a program negotiated with the Fund. In the recent past, Executive Directors had strongly criticized the commitment of large amounts of Fund resources without sufficient guarantees for adjustment, and in the present case of South Africa the Executive Board was being asked to approve a program in which adjustment would be minor. Under the proposed phasing of the disbursement under the stand-by arrangement more than three quarters of the total Fund resources to be made available would be committed before the South African authorities had passed any

test of performance under the adjustment program. The Fund should be careful to prevent such cases under the compensatory financing facility recurring in the future.

Although many of the problems facing the economy had been caused by decisions made by the Government itself, they had their roots in structural imbalances in the economy, Mr. Lovato remarked. As the staff had noted in its report for the 1982 Article IV consultation with South Africa, structural rigidity had prevented an efficient functioning of the labor market, thereby causing widespread shortages of skilled labor that had contributed to the rise in costs and the acceleration of inflation. The increase in the price of gold in recent years had given the authorities an opportunity to make badly needed structural reforms, but they had instead sharply increased expenditures, including defense outlays, had let final domestic grow at the very rapid rate of 13.5 per cent and 9.8 per cent in real terms in 1980 and 1981, respectively, well in excess of the rate of growth of output, and had maintained low interest rates which had supported a rapid increase in liquidity. It was therefore not surprising that the current account deficit had moved from a comfortable surplus in 1979 and 1980 to a large deficit in 1981 and 1982.

In addition to introducing short-term measures to reverse the present critical situation, Mr. Finaish went on, the authorities should address the structural roots of the problems facing the economy. It

was true that the proposed stand-by arrangement was for a period of only 14 months, but it was likely to be the first in a series of such arrangements, and the authorities should be aware of the need to go beyond short-term adjustment measures. Elements of structural modification should be a part of any stand-by arrangement, and the staff should have attempted to discuss more precisely the artificial constraints on the smooth functioning of the markets in South Africa and the actions to eliminate the constraints. The need for structural adjustment should be kept in mind if and when a continuation of the proposed adjustment program was considered.

He was pleased, Mr. Lovato said, that both the growth of the monetary aggregates and the level of interest rates were to be made consistent with the needed degree of restraint. However, no action had been recommended with respect to the Land Bank bills, which constituted a distortion of the financial markets, prevented an efficient allocation of resources, and had been responsible for the flood of liquidity to the banking system in 1981.

The authorities' commitment to move the proposed credit ceilings in response to shifts in the price of gold would ensure that, if the price of gold declined, the adjustment effort by South Africa would be strengthened, Mr. Lovato said. The readiness of the authorities to take immediate further steps if developments beyond their control indicated a need for further action was welcome. The price of gold had recently been fluctuating around $420 per ounce, and he wondered

whether that price, or a somewhat higher one, might not strengthen the balance of payments sufficiently to eliminate South Africa's need for Fund assistance.

Commenting on fiscal policy, Mr. Lovato said that he was somewhat worried about the lack of a precise program for the rest of the coming year, particularly as the expenditure overruns in the first quarter of the present fiscal year seemed to have been caused by factors that were likely to continue to be evident in the future. The mid-term review of the proposed stand-by arrangement would therefore be very important, and it was unfortunate that by the time of that review more than half of the amount of Fund resources available to South Africa under the proposed stand-by arrangement would have been dispersed.

He was somewhat surprised that a more detailed schedule for the removal of the surcharge on imports not subject to GATT rules had not been negotiated before the proposed stand-by arrangement was brought to the agenda of the Executive Board, Mr. Lovato remarked. In addition, it would have been better if a more explicit agreement had been reached on the unification of the dual exchange rate system. Internal conditions that restored investors' confidence in the prospects of the country were a better way of attracting foreign capital than the present dual exchange rate system.

He hoped that the proposed large commitment of Fund resources would help the authorities to solve the problems facing the economy,

thereby reducing the hardship that had been imposed on large segments of the population, Mr. Lovato stated. However, the proposed measures were unlikely to eliminate the root causes of the present economic problems. He could go along with the proposed decisions, although his Greek and Maltese authorities did not favor the extension of any credit to South Africa.

Mr. de Vries remarked that he had examined the staff papers in the light of the economic and financial merits of the proposed request. As Mr. Erb had mentioned, the duties of the Executive Directors were not always fully understood outside the Fund, and he hoped that the Chairman would consider making a part of his reply to the Secretary General of the United Nations available to the public. Some thought should be given to determining how the Fund could inform the public of its special tasks and duties so that the public would understand how the Fund would draw very different conclusions from other international organizations about South Africa's requests.

He had no difficulty in accepting the proposed decisions, Mr. de Vries said, although he, like previous speakers, had certain questions that he wished to raise. For instance, he wondered why the staff had agreed with the authorities to provide a relatively large amount of the total assistance under the compensatory financing facility and a relatively small amount under the proposed stand-by arrangement. The suggested mix of resources greatly weakened the conditionality that

could conceivably have been applied, something that, as a matter of principle, was quite worrying. In practice, however, the mix of resources in the present case of South Africa was not particularly worrying, as the authorities had given a number of indications of the seriousness with which they took the adjustment program. However, acceptance of the proposed mix of resources might set an undesirable precedent.

The difficulties facing the economy had clearly been caused by the decline in the gold price, weak export demand, and excessive domestic demand, Mr. de Vries remarked, and to a large extent the authorities had obviously taken steps that were in the right direction. The tone for adjustment had been set by the improvement in expenditure control, the decline in real spending, the significant increases in taxes, the shift in monetary policy that had resulted in positive real interest rates, and the substantial effective depreciation of the exchange rate. The cautious assumption about the price of gold was appropriate, and the proposed targets for the current account deficit were necessary and welcome. He agreed with the staff that if the price of gold fell further below the level of recent years additional measures would be needed, and that given the accumulation of considerable short-term debt, if the price rose or remained at its present level, the policy stance should not be relaxed.

In sum, Mr. de Vries said, the authorities had made clear their intention to take a rather full dose of Fund medicine, and he hoped that

the country would act to ensure that the medicine worked as it was intended to do. At the same time, however, he was concerned that the authorities might be overly reliant on the Fund's remedies. There was some danger that, if the price of gold fell, there would be excessive restriction of demand alone, and that if the price of gold rose, there might be too little adjustment. In addition to the Fund's recommendations concerning tight demand management, the authorities should pay adequate attention to the need for structural changes. The authorities seemed to be aware of the need for structural adjustment in the long run, but the point was worth underscoring. Their intention of avoiding spending cuts in critical training and infrastructure programs designed to ease the medium term constraints on growth was very encouraging. Indeed, that step seemed to be an essential element of the authorities' plans, and some additional effort to make needed structural adjustments might well be needed.

The reduction and intended phasing out of the import surcharge was welcome, Mr. de Vries stated. As for the request to use the compensatory financing facility, it met all the relevant requirements. The special treatment of gold in the calculation of South Africa's export shortfall was inventive, but the same procedure should not automatically be applied to other countries in similar circumstances in the future.

He understood why South Africa wished to hold a large part of its reserves in gold, Mr. de Vries remarked. The authorities attached special importance to the role of gold as a reserve asset, and holding a

large portion of their reserves in gold lessened their dependence on decisions taken outside of South Africa that affected foreign currency holdings. On the other hand, the large gold holdings made the South African economy quite vulnerable, as a significant portion of total South African exports were in gold. A fall in the price of gold increased South Africa's need for reserves while reducing the value of its existing reserves. If the adjustment program worked and the balance of payments strengthened, the authorities might wish to consider holding part of their reserves in the form of SDR-denominated claims on the Fund.

Mr. Jayawardena remarked that after a long recession in the mid-1970s, the South African economy had turned sharply upward following the gold price boom in 1979-80. Misreading the longer-term international outlook, the authorities had ventured to expand the economy with greatly increased budgets and an extraordinarily accommodating monetary policy, something that many other countries had done repeatedly in response to export booms, to their subsequent regret. By the end of 1980, the boom in South Africa had ended. The staff attributed the reversal of the economic situation in South Africa largely, if not entirely, to the steep drop in the world price of gold. In his view, however, that did not tell the whole story. Among the other, and perhaps more important, factors contributing to the crisis that had started in late 1980 and had persisted to the present were the remarkable expansion in government expenditure, the inappropriate fiscal, monetary and exchange rate

policies, and the complicated structural imbalance in the labor market that had constituted a serious constraint on both economic growth and price stability.

That there had been two years between the most recent and the previous Article IV consultations with South Africa was regrettable, Mr. Jayawardena continued. The rapid deterioration in the economy in 1981 would certainly have been highlighted in the staff report for a consultation in 1981. Apparently either the general election in mid-1981 or the continued optimistic view of the authorities that their problems would be short-lived had prevented an earlier consultation. In any event, in its report for the 1982 Article IV consultation with South Africa the staff was extraordinarily optimistic in concluding that the balance of payments financing in 1982 and 1983 was managable and even sustainable over the medium term, and that the authorities' commitment to the current policies would facilitate a rapid correction of the payments imbalance. The fact that South Africa had had to come to the Fund for emergency assistance of a large magnitude within five months of the staff's optimistic appraisal emphasized the great importance that should be attached to regular and comprehensive Article IV consultations as a part of the Fund's surveillance procedures.

Gold obviously occupied a central position in the South African economy, Mr. Jayawardena said. It accounted for about 16 per cent of GDP, and gold exports exceeded the value of merchandise exports. Taxes and lease payments by gold mining companies accounted for about 27 per

cent of government revenue. Gold prices had risen steadily in the early 1970s to $184 an ounce in December 1974, had declined to $110 in August 1976, had risen rapidly to $613 in 1980, and had declined to an average of $460 in 1981 and about $350 in mid-1982. The obvious strong fluctuations in the price of gold should have prompted the authorities to adopt a very cautious approach to economic policy, especially in the light of gold's predominant role in the economy. The establishment of a stabilization account, which could have taken the shocks of the swings in the price of gold on the economy, or the adoption of appropriate countercyclical policies would have greatly facilitated the management of the economy. Those approaches had been examined and commented on in the Annex, entitled "Gold Price Movements," to SM/82/89 (5/11/82). In fact, the authorities' recent actions had apparently intensified the negative effects of the cyclical swings in the price of gold. As a rule, when revenues from gold had been buoyant, the budget had been expanded and monetary policy had been expansionary, thereby causing a marked deterioration in the balance of payments. The authorities had introduced controls on capital outflows and levies on imports which had intensified the inflationary pressure in South Africa. The rand had been devalued in 1975 and on several occasions following the floating of the currency in early 1979, but because of the conditions in the domestic economy, the currency had nevertheless apparently remained overvalued most of the time.

The authorities admittedly had adopted several remedial measures to reverse the present extremely untenable economic situation, Mr. Jayawardena continued. They had also undertaken to persevere with a moderate policy thrust in collaboration with the Fund, and it was appropriate for the Executive Board to consider the adequacy of South Africa's present policy stance in coping with the problems that were likely to persist in the coming period. The scaling down of budgetary expenditure and the authorities' commitment to avoid resorting to bank financing of budget deficits were welcome. In the past, however, expenditures had considerably exceeded the original intentions and, although the overruns had probably been due to extraordinary circumstances, there was little reason to be optimistic about South Africa's ability to maintain with ease the planned expenditure constraint. Fiscal deficits were likely to persist and, as Mr. Nimatallah had stressed, the ratio of the budget deficit to GDP was likely to remain high even during the adjustment period. The administered prices and price controls were also a cause for concern, and energy pricing policy was particularly worrying. The domestic price of coal was controlled and, despite a substantial increase in 1981, was still about one third of the international price. In the light of South Africa's dependence on oil imports, its policy of subsidizing domestic energy prices was surprising. Had the staff discussed the appropriateness of energy pricing policy with the authorities? It would be useful to know more about the other administered prices and the reason for the mainten-

ance of price regulation in South Africa. The shift in policy from direct to indirect taxation was another cause for concern. South Africa had vast income disparities, and the reduction in income taxes together with the increase in indirect taxes could be highly regressive. In the circumstances, it was difficult to ignore the equity aspects of South Africa's fiscal policy.

The recent tightening of monetary policy and the abandonment of negative real interest rates were welcome, Mr. Jayawardena said. However, the lowering of the reserve requirement mentioned by Mr. Brand in his opening statement seemed to be inconsistent with the objective of tightening monetary policy. The reserve requirement was a blunt instrument of monetary policy, and the additional liquidity creating by lowering the requirement could be considerable. Mr. Brand had maintained that the potential credit creation following the reduction of the reserve requirement would be offset by open market operations, but the change in the reserve requirement was not an appropriate signal to give at a time when strong credit restraint was the official policy. Intensive adjustment was required, and the reduction in the reserve requirement could be very damaging. As a result, he did not agree that the thrust of monetary policy was appropriate.

For some time, Mr. Jayawardena noted, South Africa had maintained a dual exchange rate system, and he was rather surprised by the Fund's benign neglect of the issue. The recent levy of a 10 per cent import surcharge--which was described as a pure revenue measure--was even more

disconcerting. Import levies greatly distorted prices and trade, and there were much better domestic fiscal measures that could achieve the same revenue objective. On other occasions in the past, South Africa, facing adverse terms of trade, had also decided to tax imports. For instance, similar action was taken in 1976 and, at that time, several Executive Directors had criticized the measure and had implied that the authorities' argument that the measure was purely for revenue purposes was not convincing. The authorities had claimed in 1976 that the import surcharge would be temporary, but it had remained in force for some time. The authorities' undertaking to make only a minor modification in the import surcharge and their inability to give an assurance as to when the surcharge would be rescinded were regrettable and, indeed, unacceptable, and he was surprised that the staff had not prevailed upon the authorities' to adopt a more sensible policy. The existence of the import surcharge and the dual exchange rate regime suggested that South Africa's recent adjustment of the exchange rate had been inadequate and had not been conducive to orderly adjustment of the economy.

Commenting on the prospects for economic growth in South Africa, Mr. Jayawardena said that the staff had concluded that the labor market constraints had been a serious bottleneck, especially during the recent growth phase of the economy. The same serious problem had been highlighted by the staff in its report in 1976 and considerable concern about the issue had been expressed by several Executive Directors during

the discussion of the report. Now, six years later, the same issue had surfaced again. Despite the assurances by the authorities that remedial measures would be taken, there had clearly been no progress in dealing with the labor market constraints. Serious discouragement of labor mobility had created considerable and critical labor shortages that had encouraged capital-intensive production, something that was very unfortunate in an economy with considerable unemployment. Although unemployment among the so-called white workers was less than 1 per cent, unemployment among black workers was at least 8 per cent and in all likelihood was well above 10 per cent. Nearly half of South African unemployment was in the group of workers aged 20-29 years, and the potential dangers of such a situation should be obvious to the authorities. It was clearly to their advantage to adopt urgently policies to improve labor mobility. Indeed, the lack of labor mobility had created such distortions in the economy that he would have expected the adoption of appropriate policies in that area to be a condition of the proposed Fund assistance. Had the staff taken up that matter with the authorities? After all, the Government had promised in 1976 to improve the training facilities, and mere expressions of similar hopes at the present stage should be regarded as totally inadequate. The expansion of skills and training services would not adequately deal with the problem of labor immobility. The problem was deep-rooted and serious and called for fundamental corrective measures.

Commenting on the overall structure of the proposed program,

Mr. Jayawardena said that he doubted whether gold should be treated as the commodity in the context of the program. Gold was of course a commodity that was demanded for its usefulness as a metal, but it was also an important part of the reserve assets of member countries. The demand for such assets was influenced by factors that were unrelated to the demand for gold as a commodity. Moreover, South Africa was the world's largest producer of gold outside the socialist countries, and its production policy could influence the price of gold and, as a result, the extent of the calculated export shortfall. On the occasion of South Africa's previous request for assistance in 1976 the staff had used a different yardstick to assess the gold market, and many Executive Directors had felt that forecasting by the Fund of the gold price might not be advisable as it might turn out to be a self-fulfilled prophecy and could therefore influence prices and the market. As a general rule, gold should not be treated as a commodity for purposes of calculations under the compensatory financing facility.

In comparison with South Africa's request to use Fund resources in 1976, Mr. Jayawardena remarked, the large amount of the present requests was striking. The proposed purchase under the compensatory financing was more than twice as large as the assistance under the proposed stand-by arrangement, and placing more emphasis on the conditional resources than the unconditional ones would have been consistent with the recent thrust of Fund policy. As Mr. Nimatallah had suggested, the proposed front-loading of the availability of the proposed assistance

would take away some of the incentive to implement the adjustment program and, given the past record of South Africa, such front-loading clearly weakened the proposed program and was not warranted. Moreover, the compensatory financing facility was meant to assist primary producing exporters to insulate their fragile economies from the vagaries of international trade; by implication access to the facility was to be limited to low-income developing countries that had little or no access to capital markets. Given its large GDP and high per capita income of nearly $2400, South Africa should not make a drawing under the compensatory financing facility, especially one of the proposed magnitude, thereby preempting resources that were meant for more disadvantaged and deserving countries. As a previous speaker had mentioned, an industrial country had been advised not to use the compensatory financing facility, even though the country had clearly had an export shortfall, because the facility was meant primarily for poorer developing countries. For the reasons that he had mentioned South Africa's request for a large purchase under the compensatory financing facility was a serious cause for concern.

South Africa's external and internal policies were not adequate to solve the problems facing the economy, Mr. Jayawardena considered. The proposed program, like the one in 1976, would probably provide only some short-term relief, and South Africa would have to approach the Fund again with a more positive adjustment program. The proposed program was poorly constructed and did not adequately ensure that the

adoption of desirable and appropriate adjustment policies would take place. He was unable to support the proposed decisions.

Mr. Salehkhou remarked that South Africa's requests should be seen in their totality, including their likely effects on the image of the Fund. Previous speakers, particularly Mr. Nimatallah and Mr. Finaish, had made useful technical comments on the weak economic justification for the requests, especially the apparent lack of satisfactory adjustment under the proposed program, and he looked forward to hearing the staff's responses. Further clarification was needed with respect to the availability of private market funds for South Africa. In the previous several months the intention within the Fund had been to limit the use of its resources as far as possible to cases involving member countries facing difficulties in securing loans from private markets. That policy was reflected in the increased conditionality applied to Fund-supported programs, the growing number of inoperative and cancelled arrangements, and the declining number of requests for stand-by and extended arrangements planned for the coming months. South Africa's creditworthiness, low debt service ratio, and large reserves did not place it in the category of needy member countries.

The improvements in South Africa's economy under the proposed program would be moderate, Mr. Salehkhou considered. Indeed, in terms of GDP, net credit to the government and the size of the budget deficit would be about the same in 1982/83 as in 1981/82. In addition, the

adverse publicity for the Fund resulting from the acceptance of the proposed decisions could have serious repercussions for years to come. The Fund had recently begun a public relations campaign to improve its image and to clear up misunderstandings evident in criticisms that had appeared in the mass media and in other fora. Approval of the proposals could result in unfortunate setbacks in the effort to improve the Fund's public image, since it was difficult to separate political and economic issues concerning South Africa, as the economic matters encompassed social, cultural, developmental and labor factors.

Approval of the proposed request would not be consistent with the spirit of international cooperation, Mr. Salehkhou considered. In that connection, the Fund had to take the recent pronouncement by the UN General Assembly and the urgent statements by the Secretary-General into account. The staff should prepare a paper examining the relationship between the Fund and the United Nations, taking into account both the letter and the spirit of international law. An increase in the consultation between the Fund and the United Nations would be desirable. He opposed the proposed decisions.

Mr. Tai stated that he agreed with the comments that had been made by Mr. Finaish, Mr. Nimatallah, Mr. Jayawardena, and Mr. Salehkhou. The requests could not be justified and should not be approved.

Mr. Sangare said that he regretted that the suggested postponement

of the present discussion had not been accepted. It would have permitted all interested Executive Directors to participate usefully in the discussion of the proposals on their merits. He regretted that he had no choice but to reserve his position on the proposed decisions. The Executive Board should continue the informal practice of accepting an practice of accepting an Executive Director's request for a postponement when the request did not prevent the Board from fulfilling its duties.

Mr. Casey commented that the sharp deterioration in South Africa's economic performance was reflected in the large negative swing of SDR 6.6 billion in the external current account. On the whole, both requests were consistent with the Articles and established policy. That judgment took into account the recent upturn in the price of gold, which had not significantly affected South Africa's balance of payments need, although that need might well prove to be temporary.

His Jamaican authorities were opposed to the proprosed decisions, Mr. Casey explained. His Irish authorities had asked him to make the following statement on their behalf:

> Ireland has supported action in the United Nations aimed generally at the cessation of loans to South Africa. It has therefore strong reservations about the proposed IMF credits. On the other hand, Ireland supports the principle that the IMF should operate on the basis of the criteria set out in its Articles of Agreement.

His Irish authorities had said that they wished to abstain from the Executive Board's approval of the proposed decisions.

The major reservation of his chair with respect to the proposed decisions, Mr. Casey continued, had to do with the labor market rigidities and the shortages of skilled labor. Those issues had hardly

been discussed at all in the staff reports under discussion, although they had been dealt with at some length during the 1982 Article IV consultation with South Africa. The labor market rigidities were an impediment to stable non-inflationary growth, and he hoped that improvements could be made, perhaps even by the time of the mid-term review of the proposed stand-by arrangement. The phasing of the proposed drawings could conceivably be adjusted in order to give the authorities some incentive to make improvements in the labor field but, given the extent of automatic front-loading that was necessarily involved, such a rephasing would not be helpful in practice.

The proposed request to use the compensatory financing facility seemed straightforward and approval should therefore be virtually automatic, Mr. Casey commented. Indeed, in calculating the export shortfall the staff seemed to have erred on the side of caution. Excluding gold from the calculation of the shortfall would not affect the size of the proposed purchase. The complications that sometimes arose with respect to stockpiling had been adequately dealt with in the present case, and the shortfall had been caused by factors largely beyond the control of the authorities. The shortfall in diamonds had perhaps not been fully beyond the control of the authorities, but the apparent discretionary element in that portion of the shortfall seemed to be minor and was in no way inconsistent with the decision on compensatory financing.

The proposed stand-by arrangement was a fairly standard example of

stabilization through demand management policy, Mr. Casey went on. Many of the adjustment measures had already been adopted, in early 1982, and there were many precedents for the acceptance of a stand-by arrangement after adjustment measures had been adopted. In any event, to a large extent the strong corrective measures had been formulated with the benefit of consultation with the staff.

Monetary policy in the program period seemed to be sufficiently tight, Mr. Casey remarked. Mr. Brand had mentioned some slippage in the reserve requirement, but it did not appear to be major, and the performance criteria were well tailored to the present policy stance. Indeed, under the proposed ceilings there would be no net domestic credit to the Government and only some external borrowing and the financing of losses on forward foreign exchange transactions. Under the program the rate of growth of broad money was to fall to 12 per cent in 1982 and 10 per cent in 1983. He agreed with the authorities that the rate of growth of domestic credit should be reduced if the price of gold declined significantly. In addition, given the continued fairly high rate of inflation, no upward adjustment in the credit ceilings would be warranted if the actual price of gold was higher than had been assumed. The recent increases in interest rates to positive real levels were consistent with the broad thrust of the proposed program. However, the staff had concluded that the interest rates were still not sufficiently high to attract foreign capital, and the authorities might wish to take a further look at the rates in the future.

The instruments of monetary policy had been improved in a number of important ways. The open market operations were clearly an improvement over direct controls, and the new focus on base money seemed appropriate.

Fiscal policy did not seem to be quite as adjustment oriented as the staff had suggested, Mr. Casey said. The staff had mentioned that fiscal policy was rigorous and austere, but the reduction in the fiscal deficit from 2.8 per cent of GDP in 1982 to 2 per cent in 1983 was not rigorous even when the continued sluggishness of gold-related revenue was taken into account. In addition, there had been expenditure over-runs in the present fiscal year. The authorities should be encouraged in their attempts to focus expenditure restraint on such areas as defense and, perhaps, subsidies.

The objective of reducing the fiscal deficit to 2 per cent of GDP in 1983 was merely a statement of intent, Mr. Casey said. The staff had noted that the budget for 1983/84 had not yet been formulated in detail. On the other hand, the authorities intended to discuss fiscal policy with a staff mission before the final formulation of the 1983/84 budget, and they intended to adopt stronger adjustment measures if the price of gold weakened. In considering the 1983-84 budget the staff should keep in mind the following comment it had made during the 1982 Article IV consultation with South Africa:

his authorities.

The Executive Directors agreed to continue their discussion in the afternoon.

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The Executive Directors agreed to continue their discussion in the afternoon.