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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/60

3:00 p.m., April 18, 1984

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	H. G. Schneider
	X. Blandin
	J. Delgadillo, Temporary
R. D. Erb	D. C. Templeman, Temporary
	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	
R. K. Joyce	D. I. S. Shaw, Temporary
A. Kafka	C. Robalino
G. Laske	G. Grosche
G. Lovato	
R. N. Malhotra	
	J. E. Suraisry
	S. El-Khouri, Temporary
J. J. Polak	
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	
	E. I. M. Mtei
	J. L. Feito
J. Tvedt	
	T. A. Clark
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant
J. A. Kay, Assistant

Also Present

P. Mentré de Loye, Consultant to the Managing Director. R. Sapunxhiu, Alternate Executive Director, IBRD. African Department: J. B. Zulu, Director; O. B. Makalou, Deputy Director; A. Doize, C. A. Francois, A. Jbili, E. Sacerdoti, L. Schmitz, A. Tahari. Asian Department: D. C. L. Nellor. European Department: J. T. Boorman, P. B. de Fontenay, L. Hansen, R. P. Hicks, W. E. Lewis, G. A. Mackenzie, H. O. Schmitt. Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; M. Allen, G. Begashaw, J. O. Bonvicini, M. Guitian, T. Hatayama, S. Kanesa-Thasan, A. K. Mitchell, P. J. Quirk, N. E. Weerasinghe, E. J. Zervoudakis. External Relations Department: D. D. Driscoll, Z. Zhang. Legal Department: J. G. Evans, Jr., Deputy General Counsel; G. F. Rea, Deputy General Counsel; W. E. Holder, A. O. Liuksila, S. A. Silard. Research Department: P. Wickham. Bureau of Statistics: S. H. Hahn, B. McLenaghan. Advisor to the Managing Director: E. W. Robichek. Advisors to Executive Directors: S. R. Abiad, H. A. Arias, S. E. Conrado, K. A. Hansen, L. Ionescu, H.-S. Lee, G. E. L. Nguyen, Y. Okubo, I. R. Panday, P. Péterfalvy, M. Z. M. Qureshi. Assistants to Executive Directors: I. Angeloni, R. L. Bernardo, M. B. Chatah, Chen J., I. Fridriksson, V. Govindarajan, D. Hammann, H. Kobayashi, G. W. K. Pickering, E. Portas, T. Ramtoolah, J. Reddy, D. J. Robinson, A. A. Scholten, Wang C. Y., M. A. Weitz, J. C. Williams, A. Yasseri.

1. YUGOSLAVIA - STAND-BY ARRANGEMENT

The Executive Directors continued from the previous meeting (EBM/84/59, 4/18/84), their consideration of a request from Yugoslavia for a stand-by arrangement for a period of one year in an amount equivalent to SDR 370 million (EBS/84/65, 3/23/84).

Mr. R. Sapunxhiu, Alternate Executive Director for Yugoslavia, World Bank, was present for the discussion.

The staff representative from the European Department, continuing his replies to questions posed at EBM/84/59, explained in response to Mr. Prowse that the reason for focusing on public sector revenues was that the authorities intended to reduce the size of the public sector. One way of achieving that goal would be to introduce a performance clause limiting the size of the public revenues, and to accompany it with another specifying a minimum accumulation of public sector deposits in banks as a means of controlling expenditures. The reduction in the size of the public sector would contribute not only to the social goals that the Yugoslav authorities had set themselves, but also to the adjustment process.

A number of speakers, the staff representative recalled, had asked for an explanation of why the Joint Reserve Funds were not part of the public sector. In fact, the Joint Reserve Funds' budgets were not included in the federal finances, although naturally the sort of activity that they engaged in was economically analogous both to taxing and to subsidizing. Conceptually, the Joint Reserve Funds had to be dealt with separately from public spending. Nevertheless, the Government could influence the spending and revenue collection operations of the Funds through legislation. In addition, the Social Accounting Service monitored all payments in the economy to ensure that they were in conformity with existing laws. A separate performance criterion for the Joint Reserve Funds was required because they were not subsumed under the federal budget, although they were enforceable under Yugoslav law.

Commenting on the effectiveness of a real wage cut in stimulating the mobility of labor, the staff representative remarked that the real wage cuts carried out in the past had been general wage cuts, meaning that they had been the consequence of unanticipated inflation that had affected the work force indiscriminately between profit-making and loss-making enterprises. What the staff and the authorities had tried to do under the new stand-by arrangement--apart from encouraging general wage restraint--was to introduce the possibility of changing relative wages between those import-intensive sectors of the economy that were likely to incur losses as a result of a devaluation of the dinar and those enterprises that were likely to make profits as a result of a devaluation. By creating wage differentials, the authorities and the staff both hoped to bring about sufficient mobility to shift labor from the sectors of the economy that should retrench to those that should expand. It was clear that in the past the reaction to price incentives, including the price of

foreign exchange, had been delayed. That was one reason why the staff had said in EBS/84/65 that the effectiveness of the policy needed watching. In addition to creating wage incentives for labor mobility, the staff had hoped that adding the performance criterion relating to the Joint Reserve Funds would substantially reduce the possibility of subsidizing loss-making enterprises, particularly those incurring losses as a consequence of the depreciation of the dinar.

Finally, the staff representative from the European Department recalled, Mr. Abiad had asked whether measures other than exchange rate measures were being introduced as a way of making Yugoslav products more competitive in world markets. Although it had not looked into the matter deeply, the staff could say that the problem of quality was not a general one for Yugoslavia's products. There was a whole range of products in which the quality of Yugoslav output was certainly up to Western European standards. If some products were of such inferior quality that the price had to be much lower in order to sell abroad, the situation ought certainly to be helped by a depreciation of the exchange rate.

Mr. Polak commended the staff for its skillful handling of the difficult negotiations with the Yugoslav authorities. During the morning, he had heard a large number of comments that had been both critical and constructive. Those comments would be helpful to the authorities in fully understanding the international atmosphere in which Yugoslavia had to operate.

Replying to a number of technical points raised by Executive Directors, Mr. Polak explained that most of the nonwage income earners in the Yugoslav economy were also wage earners. The nonsocialized sector was much broader than the underground economy was in some other countries. One additional reason for the relatively good maintenance of consumer demand might well be the large capital gains that had been made on the foreign currency accounts as the dinar depreciated.

As to why inflation had been consistently underestimated so that positive real interest rates had never been achieved--a question raised by Mr. Schneider--Mr. Polak considered that there had been a certain amount of wishful thinking. The authorities had hoped that inflation would not be so great that modest increases in the interest rate would not be sufficient. However, they had become convinced that positive real interest rates were an absolute necessity; the staff had produced a mechanical formula that was sure to bring about such rates in the relatively near future. He could agree with Mr. Clark that the real interest rate would be considerably higher, if inflationary expectations began to recede.

Regarding the status of the studies on the foreign exchange market mechanism to be undertaken by the staff and the Yugoslav authorities in parallel, Mr. Polak said that he could assure Mr. Zhang that, unlike some other studies, there was no presumption that the conclusions reached by the staff would come to be incorporated in a program as performance criteria if the Yugoslav authorities did not agree with them. Nevertheless, the studies were of the greatest importance.

As many Executive Directors had said, Mr. Polak went on, the program was "tight" both in the sense that it would be difficult to achieve in full, and in the sense that it was highly controlled by a number of performance criteria and reviews. The staff had set out all the requirements in the technical notes appended to the stand-by arrangement, a sound scheme in view of the uncertainties that had arisen in the past as to the precise obligations of the authorities. Moreover, it was becoming vital to the continued success of the Yugoslav economy to solve a number of structural problems that had not been overcome in the past year.

As for Mr. Prowse's question whether the Fund's cooperation with countries having centrally planned economies would be sufficient to make it worthwhile for the Fund to commit its money to adjustment programs in such countries, Mr. Polak explained that the difficulties for Yugoslavia did not stem from its having a centrally planned economy; on the contrary, the problems were similar to those referred to by Mr. Joyce as provincial problems in Canada, but on a larger scale. Despite the disappointments, and the time that it had taken to agree with the authorities on a structurally viable system, the Fund's cooperation with Yugoslavia was justified in the sense that the Fund was making a great contribution to restructuring the Yugoslav economy, a point that was well recognized by the authorities. Yugoslavia was not the only socialist country in which the Fund was making such a contribution; it should not hesitate to perform its role fully for all members, including socialist countries.

Mr. Zhang, referring to the staff representative's reply to his question regarding depreciation at EBM/84/59, inquired whether the staff's intention was that the depreciation of the dinar, which had been begun in 1983, should continue in 1984.

The staff representative from the European Department explained that the intention was not to increase the amount of depreciation during 1984, but only to restore the level of depreciation reached at the end of 1983.

Mr. Zhang remarked that the staff had admitted that depreciation had an impact on import prices, which led to further inflation at home. Furthermore, the staff had maintained that Yugoslavia, a relatively small exporter, could not affect world market prices for its products. He therefore doubted whether depreciation would really increase the competitiveness of Yugoslav products in the world market to an extent that could be justified in view of the damage caused by inflation at home.

The staff representative from the European Department replied that the fundamental intention was to create incentives for more of the national product to shift from the domestic sector to the export sector. The basic question was: "What price incentives would bring about such a shift?" What was needed was to find the relative price at home, not abroad, that would persuade a worker to switch his activity from supplying the domestic market to supplying a foreign market, by offering him more in dinars for working in the export sector.

Mr. Zhang said that he recognized the validity of the staff representative's argument, but there must be some more effective devices that would not have such a powerful impact on the price of imports. One method would be the use of subsidies to increase the supply of commodities for export, although he understood that subsidies went against Fund dogma.

The staff representative from the European Department considered that one of the aims was to increase the price of imports in dinars as a way of encouraging the relatively export-intensive firms. If the authorities were successful in so doing, the balance of payments would begin to correct itself; thus, the exchange rate happened to be a convenient single measure for achieving a number of aims at the same time.

The Executive Board thereupon took the following decision:

1. The Government of Yugoslavia has requested a stand-by arrangement for a period of one year beginning April 18, 1984 in an amount equivalent to SDR 370 million.

2. The Fund approves the stand-by arrangement set forth in EBS/84/65, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii) of the Articles of Agreement.

Decision No. 7671-(84/60), adopted
April 18, 1984

2. ALGERIA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Algeria (SM/84/57, 2/27/84). They also had before them a report on recent economic developments in Algeria (SM/84/60, 3/8/84).

Mr. Salehkhou made the following statement:

In an environment of continuously declining global prices of petroleum, which has persisted for some years, affecting many oil producing economies, the Algerian economy in 1983 was able to continue with its pursuit of high growth and employment, high investment, and infrastructural improvement while maintaining external account stability. An exogenous aggravation was the drought and unfavorable weather in 1982 and 1983, to which the Government had to respond quickly. In addition, the Algerian economy has had to cope, like other developing countries, with the problems of high international interest rates and recessionary trends. Yet despite the confluence of adverse external factors lasting for several consecutive years, the economy has demonstrated resiliency and adjusted favorably to the changing environment.

The importance of the hydrocarbon sector to the economy is paramount, accounting for nearly all exports, more than half of budgetary revenues, and almost one third of nominal GDP. The hydrocarbon policy of the authorities in recent years has been to supplement falling petroleum production with an increase in natural gas production and export and by a greater shift to refined oil products and condensates. This policy of diversification within the energy sector has been instrumental in containing the adverse effects on the economy of falling prices in the oil markets and increasing Algeria's share in the international energy market. Crude oil production, reflecting global market trends, further decreased in 1983, but production of condensates, all of which is exported, rose rapidly. At the same time, the production of liquefied petroleum gas expanded further. Refined petroleum products, consisting mainly of gas oil, fuel oil, and naphtha, a high percentage of which is exported, have been steadily increasing in recent years. Natural gas production has also registered a rising trend. Gas exports consisting of liquefied and natural gas rose by 53 percent in 1983 compared with a year earlier. All in all, hydrocarbon export receipts rose by 2.5 percent in SDR terms in 1983 despite the decline in petroleum exports and notwithstanding globally depressed oil markets.

Development planning and a significant share of economic management are traditionally vested in the state. During the 1970s, greater attention was paid to heavy industry and hydrocarbons; priority has been increasingly accorded to agriculture, housing, and social infrastructural developments in recent years. The investment objectives of the 1980-84 Development Plan have, therefore, shown a shift in the composition of investment in favor of capital expenditure by government departments and away from public enterprises. For 1982 and 1983, investment policies have been in tandem with the plan objectives.

In a comprehensive restructuring of public enterprises, provided for in the plan, large parastatals were reorganized by splitting enterprises into smaller, more efficient units to correct the lags and imbalances in industry, to increase productivity, and to reduce inefficiencies in the production and distribution systems. As a corollary, industrial objectives have aimed at decentralization of activities. In this spirit, the task of reorganization has been based on technical specialization along product lines, separation of production and marketing functions, and appropriate location by region. The financial aspects of reorganization, though still not completed, aim at replenishing the capital eroded by operating losses, reducing bank indebtedness, and rationalization of cost-price structures. In this connection, the authorities fully realize that the increase in the enterprises' recourse to bank debt in recent years had raised the financial burdens of the enterprises and had necessitated their financial overhaul.

Notwithstanding the pivotal role of the state in the socio-economic strata of the society, some 40 percent of GDP originates in the private sector and a large segment of production is market or quasi-market oriented. To this end, the authorities, in line with the directives of the plan, have formulated regulations aimed at further stimulating private sector activity by providing an appropriately efficient working environment for the private sector. In particular, regulations to facilitate private domestic investments, substantial tax advantages, and access to long-term low-interest rates should create a climate of confidence for potential investors, specially for nationals residing abroad. In the agricultural sector, too, the tendency to stimulate private sector activities is being strengthened through liberalization of the marketing and pricing systems, breakup of the large state farms, and the turning-over to the private sector of a portion of arable land.

The reform measures have also aimed at modifying the complex system of price controls. Greater flexibility is being introduced into the pricing mechanism more realistically to reflect cost structures and to rectify imbalances in the domestic market. Nevertheless, in order to protect the purchasing power of lower-income earners, price stabilization schemes are in effect within the overall economic planning framework.

Despite the change of emphasis within the framework of the 1980-84 Plan toward other goals, heavy industries recorded solid growth. In the mining and light industry sectors, too, production increased in 1982 and 1983. Construction, which is a priority sector under the plan, performed satisfactorily, and, in line with the restructuring of public enterprises, construction has benefited from the policy of decentralization. Measures have been taken to invigorate private construction.

Agricultural production was adversely affected in 1982 owing to the drought, although, in 1983, available estimates point to a modest recovery. The drought nevertheless adversely affected the production of cereals and animal fodder. Given the nature of the agricultural sector and the extent of state intervention, the rehabilitation of management, the availability of raw materials, and extension services have assumed preponderance over agricultural pricing. Nevertheless, the authorities are cognizant of the need to introduce greater rationalization of the whole price spectrum. In tandem with this recognition, substantial changes in management, pricing, and structure have been introduced, and the liberalization of some aspects of pricing and marketing has led to positive results.

The growth of GDP at constant prices rose significantly from 4.2 percent in 1982 to 7.3 percent in 1983. At the same time, inflationary pressures eased from a high of 14.6 percent in 1981 to 6.7 percent in 1982. In 1983, inflation is expected to have reached 8 percent.

In 1983, tax receipts--which account for over 90 percent of revenue--rose significantly, by almost 13 percent, after a decline in 1982. This was due to a sharp increase in nonhydrocarbon revenues, incresing measures adopted to strengthen tax administration, and containment of tax loopholes. Indirect taxes also rose significantly in response to increased domestic production. On the expenditure side, current expenditure rose by 18.4 percent, reflecting greater outlays on wages and salaries and a more than doubling of payments for interest on public debt. Price subsidies, mainly relating to cereals and sugar, have been kept steady in recent years. Reflecting increased investment outlays for irrigation, transportation, and infrastructure in line with plan objectives, and reflecting entry into operation of large public works programs, capital expenditures increased by 16.8 percent in 1983, significantly less than the 1982 increase. At the same time, public enterprise investments have remained stable. The overall treasury deficit, as a proportion of GDP, rose slightly to 6 percent in 1983 and was mainly financed by the Central Bank. Considering the importance of the Treasury as a major financial intermediary and the channeling of resources to productive sectors that a treasury deficit could achieve, the liquidity effects and the possible consequent inflationary implications are probably less pronounced than they might otherwise be. The authorities, nevertheless, expect a slowing down in investment expenditure in 1984 and a relative stability in the Central Bank claims on the Treasury.

The financial network in Algeria is controlled by the state. In line with the major restructuring of the economy, there has been further progress in the establishment of new banking units, and more extensive branch banking, to serve better the recently decentralized enterprises, has been undertaken. Moreover, withdrawal from circulation of large banknotes has led to greater banking activity by potential depositors.

For 1983, available estimates suggest that the growth of the money supply has decelerated. In 1982, domestic credit rose significantly, reflecting the exceptional financing requirements of public enterprises, and net foreign assets declined markedly, reflecting the developments in the balance of payments. Notwithstanding the relatively moderate increase in 1983, compared with 1982, the increasing share of bank credit in financing operations could lead to an accumulation of excess liquidity. However, given the particular nature of the economy and the characteristics of the society, the authorities feel that measures already adopted to offer the public outlets for using excess funds will prevent undesirable monetary consequences.

The performance of the external sector in 1982 and 1983 has been better than envisaged despite the continued weakness in the international demand for oil and a sharp deterioration (by almost

9 percent) in the terms of trade in 1983. The worsening in the terms of trade was instrumental in reducing the potential improvement in the trade balance for both 1982 and 1983. Nevertheless, the current account balance recorded an estimated SDR 140 million surplus in 1983 as a result of stable hydrocarbon exports, increases in natural gas and condensate exports, and a slight decline in imports, mainly with respect to consumer goods.

Foreign borrowings have been lower than debt amortization. Indeed, external debts, as a percentage of GDP, have steadily declined in recent years reflecting a better debt portfolio management by the authorities and relatively greater uses of suppliers' credits in the face of hardening of terms in the international financial markets. Notwithstanding, the total debt service ratio has risen in recent years as a result of greater capital amortization. This ratio is expected, however, to decline in the future.

The diversification within the hydrocarbon sector has helped the authorities to provide for the exigencies of the economy and to cope with the vicissitudes of the oil market. In the immediate years ahead, current projections point to further increases in the export of gas and condensates, while petroleum exports may slightly decline as a result of greater domestic use. Overall, export receipts in SDR terms are projected to grow. With the relative moderation of the value of total imports for 1984, a current account surplus of 1.3 percent of GDP is forecast, and the surplus on current account is expected to continue for the succeeding three years, under certain plausible assumptions.

With regard to import policy, greater flexibility has been introduced in recognition of the increased requirements of the private sector and to facilitate the import of spare parts and the provision of technical services. Import policy will be closely monitored by the authorities for possible further refinement.

Mr. El-Khouri said that it was encouraging to see that the recent weakening in the world demand for petroleum had had only a limited adverse impact on the Algerian economy, owing in large part to the high degree of diversification of Algeria's hydrocarbon exports. Indeed, economic developments in general had continued to be favorable during 1982 and 1983. Economic growth had been high; the current account of the balance of payments had been in near-equilibrium; external indebtedness had been reduced. Those favorable developments had mainly been the result of prudent policies by the authorities, for which they should be commended.

On the structural side, Mr. El-Khouri continued, several important adjustment measures had been taken under the 1980-84 Five-Year Development Plan. They included the reorganization of the public enterprise sector, the introduction of productivity and profit-sharing bonuses into the national wage policy, and measures to encourage greater private sector

participation in the economy. Taken together, those policies should help to increase productivity and to improve the allocation of resources in the economy.

In public finances, Mr. El-Khouri remarked, the authorities had made commendable progress in strengthening tax administration. The increase in budgetary receipts from nonhydrocarbon sources over the past two years had been impressive. However, the sharp rise in budgetary outlays in 1982 and 1983 had led to the emergence of large fiscal deficits. Although those deficits had not been financed by external borrowing, which would have aggravated the debt problem, they had been largely monetized. That policy had led to excessive money creation in the economy, which could undermine financial stability. It was, therefore, important that the authorities sought to reduce the fiscal deficit over time, mainly through greater control over government spending. It was also important that the authorities carried on with their plan for a financial restructuring of the public enterprise sector, which had depended excessively on domestic bank credit.

Commenting on the external sector, Mr. El-Khouri welcomed the steps taken in recent years to liberalize the exchange and trade system. He hoped that further progress could be made. He commended the authorities on their success during the past two years in reducing outstanding external debt and on their intention to continue the pursuit of a cautious debt management policy.

The staff's analysis raised several questions with regard to exchange rate policy, Mr. El-Khouri noted. First, the staff argued that the appreciation in the import-weighted real effective exchange rate between 1980 and 1983 had had adverse effects on the Algerian economy. It cited the adverse impact of such an appreciation on the decisions of enterprises, on the establishment of a realistic pricing system, and on the prospects for a diversification of exports. He invited the staff to comment further on the basis on which it had made those judgments. Second, it was unclear what the staff was recommending for exchange rate policy. Did the staff believe that the dinar should be pegged to a currency basket based on import weights, and that it should be adjusted frequently to prevent the rate from appreciating in real effective terms? Third, it was also unclear why the peg to a basket based on import weights would be superior to the authorities' peg to a basket based on the composition of external payments.

In view of those uncertainties, Mr. El-Khouri added, it was encouraging that the authorities had agreed to carry out an analysis of the impact of recent trends in the exchange rate on the Algerian economy. Perhaps such a study would help to resolve some of the differences between the authorities and the staff on the issue. In sum, the Algerian economy had performed well in recent years and the outlook for the medium term appeared relatively favorable. He wished the authorities well in their adjustment efforts, and he supported the proposed decision.

Mr. Blandin stated that the Article IV consultation with Algeria provided a good opportunity for Directors to discuss an interesting but, unfortunately, rare case, namely, that of a country tackling successfully at the same time both short-term adjustment problems and long-term structural reforms. Algeria had been helped by being a large hydrocarbon producer and exporter. However, as Directors were aware, such an advantage was not always a sufficient condition for success. The Algerian authorities should, therefore, be commended for their prudent, pragmatic approach, which had already borne fruit.

The overall internal and external positions seemed to be satisfactory and manageable, Mr. Blandin continued, although some recent internal developments, particularly with regard to fiscal policies, should continue to be monitored carefully by the authorities. The recent increase in the overall treasury deficit was undoubtedly a matter of concern. The sharp decrease in current revenues, due to the decline of petroleum receipts, had not been offset by a parallel decrease in current or capital expenditures.

Nevertheless, there were also reasons for optimism, Mr. Blandin remarked. First, the contribution of nonhydrocarbon tax revenues should strengthen in the years ahead, following the measures to improve tax collection in that field. Those revenues had increased by 22.6 percent in 1983, following an increase of 30.7 percent in 1981. He invited the staff to comment on the prospects for further improvement in 1984. Second, with regard to the sharp increase in current expenditures, the salary actions were said to have been designed to align wages and salaries in the civil service with those prevailing in other sectors. Substantial increases were to take place in 1984. While the adjustment was necessary and might have positive effects, the process should be cautiously monitored, particularly as wage comparisons between industry and administration were sometimes difficult to assess. The initiation of a vicious circle in wage increases should be avoided. A third reason for optimism was that budget expenditures for investment should slow down considerably in 1984, following the rapid expansion in 1982 and 1983. In sum, a major part of the budget slippages in 1982 and 1983 reflected restructuring efforts by the Algerian authorities. They had been necessary and transitional. However, he did not wish to imply that the resulting deficit could be neglected. If maintained, it would become a source of great concern. Although there were no data in the staff report on the 1984 budget, the deficit could remain important. The main problem for the Algerian authorities would be to contain liquidity creation.

Turning to monetary and credit policies, Mr. Blandin noted that the ratio of money and quasi-money to GDP had increased markedly during the previous two years, from 58 percent in 1981 to 73 percent in 1983, reflecting mainly a sharp increase in credit to the Government in 1982 and, probably, in 1983. He agreed with the staff that the position could indicate the existence of excess liquidity in the economy, which in turn could revive the inflationary pressures that had been contained so far. He welcomed the improvements in the efficiency of banking services that had already taken place, and he agreed with the staff that the Algerian

authorities should improve further the attractiveness of savings instruments. It was regrettable that only preliminary data for the first half of 1983 were available, as the result of the division of the largest bank into two separate banks. Perhaps the Algerian authorities could benefit from technical assistance from the Fund in that particular area.

The results on the external side were impressive, Mr. Blandin considered. The surplus in the trade balance had increased in 1983, and it was projected to increase again in 1984. In the meantime, the decline in petroleum products had been fully offset by the increase in other exports, in particular condensate and liquefied natural gas exports. The current account had been in balance in 1983 and was projected to show a surplus of SDR 700 million in 1984. External debt remained manageable; outstanding external debt had decreased in 1982 and 1983.

With the economic situation remaining sound, Mr. Blandin went on, the Algerian authorities had undoubtedly improved the structure of their economy and increased its efficiency, both domestically and externally. In the industrial sector, the substantial reorganization of the public enterprise system had increased its efficiency and productivity. Large parastatal enterprises had been split into smaller, more efficient units. The reorganization and rationalization of the enterprise sector had been stressed in the 1980-84 Development Plan, in which priority had rightly been given to tackling traditional bottlenecks in Algeria--infrastructure, housing, social services, and the like--together with greater emphasis on the agricultural sector. As Mr. Salehkhou had noted, private sector agricultural activities had been stimulated. Third, a more flexible wage policy, in particular a system of individual and collective productivity incentives, had been introduced, increasing workers' motivation and performance. As a result of all those measures, productivity had increased substantially more in 1982 and 1983 than in previous years. The result was impressive, although, as the staff had stressed, more could be done in financial restructuring of enterprises and the pricing system.

On the external side, progress had been somewhat slower, Mr. Blandin remarked, although a number of structural steps had already been taken. Measures had been implemented in 1982 and 1983 to increase the flexibility of the trade system and to liberalize certain imports. The Algerian authorities were committed to continuing in that direction. Measures had also been taken to limit the scope of multiple currency practices with regard to workers' remittances. The complex question of the exchange rate system had been discussed at length during the 1982 Article IV consultation. The authorities had agreed to study the impact of recent trends in the exchange rate on the Algerian economy. In sum, the authorities should be commended for their pragmatism and for the encouraging results that they had already achieved.

Mr. Alhaimus commented that the Algerian economy had generally performed well since the previous Article IV consultation. The rate of real GDP growth had accelerated considerably in 1982 and 1983 relative to the previous two years. That achievement had been accompanied by a measure

of domestic and external financial stability, as the rate of price increases had remained moderate while the external accounts had generally been favorable.

Developments in the real sector well illustrated the authorities' efforts to diversify the economy's productive base, both within and outside the hydrocarbon sector, Mr. Alhaimus continued. The success of those efforts could be gauged from the acceleration of growth in the nonhydrocarbon sectors over the previous two years, despite the severe impact of the 1982 drought on agricultural output. It was particularly noteworthy that the rapid increase in industrial output had been accompanied by a remarkable improvement in productivity. Further productivity gains should result from the reorientation of investments and from the administrative reorganization of the public sector enterprises, an effort aimed at improving management efficiency and control of costs and production.

In the financial area, Mr. Alhaimus said, the emphasis of fiscal policy had correctly been placed on reducing revenue dependence on the hydrocarbon sector. Efforts in that direction had started to yield encouraging results. Indeed, in 1983, nonhydrocarbon budgetary receipts were reported to have increased sharply, reflecting the considerable strengthening of tax administration, the widening of the tax base, and other supportive measures introduced since 1982. The continuation of that trend in the period ahead would be in line with the diversification policies pursued in the real sector. It would also contribute to reducing the recent increase in the Treasury deficit, which had resulted mainly from the acceleration of investment outlays in 1982 and 1983 that had been designed to correct the shortfalls in the previous two years of the current development plan, the doubling of payments for interest and public debt, and the wage adjustments associated with the job reclassification in the civil service.

Turning to the external sector, Mr. Alhaimus noted that a number of measures had been taken since 1981 that, in Algeria's institutional framework, represented a substantial increase in the flexibility of the country's trade and payments system. The staff had noted that the import-weighted effective exchange rate of the dinar had appreciated in recent years in both nominal and real terms. It had also described the impact of those developments on Algeria's international competitiveness, investment decisions, and economic diversification. There was merit in the authorities' arguments in favor of the present system of weighting currencies for determining the dinar's exchange rate that took due account of the totality of external outlays, given the importance of interest and debt amortization charges facing the country. There was also merit in their view that the question of export diversification, although significant in the long run, was not a pressing issue in view of the present composition of exports, the overwhelming portion of which was insensitive to exchange rate considerations. At the same time, the authorities had an open mind on those matters, since they had indicated their willingness to study them in greater detail.

There were a number of difficulties in interpreting the exchange rate indices shown in Table XLIV of SM/84/60 and in the lower part of Chart 4 in SM/84/57, Mr. Alhaimus observed. First, one implicit assumption underlying the use of an import-weighted exchange rate index in assessing export competitiveness was that the country's competitors were also the countries that supplied the bulk of its imports. A second difficulty related to the use of the 1980 trade weights for the whole period. The question was whether there had been a shift in those weights during the period 1975-80 and, if so, how significant it had been. Third, there was the broader issue of the difficulty of determining a particular time when the exchange rate could be said to have been in equilibrium. The staff had noted that, in the case under consideration, the rate "had remained broadly stable between 1975 and 1980." It was not clear whether that observed stability could be considered an indicator of equilibrium. Those questions reflected some of the complexities of the exchange rate issue in general, but in a semicentrally planned oil-based economy such as Algeria in particular, and they called for more comprehensive treatment in the future.

Mr. Templeman stated that Algeria represented an interesting example of an oil-exporting developing country that had managed quite well to adjust to sharp changes in the world energy market through prudent macroeconomic policies, coupled with modest structural reforms, in the context of a highly planned economy. Although there were some potential problems emerging in both the fiscal and monetary areas, as well as a need to consider the long term in providing for the evolution of the economy when energy became a less important factor in development, the Algerian people had benefited from the prudent macroeconomic policies followed by the Government, as illustrated by recent economic performance.

Despite the good recent record on fiscal and monetary management, Mr. Templeman continued, the authorities might be becoming too complacent in both areas. They had correctly assigned importance to creating a source of revenue that was not dependent on the fluctuating energy situation. Broadening of the tax base, tax simplification, and more efficient tax administration were important, particularly if both current and capital expenditures continued to grow at recent rates. The rise in the Government's wage and salary bill, with an average annual growth rate of almost 25 percent between 1979 and 1983, was striking compared with the average annual increase in prices of only 10 percent. Since the staff did not cite the growth of government employment as a factor, it appeared that rising wage rates explained the increased wage costs. Whatever the equity arguments might be for closing the wage gap between the civil service and industry, the pace of wage increases might not need to be so rapid. Furthermore, did the harmonization of wages mentioned by the staff mean that wage differentials throughout the economy were to be reduced? If so, how would that development affect labor mobility? A similar question about the effects on demand and on inflation arose with regard to the sharp increase in investment expenditures by the Government, even though investment expenditures by the public enterprises had remained relatively stable and the growth of large infrastructure expenditure was expected to taper off in 1984.

Commenting on monetary policy, Mr. Templeman suggested that the authorities did not seem concerned about a growth rate of net domestic credit, particularly credit to the Government, and of money and quasi-money that had averaged about 28 percent and 25 percent in 1982 and 1983, respectively, rates significantly higher than in previous years. Although the increase in liquidity did not yet appear to have fed inflationary pressures, it could do so if the financial system did not develop quickly enough to absorb such liquidity. The staff correctly stressed the importance of introducing attractive savings instruments to encourage household savings. Interest rates were generally negative on both the lending and the deposit sides. Was information available on the sources of the high level of gross domestic savings reported on page 3 of SM/84/57 and on pages 54 and 55 of SM/84/60?

The staff had held extensive discussions with the authorities concerning the appropriateness of an exchange rate policy that had led to a real effective appreciation of the dinar, on an import-weighted basis, of 19 percent between 1980 and October 1983, Mr. Templeman noted. Although the authorities had evidently not been persuaded by the arguments made by the staff for modifying exchange rate policy, he was pleased that they had agreed to carry out an analysis of the impact of recent trends in the exchange rate on the Algerian economy. The authorities' arguments about inelastic demand for energy exports, the existence of tight controls on imports, and the desire for exchange rate stability represented too static and short-term a view. The position seemed inconsistent with other policies being adopted by the authorities to free the economy from tight controls on domestic activities and on foreign trade and payments so as to create an environment that would favor the growth and diversification of production and exports. It took time for such new sources of growth, employment, and exports to develop, particularly as a country evolved from an exporter of simple commodities into an exporter of more complex manufactured goods. The data on noncommodity exports in SM/84/60 showed little growth in the previous three years.

The authorities had embarked on a welcome variety of measures to reform the economy in order to make the planning system less rigid, Mr. Templeman went on, with particular emphasis on organizational and financial restructuring of the public enterprises by reducing their size, decentralizing management, strengthening the capital base, and increasing administered prices to cover costs, while avoiding the creation of a large financial burden on the Treasury. The measures adopted to take advantage of the entrepreneurial talent and financial resources of the private sector by treating private firms on a basis similar to that extended to public enterprises had been positive steps, as had been the slight opening up of the economy to foreign direct investment.

A point applicable to Article IV consultation reports in general was the absence of forecasts of economic variables for the current year, Mr. Templeman remarked. The Algerian case was a particularly obvious example, as the consultations had been held five months earlier and as data on the Algerian economy were typically not very up to date anyway.

Except for a staff forecast of the 1984 balance of payments, there were practically no other references or estimates in the report concerning economic prospects for 1984. He invited the staff to say whether more recent data had become available, particularly regarding developments in monetary and fiscal policy.

Mr. Laske said that he agreed with those Directors who had congratulated the authorities on the economy's satisfactory performance in the past year. An outstanding aspect was the current account of the balance of payments, which had been in virtual balance. Real GDP had increased by more than 7 percent, and public external indebtedness had been reduced further. Despite those favorable aspects, there were a number of other grounds for concern because of the continued existence of maladjustments that could inhibit further progress of the Algerian economy unless they were rectified.

Algeria's industrial structure appeared lopsided, Mr. Laske commented. It was heavily oriented toward producing and refining petroleum and natural gas, activities that provided the country with the bulk of its foreign exchange earnings. Because those areas of industry were capital intensive, they could contribute little to easing the pressures in the labor market. Unemployment was particularly prominent among young people, a factor that would argue for the promotion of labor-intensive investment. As a result of the skillful negotiation of long-term supply contracts, Algeria had so far managed to mitigate the economic impact of the declines in the prices of petroleum and natural gas. However, it might not be possible to do so in the years ahead. Other things being equal, Algeria would be faced with shrinking revenues from its gas and petroleum exports, a development that would affect the balance of payments as well as budget revenues. The competitiveness of Algeria's nonhydrocarbon-related economy continued to be impaired by the overvaluation of its currency. He agreed with the staff that an adequate exchange rate adjustment would be appropriate to bring about a more realistic relationship between the internal and the external values of the dinar.

The preceding considerations suggested the need for long-term structural measures, Mr. Laske continued, designed to maintain over the medium term the momentum of the favorable performance to date. Such measures should include further liberalization of private sector activities, particularly because earlier liberalizing steps had produced positive results for the overall level of economic activity. The industrial sector should be broadened and diversified. The efforts undertaken to strengthen the agricultural sector were laudable; they should be intensified. Although a number of key prices had been corrected recently, maladjustments in the structure of relative prices continued to exist. Progressive elimination of those distortions would help prices to serve better as indicators of relative scarcities and to reflect relative demand and supply conditions adequately. He agreed with the staff that the efficiency and effectiveness of the banking system was in urgent need of further improvement. A more broadly based banking sector and a more flexible structure of interest rates would attract additional deposits and would channel such savings

into areas and projects that offered the best return. The Fund's non-approval of Algeria's multiple exchange rate practices continued; he hoped that the authorities would remove those restrictions soon.

Mr. Shaw observed that the Algerian economy had made good progress in the past year. Despite Algeria's almost exclusive reliance on the energy sector for its exports, its ability to diversify its hydrocarbon products had enabled it to weather so far the decline in the oil market and the sharp fall in the terms of trade. In view of the excess supply that might be appearing in the natural gas market, the vigorous attempts by the Government to strengthen the non-oil sector of the domestic economy were encouraging. Previous high levels of savings and investment had resulted in the rapid growth of nonhydrocarbon GDP, particularly in manufacturing. The authorities should be commended for liberalizing the pricing and marketing system, broadening the scope of the private sector, and reorganizing and decentralizing public enterprises. Algeria's net retirement of external debt since 1982 appeared prudent in view of the present high debt service ratio.

The fiscal situation was a matter of concern, Mr. Shaw continued, as evidenced by the rapid deterioration in the budget to an estimated deficit of 6 percent of GDP in 1983 from a surplus of 3.6 percent in 1981, despite recent efforts to increase hydrocarbon revenues through improvements in tax administration and a reduction in tax evasion. Both current and capital expenditures had grown sharply, with wages and salaries, as well as transfers and subsidies, increasing at a particularly strong rate. He invited the staff to say whether wages and salaries should be brought more into line with private sector levels. In addition, as other Directors had remarked, the steady 7 percent annual rate of growth in personnel appeared high.

Part of the reason for his concern about the increase in the government budget deficit was the recent large increase in government borrowing from the Central Bank, Mr. Shaw stated. Together with the relatively large lending to the private sector, it had contributed to a rate of growth of the money supply far in excess of the increase in nominal GNP. That development was worrisome at a time when the authorities were taking welcome measures to make the system of price controls more flexible. Had the authorities considered placing more emphasis on domestic nonbank sources of financing for the deficit, other than postal savings accounts?

A second area of concern was the external situation, Mr. Shaw went on. He agreed with the staff's views and recommendation regarding the appreciation of the real effective exchange rate during the past three years, and he welcomed the authorities' intentions to review exchange rate developments and policies. That review could be helpful for the reasons cited by the staff; in particular, a more competitive exchange rate could facilitate the Government's policy of promoting nonhydrocarbon exports. Action on the exchange rate would be particularly desirable if, as had recently been reported, receipts from exports of natural gas in 1984 were lower than expected.

The staff and the authorities might be too optimistic in judging that exports would grow at approximately 13 percent in 1984, Mr. Shaw suggested. If exports grew by only 6 percent, a deficit on current account of about $1 billion could emerge. Furthermore, workers' remittances had not increased, a development that was particularly related to the levels of Algeria's exchange rate and interest rates. Another indication of pressure on the external side was the deterioration in the reserve position between 1981 and 1983. There had been a large amount of borrowing--about $1.5 billion--in the international capital market in 1983. He invited the staff to comment on the use to which that borrowing had been put. Finally, although the question had not been raised by the staff, would it be correct to assume that the next Article IV consultation with Algeria would be held on the standard 12-month cycle?

Mr. Mtei remarked that he agreed broadly with the staff's appraisal of recent economic developments in the Algerian economy. The 7 percent growth of real output in 1983 had been a commendable achievement, especially against a background of continued recession in the world economy. The growth of the nonhydrocarbon sector was particularly noteworthy; it had been sufficiently significant in recent years to offset the decline in value added from the hydrocarbon sector. The staff correctly attributed that favorable performance to the prudent policies pursued by the authorities to diversify the economic base, supported to a large extent by resources from the oil industry. The hydrocarbon sector remained important to the Algerian economy, constituting about 29 percent of GDP and 98 percent of exports.

Diversification had not proceeded with equal strength in the agricultural sector, Mr. Mtei continued. Since its 1979 peak, growth in the agricultural sector had been declining steadily and had been negative in 1982, remaining sluggish in 1983, partly as a reflection of bad weather. Aware of those developments, the authorities had taken measures to promote agricultural production in 1981 and 1982. He encouraged them to strengthen the measures to bring production up to its potential level. He welcomed the establishment of a new credit institution to promote investment and production in the agricultural sector, a policy that was often a major missing link in the promotion of agriculture in many developing countries.

In the fiscal area, Mr. Mtei noted, revenues had benefited from the diversification of domestic production through a widening of the tax base. While hydrocarbons remained a significant source of budgetary revenue, nonhydrocarbon revenues had been increasing steadily in the previous two years. In 1983, increased revenues from that source had been supplemented by measures to improve tax administration. It would be necessary to strengthen nonhydrocarbon revenues further, given the weakening of external demand for petroleum products and the persistence of the budgetary deficit because of increased outlays on both recurrent and capital expenditures.

The staff indicated that the nominal import-weighted effective exchange rate of the dinar had appreciated significantly in recent years, Mr. Mtei observed. It pointed out on page 18 of SM/84/57 that that development might

have "an adverse impact on enterprises' decisions, [and] hamper the establishment of a realistic price system...." In a country where exports were dominated by hydrocarbons, where production was predominantly in the hands of the public sector, and where there was an elaborate system of controls, an adjustment of the exchange rate would not play a very prominent role in influencing investment decisions. It was difficult to visualize how such an adjustment would improve price relationships, as the existence of both domestic and external controls would negate such action. Nevertheless, he welcomed the authorities' commitment to keeping the question under review.

Mr. Lovato said that he agreed with the staff appraisal. He commended the authorities for their cautious and pragmatic attitude in adopting measures during the past two years to make the trade and payments system more flexible and more open. He encouraged them to continue those policies and to adopt a flexible attitude in their exchange rate policy also. He strongly supported the proposed decision.

The staff representative from the African Department recalled that at the time of the staff mission to Algeria the authorities had not made clear their position on the budget, the official import program, or the investment program for 1984. The budget, which had been made available in early January, was broadly in line with the indications in SM/84/57. There was to be a strong continuing increase in nonhydrocarbon revenues as a result of an expansion of the tax base, increased rates on some imported luxury goods, and modifications to the tax system, including a new method of assessing income for small enterprises. On the expenditure side, the budget confirmed the increase in wages referred to in the staff report. As the staff had pointed out, wages had increased relatively rapidly in public enterprises in the past few years, while increases in public administration had been considerably lower. Thus, according to the schedule determined a few years earlier, there would be a final adjustment in the wage scale for administrative staff in 1984. However, it had not been possible for the staff to update the tables in its reports, because the budget made available by the authorities did not include forecasts. In addition, the budget figures had to be adjusted if they were to be translated into revenues and expenditures in cash terms. With regard to the staff's export forecasts for 1984 and the medium term, which one Director had considered a little optimistic, it was true that the price of Algeria's natural gas was high relative to the market price and that Algeria had had difficulty in diversifying its markets. However, the available information made it difficult to be precise about the export outlook.

The question of the exchange rate had been discussed with the authorities during the previous Article IV consultation, the staff representative continued. While the authorities had regarded the issue as important, they had not considered it necessary to take action because the external situation had been relatively favorable and because they had wished to concentrate on reform of the productive sector. More recently, the staff had had extensive discussions on the exchange rate, primarily with the

central banking authorities, but those discussions had concentrated more on the methodology used to measure nominal and real effective exchange rates rather than on the economic implications of various exchange rate policies or on the implications of the actual policy pursued during the past few years.

The differences in assessing the appropriateness of the exchange rate as judged by the Fund staff and the staff of the Central Bank of Algeria were based mainly on the different weighting systems that each side used, the staff representative observed. The import weighting system used by the Fund staff placed a relatively small weight on the U.S. dollar, less than 6 percent, while in the basket used by the Algerian authorities, which took into account payments related to external debt, the dollar's share was more than 40 percent. The Algerian basket ensured greater exchange rate stability vis-à-vis the dollar, and consequently in the financial flows, expressed in local currency, related to export receipts and debt service payments. At the same time, however, the stability in relation to the dollar had led to a relative reduction in the cost of imports from Europe because of the sharp appreciation of the dollar against European currencies. Because domestic costs in Algeria had not declined during the past three years, there was a strong presumption that the competitiveness of the non-oil sector of the Algerian economy had declined.

Even in a highly protected, oil-producing economy, an appropriate exchange rate was important both to determine the relative costs of production on the basis of which new investment projects could be evaluated and to contain imports without excessive reliance on administrative controls, the staff representative stated. The staff had been careful to avoid saying that the present exchange rate policy had already had a negative impact on the economy. It had based its views on the potential impact in the period ahead, particularly in view of the authorities' efforts to restore normative production costs. The staff had been unable to undertake a comprehensive study of the competitiveness of the Algerian economy because the relevant data were not available, but there was a strong presumption, based on partial data and on qualitative judgments by the Algerian authorities, that the appreciation of the exchange rate by almost 40 percent could cause problems in that regard. The staff strongly recommended that the authorities should adopt an import weighting system along the lines suggested. However, the more immediate issue was whether the appreciation that had already taken place should be reduced, a question that would be the subject of the study to be carried out by the Central Bank in the coming months.

Finally, on the question of borrowing in the international financial markets, the staff representative from the African Department remarked, Algeria had received two loans in 1983, both related to investment projects under the Fourth Plan. With regard to the composition of domestic savings, the staff had no breakdown of savings by sector, other than the information presented in SM/84/60, which indicated the breakdown of savings between the government sector and other sectors of the economy.

The Acting Chairman asked how much the exchange rate was estimated to have appreciated on the basis of the weighting system used by the Algerian authorities.

The staff representative from the African Department replied that on that basis there had been no appreciation of the exchange rate because of the relatively large weight of the dollar.

Mr. Salehkhou commented that, although the Algerian economy was considered centrally planned, the flexible approach of the authorities had enabled them to mobilize resources from both the public and private sectors to promote development. For several years, the authorities had been seeking to diversify the productive base away from its heavy reliance on the oil sector. In addition to hydrocarbons and condensates, other industrial products had been promoted as well as agricultural products. Unfortunately, agriculture had not performed as well as expected because of the drought in recent years. As a result of the overemphasis on industrial and agricultural production, shortages had arisen in social areas, such as housing. Thus, the present plan put a good deal of stress on housing development; the private sector was expected to continue to contribute substantially to the removal of shortages in that area.

However, the emphasis on housing and other social expenditures did not imply that the authorities intended to neglect industry and agriculture, Mr. Salehkhou continued. A major restructuring of the public enterprises was under way, a process in which the authorities had consulted lower-level managers so that the changes would be implemented effectively. The principal aim was to reach an appropriate size for the public enterprises; thus, some of the largest enterprises were being broken up, while at the other end of the scale, some of the smallest firms, particularly in agriculture, were being merged to establish them on a more viable basis.

A major consideration had been to achieve a more equitable distribution of income, Mr. Salehkhou remarked, for example, through the harmonization of wage scales in different sectors. The Government had also taken steps to decentralize various agencies, relocating them in different parts of the country. As a result, not only was the construction industry aided, thereby increasing the domestic tax base, but employment opportunities were expanded in the more remote regions. The Algerian authorities intended to continue their flexible approach in order to achieve the growth targets set out in the current plan.

The Acting Chairman made the following summing up:

> Executive Directors generally concurred with the thrust of the views expressed in the staff appraisal for the 1983 Article IV consultation with Algeria. Directors expressed satisfaction that, despite a substantial weakening in world demand for oil, the Algerian economy had experienced rapid and broadly based growth and had maintained approximate equilibrium in the current account of the balance of payments. While noting that the increasing

diversification of hydrocarbon exports had enabled Algeria to avoid a decline in its export receipts, Directors considered that adjustments in economic and financial policies had also contributed importantly to the favorable domestic and external performance. They also noted with satisfaction the prudent external borrowing policy, which had brought about a reduction in Algeria's external debt.

Directors commended the authorities for effectively implementing a major reorganization of the public enterprises in order to introduce greater economic efficiency in the operations of that sector. They particularly welcomed the decentralization of enterprises into more manageable units, the adoption of production incentives, and a move toward a more realistic and flexible pricing system. While noting the stability of investment in the industrial sector, Directors welcomed the emphasis placed on improving the performance of agriculture and the progress achieved in reducing the bottlenecks in housing and public infrastructure. They also agreed with the authorities' assessment that in the period ahead the private sector could play a significant role in maintaining economic expansion.

In view of the slowing down in hydrocarbon fiscal revenues in recent years, Directors underscored Algeria's efforts to increase non-oil revenues and to improve budgetary and tax administration. They observed, however, that rapid expansion in both current and capital expenditures had led to widening treasury deficits. Directors stressed that a further broadening of the tax base and greater fiscal restraint would be necessary in the future to reduce the Government's financing requirements, which had been 6 percent of GDP in 1983. Directors also noted the rapid increase in monetary aggregates in recent years. In that context, they recommended that the authorities pursue a more active policy in developing attractive financial instruments so as to absorb the existing high level of liquidity in the economy and to facilitate the financing of the requirements of the Government and of enterprises.

With respect to the external sector, Directors welcomed the increased flexibility introduced into the trade and payments system. They observed that the nominal effective exchange rate of the dinar had appreciated considerably, on an import-weighted basis, in recent years, and they noted the staff's analysis regarding the need for appropriate relative prices for the sustainable development of the non-oil sector, the diversification of exports, and the containment of imports without excessive reliance on controls. Directors welcomed the intention of the authorities to undertake a careful review of exchange rate policy.

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

The Executive Directors then took the following decision:

1. The Fund takes this decision relating to Algeria's exchange measures subject to Article VIII, Sections 2 and 3, in concluding the 1983 Article XIV consultation with Algeria and in the light of the 1983 Article IV consultation with Algeria conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund welcomes the steps taken by the Algerian authorities to liberalize some restrictions on payments and transfers for current international transactions and the termination of the remaining bilateral payments arrangements with Fund members. The Fund urges Algeria to ease further the external payments restrictions and to adopt policies which would enable it to eliminate the multiple currency practice resulting from the premium on workers' remittances from abroad, as described in SM/84/60.

Decision No. 7672-(84/60), adopted
April 18, 1984

3. EXPERIENCE WITH MULTIPLE EXCHANGE RATE REGIMES - REVIEW

The Executive Directors considered a staff paper on a review of experience with multiple exchange rate regimes (SM/84/64, 3/19/84; and Cor. 1, 3/28/84). They also had before them a paper providing background information on the same subject (SM/84/65, 3/20/84; Cor. 1, 3/22/84; and Cor. 2, 4/4/84).

Mr. Kafka stated that the main provisions of the Articles of Agreement dealing explicitly with multiple exchange rate regimes appeared to be Article VIII, Section 3, and Article XIV; in more general terms, Article I(iv) might also be applicable. Those provisions implied that approval by the Fund of multiple exchange rates could not be permanent, nor perhaps even indefinite. However, they in no way implied that approval of multiple rates had to be substantively short term. Each case had to be judged on its merits at the time when consideration was given to it. By "substantively short term," he meant that approval might be for a short period, for example, a year, or perhaps a little longer or a little shorter, but that it would not be repeated many times.

Furthermore, the staff's affirmation that the Fund's concern in a broad sense "encompasses practices that fall outside [its] jurisdiction" was not clear, Mr. Kafka suggested. If "concern" did not mean assuming jurisdiction, what did it mean? It could be dangerous for the Fund excessively to expand its jurisdiction, or even its "concern" if that "concern" were tantamount to jurisdiction, because the Fund was all powerful vis-à-vis members that obtained its financial assistance and helpless vis-à-vis other members, even allowing for the fact that it could make

recommendations that irritated the latter members. While the asymmetry in influence was not the fault of the Fund, it imposed on the organization an obligation to be extremely careful to avoid assuming jurisdiction or showing concern in a way that would be perceived as not evenhanded. The Fund had been endowed with financial resources in order to enable members to avoid measures destructive of national or international prosperity when they were in balance of payments difficulties. However, the underlying assumption in that regard was that the members not in such difficulties would refrain from action detrimental to national or international prosperity, a proposition that was manifestly untrue.

The staff discussed four characteristics of multiple exchange rates, Mr. Kafka noted. He did not disagree with the staff's findings, although they did not appear to go far. First, the staff stated that multiple exchange rate systems had the tendency to become long lasting, but the average duration for 61 members was five years, a period that could be considered long but less than excessive. Second, the staff stated that multiple exchange rate systems did not always produce the desired result or did so only at high economic cost. The first statement was true of almost any economic measure, indeed, of almost any human activity other than laboratory experiments. It was, therefore, hardly illuminating. The second statement was an affirmation made without reference to the cost of available alternatives. It was not possible to deduce "high economic costs" from the evidence in SM/84/65. In Table 3 of that paper, the staff sought to show the relationship between multiple exchange rates and various economic characteristics, but in many of the cases the direction of causation could go in either direction, and there was no evidence in the paper to suggest in which direction it was supposed to go. In other cases, the association of multiple exchange rates with less growth or more inflation might be spurious, because, as the staff recognized, other characteristics of the situation would have to be stressed. Certainly, the evidence was not uniform.

A third important characteristic suggested by the staff was that "in general" multiple exchange rates did not produce an effective shield against capital movements, Mr. Kafka continued. Again, there had been no discussion of available alternatives. Finally, the staff had made no analysis of the available alternatives or the costs associated with the circumstances that gave rise to frequent modifications in multiple exchange rates or to the complexity of legislation or administrative rulings associated with them. His comments should not be taken as a defense of multiple rates; they were intended simply to indicate that the Fund's judgment on the economics and administration of multiple rates needed more solid underpinnings. Otherwise, the staff's attitude, particularly on the advisable speed of substitution or elimination of multiple exchange rates, would lack the desired credibility.

Two points were raised by the staff with regard to implementation of Fund policies, Mr. Kafka noted. The first was the old question of multiple exchange rates that affected solely medium-term and long-term capital flows. There was nothing in the Articles of Agreement that would

authorize the Fund, nor any considerations that would make it advisable for it, to assume jurisdiction over such multiple exchange rates. Given that there were undoubtedly differences of views among Directors on that question, it would be preferable to let the matter remain as it stood at present. Second, on the question of multiple rates maintained for reasons other than those relating to the balance of payments, the present policy appeared adequate in concept, but inadequate in practice. There was certainly no reason to maintain multiple exchange rates if other measures with identical effects were available. However, the administrative and political problems involved in the process of substitution also had to be considered. The practice should be not to deny approval, even for extended periods, provided that no harm was done to other members; for example, merely to replace one form of tax with another did not justify creating problems for a member. It was no doubt for that reason that the Articles of Agreement had been formulated in a way that gave ample discretion to the Fund.

Turning to the nine issues raised by the staff for discussion on pages 25 and 26 of SM/84/64, Mr. Kafka commented that the first point--that multiple rate systems were costly, burdensome, and the like--was often true, but it had to be proved in each case. The staff's statement in its present general form did not say much. The second statement, that economic reasoning did not justify the persistent maintenance of multiple rate systems, was not formulated sharply enough. Depending on the circumstances, it might be justifiable to maintain multiple rates, not permanently but for extended periods. Again, each case had to be judged on its merits; the statement in its present form did not appear helpful. He agreed with the third statement, that the reasons cited for introducing a multiple exchange system, such as a delay in the process of transition to a sustainable set of price relationships or a desire for a particular income distribution effect, did not hold indefinitely and that in due course those objectives were better sought through the budget process, although much depended on the meaning of "in due course."

The staff went on to state that "multiple rate practices introduced to mitigate the impact on balance sheets of increased domestic currency cost of foreign currency debt and debt servicing have acquired particular significance recently," Mr. Kafka noted. It added that "the case for such subsidies is often overstated: the industry to be protected in this fashion might not be viable and its reorganization might be desirable...." That point was not always valid. It was difficult to see the purpose of that kind of general statement. The fifth statement, that "the Fund's policy since 1981 continues to have flexibility" and that "such flexibility should only be exercised with care," was perfectly acceptable. However, the statement was almost tautological. The sixth statement was that "Fund reluctance to accept [multiple rate practices] remains appropriate," and that in most instances they should be eliminated "within a specified and appropriately short period from their identification." That statement should be reformulated to say that early elimination should not be a matter of principle but rather should correspond to the particular circumstances in each case, particularly when the Fund was dealing with

multiple rate practices that had not been introduced for balance of payments purposes. Lenient treatment would be appropriate, because in such cases the Fund often insisted, sometimes at considerable political costs, on the replacement of what it considered a multiple rate system by an exactly equivalent export tax. The result was to create difficulties without making any practical difference.

As to the seventh item, Mr. Kafka suggested that the staff's comment required an addendum: temporary approval should not be interpreted to mean elimination after a short period. In particular, multiple currency practices for reasons other than balance of payments purposes required lenient treatment. On the eighth item, the assumption that the Fund should show concern about the appropriateness of matters over which it did not have jurisdiction was difficult to understand. Unless the assumption could be explained and justified, it should be eliminated. Finally, with regard to the Fund's jurisdiction over multiple rates applicable exclusively to long-term and medium-term capital flows, such jurisdiction should not be assumed.

Mr. Polak remarked that the staff was seeking further guidance by the Executive Board on the question of multiple exchange rates for two reasons: because experience had provided grounds for skepticism with regard to the merits of so-called temporary reliance on multiple rates, and because in the 1981 surveillance review (EBM/81/51 and EBM/81/52, 4/8/81 and 4/9/81) multiple exchange rates had been mentioned as a second-best solution in perhaps too favorable terms. As a result, the staff's task in discussing such issues with members had become more difficult.

The case against multiple exchange rates rested on economic grounds, not on questions of dogma, as the staff correctly pointed out, Mr. Polak continued. Article VIII, Section 3 created a presumption against multiple currency practices; however, it stated only that a member should not engage in nonapproved multiple currency practices. There existed a substantial body of evidence and experience that unified exchange rates contributed to efficient domestic and international resource allocation through appropriate balance of payments adjustment and to the growth of world trade. To put the matter the other way round, multiple exchange rates were often ineffective, created distortions, led to complex legislation, to windfall profits, and, as the staff mentioned, to corruption.

Although the staff did not cite the literature in which such evidence could be found--and Mr. Kafka was correct in saying that the staff had not provided convincing evidence in the papers--the many country discussions in the Executive Board in which cases of multiple exchange rates had arisen should have convinced Directors on various counts, Mr. Polak considered. First, the staff said that the adjustment process was better served on the basis of a realistic unified exchange rate than through a multiple exchange rate regime; second, that systems introduced as temporary often tended to remain in place to the point where they were a hindrance rather than a help to adjustment; and third, that to attain particular price effects, taxes and subsidies, i.e., fiscal measures, had fewer disadvantages than

multiple exchange rates. The evidence was, therefore, convincing. However, the staff's comparison of countries with multiple exchange rate regimes with other countries was not impressive. The staff acknowledged that the direction of causation between the various economic variables and the exchange rate regime could not be shown. It would have been preferable to omit those references.

The staff stated that to an increasing degree members tended to resort to multiple exchange rate regimes not as a temporary, second-best solution, but as a device to postpone adjustment, and not instead of but in addition to, quantitative exchange and trade controls, Mr. Polak observed. The degree to which a qualitative change had taken place was not clear from the staff's analysis, and Table 1 in SM/84/65 did not support the view that since 1980 there had been a quantitative change of trend for the Fund's membership as a whole, although the staff made a statement to that effect on page 4. However, the point was not particularly relevant, because every multiple exchange rate was clearly against the spirit of the 1981 surveillance review, which had stated that multiple exchange rates were possibly a second-best solution. In that context, a multiple exchange rate regime could be accepted as a second-best solution only when it was accompanied by a meaningful reduction in quantitative controls. Without accompanying measures, it was not clear what the multiple rate system produced, nor why it should be preferred to a black market. He agreed with the staff that under Fund arrangements a strict approach was called for, implying that the temporary character of multiple rates should be firmly included in the terms of the arrangements.

The position of the staff and of the Executive Board should be the same for members that did not use the Fund's resources as for borrowing members, Mr. Polak stated. As in so many questions of surveillance, the Fund's leverage was much smaller in the former case, and there was often little that the Fund could do other than decide on nonapproval of certain practices. A proliferation of nonapproval cases was not to be welcomed; he invited the staff to comment on the legal importance for the international financial community of nonapproval.

With regard to the Fund's jurisdiction over multiple rates in connection with capital transactions, Mr. Polak concluded, the staff was absolutely correct to examine in the course of Article IV consultations multiple currency practices affecting capital transactions. The question of the appropriateness of the Fund's jurisdiction deserved to be reexamined; it was intellectually uncomfortable for the Fund implicitly to abandon its jurisdiction in that respect. If the Fund wished, it should decide explicitly to abandon its jurisdiction. Finally, the policy with regard to multiple currency practices for reasons other than the balance of payments was satisfactory as it stood.

Mr. Lovato said that he agreed with the proposition that the principle of flexibility in the implementation of Fund policies toward multiple currency practices continued to be appropriate; however, a continued flexible posture should be seen not as a universal acceptance of such

practices, but rather as a qualified acceptance under specific conditions. The adoption of a multiple exchange rate system, and its approval by the Fund, should not be an expedient for postponing the necessary adjustment; in any case, it should be only a very temporary measure. He agreed with the staff that Fund-supported programs should incorporate provisions for the effective phasing out, within a specific timetable, of multiple exchange rates, along with the policy actions that were deemed necessary to improve the payments position of the country and to stabilize its currency. He was convinced that, although no certainty existed that removing any one of the many distortions and market imperfections that characterized modern economies would drive them closer to an optimal welfare configuration, the case could certainly be made that, over the longer term, multiple exchange rate systems entailed higher resource costs, were often accompanied by, instead of being an alternative to, administrative controls and restrictions, and that unfortunately they often became a semipermanent feature of economic management, rather than a temporary arrangement during a needed period of adjustment.

Commenting on some of the specific issues raised by the staff, Mr. Lovato stressed that multiple rates were equivalent to a set of implicit subsidies and taxes on different categories of external transactions, intended to attain particular social and distributional goals. In such instances, it would be desirable, whenever possible, to devise schemes through the budget, involving explicit subsidies and taxes whose costs could be directly measured and whose consistency with other policy instruments could be more precisely assessed. On the question of the indirect subsidy provided by multiple rates to external debt service payments, he broadly accepted the argument that, whenever it was necessary to support domestic industries or financial entities affected by a devaluation in order to enable them to service their accumulated debt, it was preferable to do so directly through fiscal mechanisms, even though there might be compelling reasons in some cases for resorting to multiple exchange rate schemes in the short run as a transitory solution.

He agreed with the staff's view that the objectives of multiple currency practices adopted for purposes other than the balance of payments could be better served by other instruments, Mr. Lovato remarked. He also agreed that such practices should be approved only temporarily, provided that they were nondiscriminatory and had no detrimental effects on the balance of payments position.

The staff should conduct a more in-depth analysis of the question of restrictions on capital flows, Mr. Lovato suggested. Given the growing influence of capital movements on balance of payments positions and exchange rates, it was incumbent upon the Fund to reconsider its current "agnostic" attitude with regard to multiple rates applied to capital transfers, but Directors did not yet have sufficient information to adopt a firm decision in the Executive Board. For example, with reference to the staff's discussion of surveillance, he broadly agreed with its assessment of the experience with dual exchange rates in industrial countries. However, the staff's dismissal of the proposal to tax capital flows in order

to stabilize exchange rates needed to be justified with more convincing arguments. The benefits of such a levy, for example, on the pattern of world savings flows and exchange rates, should be considered along with the drawbacks.

The Fund should be prepared to grant approval to multiple exchange rates under the provisions of Article VIII in the exercise of its surveillance function and in programs entailing Fund credit, Mr. Lovato considered. However, such approval ought to be temporary, and contingent upon an agreed plan for simplifying and eventually eliminating the restrictions. Some leeway had to be maintained with respect to the speed at which the multiple rates were to be phased out. Once agreed, the process of simplification should be closely monitored through review clauses and specific understandings between the Fund and the member.

Mr. Joyce observed that it had been just over three years since the Board had discussed the Fund's policies on multiple currency practices; during that period there had been important developments affecting Fund surveillance over members' exchange rate policies and over the adjustment process. He welcomed the review of recent experience with multiple exchange rate regimes; he agreed with most of the points made by the staff.

A uniform, stable exchange rate system that promoted efficient resource allocation and fostered the balanced growth of international trade was important to members, Mr. Joyce continued. Therefore, he shared the staff's concern about the weakness associated with multiple exchange rate systems. Those schemes hindered efficient resource allocation, frequently entailed a need for extensive administrative systems, and could create incentives for evasion or corruption. They failed to make clear the extent of the implicit taxation or subsidization that they entailed. Moreover, the policy objectives being pursued could often be met more efficiently in other ways.

Nevertheless, there could be individual cases in which the temporary use of a multiple exchange rate regime could play a useful role in assisting a country to adjust its exchange rate system in order to reflect underlying market conditions better, Mr. Joyce suggested. Indeed, there could be situations in which such practices would be better than the other alternatives that a government might consider. A multiple exchange rate system often represented a first step toward an exchange rate adjustment that might otherwise not be taken. Therefore, it would be a mistake to be too dogmatic about such practices, especially when adopted by countries at different stages of development. What was suitable for the more developed industrial countries might be less effective in other societies. The implementation of Fund policies established at the time of the 1981 review appeared to be compatible with that view. The Fund had been flexible in its approach while adhering to the basic principle that multiple rates tended to postpone rather than to facilitate the implementation of necessary adjustment policies and that they should therefore be phased out on a planned basis.

He fully supported the Fund's efforts to reduce the incidence of multiple currency practices, Mr. Joyce stated. A case could be made for strengthening the Fund's role in that area. Of 20 members with multiple exchange rate systems in effect at the time of approval of a Fund arrangement, only 7 could truly be said to have simplified or eliminated those systems. That result was not particularly encouraging. Consequently, he supported the view that in Fund-supported adjustment programs, while the Fund should continue to be flexible in its approach, a clear schedule should be developed with the member for the elimination of multiple rates within a specified and reasonably short period of time. In the course of Article IV consultations, increased attention should be paid to such practices, and assessments should be made as to their continued necessity. It might also be useful for the staff to provide in its reports suggestions on alternative policy measures that the members might use to replace those systems.

On the issue of multiple exchange rates applicable to capital transactions, Mr. Joyce remarked, the Fund had jurisdiction in that area. It was appropriate that such practices should be subject to evaluation by the Fund, possibly to approval or disapproval similar to that which the Fund applied to restrictions on current transactions. Of course, legal questions could be raised with respect to the Fund's jurisdiction under Article VIII with regard to exchange rate policies affecting capital movements. It would be necessary for the Executive Board in the near future to re-examine those legal questions and, more generally, to assess whether the provisions of Article VI, Section 3 impeded the Fund's jurisdiction in that area. In the meantime, the Fund ought to continue to display flexibility. In view of the risk of multiple rates hindering the adjustment process and of the key role often played by capital shifts in balance of payments problems, it was important that the Fund should assess the economic impact of such practices at least in individual cases, particularly with regard to their impact on the adjustment process.

Mr. Grosche said that he agreed broadly with the staff's analysis and generally supported the policy recommendations. In particular, he shared the staff's impression that in recent years multiple rates had become more markedly a device for postponing necessary adjustments instead of merely providing additional time for the implementation of corrective measures. Multiple exchange rate regimes were no alternative to necessary adjustments and members should rely on them only temporarily and in exceptional circumstances. The staff pointed to the high economic costs of delaying exchange rate adjustments, and it provided useful arguments in favor of a timely adoption of corrective measures. Moreover, it made a convincing case against the subsidy aspect of dual or multiple exchange rates. He shared the staff's conclusion that, if subsidies were deemed necessary, they were better provided through the budget in order to facilitate the assessment of their costs.

He also agreed with the staff that the Fund's reluctance to accept multiple exchange rate practices remained appropriate, Mr. Grosche continued. In future, the Fund should demonstrate even greater reluctance

and it should exercise flexibility with greater care, in particular because of recent experience that confirmed the impression that multiple rates often served to postpone adjustment. In principle, multiple currency practices should be approved under Article VIII, Section 3 only if an adjustment program with the Fund had been agreed upon, including a firm understanding with regard to the early removal of those practices. Because understandings could be regarded as more or less firm, it would be preferable if they could be incorporated into the agreement as performance criteria. Understandings toward the elimination or simplification of the multiple exchange rate system should directly affect the member's drawing rights. If review clauses regarding exchange rate policies under a program were agreed upon, they should be clear as to whether they were meant to deal with the questions of the multiple exchange rate system or with exchange rates in general, a problem that the staff mentioned in footnote 4 on page 15 of SM/84/64. Members with multiple currency practices for which Fund approval had not been granted should only in exceptional circumstances receive financial support from the Fund. In any case, the practices in question should be of only minor importance.

When discussing the subject on previous occasions, the Executive Board had been divided on the question whether multiple currency practices that applied only to capital flows required prior approval by the Fund under Article VIII, Section 3, Mr. Grosche recalled. The position of his chair had not changed. He continued to believe that the Fund, in dealing with those practices, should carefully examine their consequences for the economic and balance of payments performance of members. But the Fund should not be given jurisdiction under Article VIII. While he was convinced that such practices could not, at least in the medium run, act as a shield against the effects of strong capital movements, they might sometimes help to fend off large destabilizing capital flows. In the present world, such flows could be triggered in a matter of hours. Members should be able to act quickly and should, therefore, continue to be able to introduce such measures without having to ask for prior Fund approval, but such practices should be regarded only as emergency measures to be applied temporarily. Nonetheless, his chair was open to further discussions on the legal basis of the Fund's jurisdiction over such practices.

Mr. Hirao remarked that he was in broad agreement with the thrust of the staff's analysis. The staff made a convincing case that multiple rate systems were costly in terms of efficiency of resource allocation. They were also burdensome to administer, tended to become increasingly cumbersome if separate exchange markets proved ineffective, and in addition were more likely to persist. Perhaps the most worrisome aspect was that they tended to create incentives to delay necessary balance of payments adjustments. The Fund should continue to discourage multiple exchange rate systems and should strive to make the exchange rate system free from the complexities that resulted from their existence.

The policy on multiple currency practices enunciated at the time of the 1981 review of surveillance remained valid, Mr. Hirao continued. In implementing the established policy, the Fund would need to be pragmatic.

The Fund's policy on such practices should continue to be based on economic and operational factors rather than on a mere desire to reduce the incidence of multiple exchange rates. There might be cases where the use of such practices was considered unavoidable as a temporary, short-term device. Nevertheless, even in such cases, a firm understanding on early removal would have to be sought in order to avoid adverse effects. With regard to the temporary approval of multiple currency practices introduced for reasons other than balance of payments, the continuation of the present policy as set out in paragraph 4 of the 1981 decision on multiple currency practices (Decision No. 6790-(81/43), 3/20/81) was appropriate.

It remained doubtful whether the Fund had legal jurisdiction over multiple exchange rates that reflected solely medium-term and long-term capital transactions, Mr. Hirao considered. It might not be desirable to reach a definite conclusion on the matter during the present discussion. Nevertheless, the appropriateness of the practices should be assessed in the exercise of the Fund's surveillance function. In any case, in assessing the appropriateness of multiple exchange rates, careful judgments should be made, taking full account of the particular circumstances of the individual members.

Mr. Clark said that he was concerned about the trend toward multiple exchange rate regimes that had been evident in the past few years, especially among developing countries. However, given the widespread increase in balance of payments pressures during that time, and consequently in the circumstances in which multiple rates were likely to be adopted, the trend was not surprising.

The staff had provided a comprehensive list of the reasons why multiple exchange rate practices were introduced, Mr. Clark continued. They could be divided into two broad categories. First, and at least numerically the most important, there was the desire to postpone or to graduate adjustment because of its prospective effect on income distribution, enterprise finances, and the like. That approach raised two further questions: was a subsidy appropriate, and, if so, was a multiple rate system the right way to provide it? He agreed with the staff that the need for subsidies could often be illusory. They could actively hinder the process of adjustment, for example, by putting a strain on the budget targets. Where they were judged absolutely necessary, there was a need to fix a timetable for their elimination in order not to perpetuate the distortion with which they were originally designed to cope.

Economic theory suggested that providing subsidies through devices such as multiple exchange rate systems was generally second best to fiscal policy because relative domestic prices were thereby distorted, Mr. Clark remarked. However, theory did not easily translate into practice. For example, there were likely to be institutional constraints and administrative costs. Sometimes the desired results could not be achieved through fiscal policy; the tax system might be insufficiently sophisticated, or it might prove administratively impossible to distribute

subsidies. In such cases, there might be an argument for multiple rates. On the other hand, multiple rates involved a variety of costs: incentives to cheat the system, administrative difficulties, and last, but from the Fund's viewpoint not least, costs to other countries.

Those considerations indicated that the merits of multiple rates imposed essentially to cushion shifts in income distribution would vary with individual countries' circumstances, Mr. Clark went on. An analysis of the costs and benefits in each case was needed. Therefore, the present flexible approach was right. However, if adjustment was to succeed, such subsidies had to be reduced; he strongly endorsed the staff's suggestion that where multiple exchange rates were included in a program there should generally be a fixed timetable for their removal.

The second broad category of reasons for the introduction of multiple currency practices had been the desire to insulate the economy from supposedly short-term shocks or disturbances in financial markets, Mr. Clark considered. He shared the staff's skepticism of the benefits of such arrangements; they tended to remain in force for long periods, and the benefits appeared unlikely to outweigh the costs. Given the relative rarity of multiple exchange rate regimes introduced for nonbalance of payments reasons, it would be appropriate to continue with the present procedures.

On multiple currency practices arising from controls on capital flows and the role of the Fund in relation to such practices, Mr. Clark said that he agreed with the staff that controls on the free movement of capital could be as serious as, and perhaps more invidious than, controls on the free movement of goods and services. In principle, it would be desirable for the Fund to extend its surveillance to that area. Several Directors had raised the question whether discretion existed to formalize the Fund's concern in some way. It was not clear if such discretion existed and, if so, how far it was circumscribed by Article VI, Section 3. He invited the staff to comment on the issue. In sum, there was a role for multiple exchange rate arrangements in a limited number of cases for limited and prescribed periods of time. However, the case for such practices should be judged carefully in each instance, and there should be an agreed program for returning to a unified rate over a relatively short period.

Mr. Prowse stated that the staff made it abundantly clear that multiple exchange rate systems, particularly where fundamental change in the regime was evidently needed, were second-best solutions. He agreed that the experience of countries that had employed such practices in recent years indicated that they were costly in terms of efficiency, that they were burdensome to administer, and that they were not conducive to medium-term balance of payments adjustment.

However, although he was convinced of the correctness of the staff's general conclusions, Mr. Prowse continued, the evidence produced in SM/84/64 and SM/84/65 was not necessarily convincing. For example, the

validity of the comparisons made on pages 5, 6, and 7 of SM/84/65 between countries that had multiple rate systems and those that did not was questionable. In the period under consideration, 1979 to 1982, the multiple rate systems had been a response to economic difficulties as viewed by the authorities in those countries. It was unsurprising that those countries had performed less well than the countries that did not have such systems. Furthermore, the discussion on pages 10 and 11 of the same paper was anecdotal. It was difficult to accept the evidence regarding the failed systems. For countries that had been undergoing severe difficulties, it was not easy to illustrate the causes and effects of various measures taken, nor to assess their capacity to deal with their problems.

He agreed with the suggestion that Fund policies regarding multiple exchange rate arrangements should be based on specific commitments by the members concerned with regard to the progressive simplification and eventual elimination of the systems over a specified period of time, Mr. Prowse remarked. No doubt there would be a need for flexibility in implementing that policy. In some cases, there had been justifications for a temporary resort to multiple rate systems: for example, in developing countries with inadequate tax mechanisms, multiple exchange rate practices might be helpful in the medium or short term to raise revenue. However, even where flexibility was justified, approval of such practices would have to be given in conjunction with specific suggestions to those countries on how to overcome the problems to which the multiple rate system was a temporary response.

He was not convinced by arguments that attempted to limit the interpretation of the Fund's authority under Article VIII, Section 3, Mr. Prowse went on. In particular, he could not accept the suggestion that the Fund should ignore multiple exchange rate arrangements introduced for nonbalance of payments reasons or arrangements applicable only to capital transactions. Insofar as such arrangements represented special cases, they should be considered an argument for flexibility rather than for altogether setting aside consideration of them. It was not clear why there should be a practical difference in the Fund's approach to multiple arrangements introduced for reasons other than balance of payments ones. The scarcity of such examples in recent years was not a reason for failing to amend the Executive Board's 1981 decision on the question. Indeed, it was not clear how rare such cases were. The motivation for a particular multiple rate practice was not always patent, and it could be difficult in a particular case to say whether it had been introduced for balance of payments reasons or for other reasons. Such arrangements invariably had significant implications for the sustainability and efficiency of adjustment in the balance of payments. Furthermore, the administration of those arrangements was increasingly difficult, increasingly costly, and often led to a most unsatisfactory decline in the standards of administration, as Mr. Polak had suggested. The conditions attached to Fund approval of such special arrangements should be of the same kind as those applying in cases in which the Fund accepted multiple arrangements for balance of payments needs.

There was also no justification for making a distinction between the Fund's jurisdiction over multiple arrangements applicable to capital transactions and those applicable to current transactions, Mr. Prowse considered. The staff's argument that the international mobility of capital necessarily shifted the burden of the adjustment to external disturbances onto the current account was particularly relevant. More generally, the distinction between capital and current transactions was no longer of substantial relevance in the circumstances of exchange rate flexibility and the high mobility of capital that had been evident since at least the mid-1970s.

The Executive Board agreed to continue their discussion on the following day.

APPROVED: September 27, 1984

LEO VAN HOUTVEN
Secretary