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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/113

3:00 p.m., July 20, 1984

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

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	S. Kolb, Temporary
	X. Blandin
	M. Teijeiro
	J. Delgadillo, Temporary
	M. K. Bush
	M. Lundsager, Temporary
M. Finaish	T. Alhaimus
	T. Yamashita
J. E. Ismael	
	L. Leonard
	D. I. S. Shaw, Temporary
A. Kafka	C. Robalino
G. Laske	G. Grosche
	W. Moerke, Temporary
G. Lovato	
R. N. Malhotra	
	J. E. Suraisry
J. J. Polak	
A. R. G. Prowse	R. L. Bernardo, Temporary
	O. Kabbaj
	E. I. M. Mtei
	J. L. Feito
J. Tvedt	K. A. Hansen, Temporary
	T. A. Clark
	Wang E.

J. W. Lang, Jr., Acting Secretary
L. Collier, Assistant

Also Present

African Department: L. Schmitz. Asian Department: K. A. Al-Eyd, A. Ariyoshi, R. C. Baban, S. P. O. Itam. European Department: B. Rose, Deputy Director; P. B. de Fontenay, Deputy Director; F. C. Adams, J. T. Boorman, B. Christensen, A. Fidjestol, S. Mitra, P. J. F. Nyberg, H. O. Schmitt. Exchange and Trade Relations Department: M. Guitián, Deputy Director; K. B. Dillon, N. Kirmani, R. Pownall, E. J. Zervoudakis. Fiscal Affairs Department: O. Pettersen. Legal Department: G. P. Nicoletopoulos, Director; P. L. Francotte, A. O. Liuksila, J. V. Surr. Research Department: A. D. Crockett, Deputy Director. Western Hemisphere Department: S. T. Beza, Associate Director; M. Caiola, D. S. Hoelscher, C.-J. Lindgren. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, S. El-Khouri, I. R. Panday, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, J. Bulloch, M. Camara, M. B. Chatah, V. Govindarajan, D. Hammann, N. U. Haque, L. Ionescu, E. Olsen, G. W. K. Pickering, D. J. Robinson, A. A. Scholten, Shao Z., S. Sornyanyontr, A. J. Tregilgas, Wang C. Y., A. Yasseri.

1. FEDERAL REPUBLIC OF GERMANY - 1984 ARTICLE IV CONSULTATION

The Executive Directors resumed from the previous meeting (EBM/84/112, 7/20/84) their consideration of the staff report for the 1984 Article IV consultation with the Federal Republic of Germany (SM/84/142, 6/22/84; Sup. 1, 7/17/84; and Sup. 1, Cor. 1, 7/18/84). They also had before them a report on recent economic developments in Germany (SM/84/152, 7/3/84).

Mr. Orleans-Lindsay stated that his chair joined others in commending the German authorities for their successful efforts in supporting the recovery in economic activity that had emerged in the first half of 1983 and continued in the second half. Overall economic performance in 1983 had thus been better than that of the past three years of severe, protracted recession. The 1.3 percent expansion in real growth had been accompanied by a further decline of 2.3 percentage points in the rate of inflation to 3 percent, reflecting lower import unit values and the relative decline in unit labor costs; the external current account position had also continued to improve. Those and other prevailing factors pointed toward a consolidation of the momentum for a sustained economic recovery beyond 1983. However, on page 1 of SM/84/152, the staff pointed out that "developments in 1983, on an annual average basis, hide a change both in the pace and pattern of economic activity during the year." The strong domestic demand originating initially from private consumption in the first quarter of 1983, followed by stockbuilding and accelerated investment, had slackened somewhat in the course of the year. Some of the components of aggregate demand had moved in uncertain directions. Developments in the first half of 1984, as indicated in the supplement to SM/84/142, had confirmed those uncertain movements, reviving the question whether the significant adjustment that had been made provided a sufficiently firm foundation to sustain the momentum of a lasting economic recovery in Germany.

Some of the developments might be transitory, according to Mr. Laske, Mr. Orleans-Lindsay continued, and the full impact on the recovery of the labor strike in metals and printing industries had not yet been assessed. However, it was encouraging that a preliminary assessment indicated that the momentum of real growth would continue, although it would not reach the target range of 2.5-3 percent. He welcomed the efforts to resolve the labor disputes through following the traditional policy of moderation in wage settlements, which should go a long way toward further strengthening industrial profitability.

The better than expected outcome of the measures taken to consolidate public sector finances was also encouraging, Mr. Orleans-Lindsay considered, as was the intention of the authorities to continue that policy in the 1985 federal budget and in a medium-term perspective. He supported their objective of attaining a sizable reduction in the budget deficit in order to enhance private sector confidence in the prospects of the economy, an essential condition for maintaining sustained growth in the medium term. In support of their objective of fiscal retrenchment, the German authorities had not hesitated to be flexible in monetary policy so as to ensure that the commendable progress being made to contain inflationary pressures was maintained while adequate liquidity was provided to sustain the momentum of growth. The flexibility that the authorities had already shown by establishing a narrower target range of 4-6 percent for central bank money for 1984 should be implemented in a manner that would not have serious consequences for the deutsche mark exchange rate.

He also welcomed the stress that the German authorities had placed on the need to increase the access of heavily indebted developing countries to the markets of industrial countries, Mr. Orleans-Lindsay stated. It appeared that ideas on how to implement that policy had not yet been finalized. He looked forward to further information on how the laudable suggestion for greater trade liberalization would operate. The German authorities' commitment to pursuing liberal trade policies in general was commendable, as was their record in resisting protectionist pressures; he encouraged them to persist in their efforts.

On behalf of the 23 countries represented by his chair, Mr. Orleans-Lindsay expressed appreciation to the German authorities for their understanding and generosity in providing grants and in canceling certain debt obligations in order to ease the external payments burden of those countries. He also commended the authorities for increasing official development assistance to 0.49 percent of GNP in 1983.

The staff representative from the European Department said that a number of factors could be cited to explain why the recovery had been stronger than anticipated despite the greater than expected withdrawal of fiscal stimulus. First, a market economy had certain self-regenerating aspects following a recession, as capital stock was replaced and technical progress created new opportunities for expansion. Second, the German authorities believed that the success in fiscal consolidation had given confidence to private investors that, if they responded to the improved outlook through renewed investment activity, they would not be crowded out by increasing fiscal deficits. Investment had, therefore, picked up more vigorously than had been foreseen. Third, the authorities had provided particular fiscal incentives aimed at increasing investment in housing construction so that the overall impact of the withdrawal of fiscal stimulus would not be too deflationary. Fourth, because there had been a possibility that the pace of fiscal consolidation might be too rapid, monetary policy had been used to encourage the private sector to take up the slack created by the reduction in the public sector.

That combination of factors could also help to explain why there had been a pause in the recovery in the early part of 1984, the staff representative continued. The authorities had been concerned that the recovery should proceed on a noninflationary path, which might have had a dampening effect on business expectations, bringing about a slowdown in investment. The ending of the temporary fiscal stimuli to investment might also have affected the momentum of the recovery at that time. In addition, there had been a rapid deceleration in the growth of the money stock, a factor that some of the German authorities believed to be pertinent. Nevertheless, the staff believed that the break in the recovery would be temporary and that the momentum of expansion would resume when it became clear that the effects of the recent labor unrest had not been as severe as they might have been. Steadiness in fiscal and monetary policy would also encourage confidence, although it would be important to ensure that monetary growth could accommodate noninflationary expansion. The staff had previously envisaged that the rate of growth in 1984 would be about 2.5-3 percent; it appeared probable that the impact of the strikes would reduce that rate a little.

Exports had been relatively slow in picking up during the current recovery, the staff representative observed, partly because the recovery in the world economy had initially been concentrated on consumer goods, while Germany's exports were more dependent on the capital goods market. As the expansion overseas had proceeded, however, Germany's capital goods exports had begun to do well, recovering lost market shares in the second half of 1983. The question of the competitiveness of German exports in the U.S. market, relative to Japanese exports to the United States, had been raised. U.S. imports from Germany had risen by 4.9 percent in 1983 as a whole, and at a rate of about 5 percent in the fourth quarter of 1983 and 5.6 percent in the first quarter of 1984, reflecting the particularly strong expansion at the end of 1983. Japan's share of U.S. imports had been about 16.1 percent in 1983 on average, rising to 17.2 percent in the last quarter of the year, and declining to 16.6 percent in the first quarter of 1984. Thus, while Japanese exports were performing well, they were not doing so at the expense of German exports.

On labor market issues, the staff representative recalled, a number of Directors had referred to the relationship between wages and profits in Germany. The basic problem, which the authorities recognized, was that economic growth in Germany during the past decade had proceeded with virtually no increase in employment. By contrast, some other countries, particularly the United States, had experienced large increases in employment. Second, there was evidence that entrepreneurs believed that capacity utilization was reaching the point at which they would need to expand; that development was occurring at a time when unemployment remained unusually high, suggesting that capacity limits were being reached before all of the labor force theoretically available had been absorbed. It had also been found, as shown in DM/84/27 (4/16/84), that the excess real wage in Germany was particularly large, suggesting that a portion of the existing unemployment reflected structural factors.

For those reasons, it could be argued that the increase in output over the past decade in the absence of employment growth reflected excessive labor costs, the staff representative suggested. In that regard, wages were not the only labor cost to be taken into consideration; for example, nonwage costs--social security, leave benefits, employee subsidies, and the like--added about 80 percent to direct wage costs in Germany. There was, therefore, scope to reduce nonwage costs so as to shift investment more in a labor-using rather than labor-saving direction. On a related point, the staff had not looked into the specific question of the effect of fiscal incentives on the substitution of labor for capital, but, in general, when investment was being subsidized in that way it would tend to bias investment in a capital-intensive direction.

It was not easy to say at what point an appropriate distribution of income between wages and profits had been reached, the staff representative stated. In general, lowering the real wage, by increasing the rate of profit, would increase the incentive to invest as well as the share of profits in income, which would increase investible resources. Thus, reduced wage costs would lead to the absorption of the additional labor through investment; at some point, the wage rate would be consistent with full employment. While it would be theoretically possible to estimate the wage rate that would bring about such an equilibrium, the staff had not attempted to do so. Although it was not possible to say exactly how far the redistribution of income should go, the point had not yet been reached at which available labor was being fully employed, nor was it likely to be soon. In that regard, the figures for the growth of employment referred to in SM/84/142, which had been provided by the German authorities, could be considered optimistic despite the fact that they were not encouraging. Furthermore, while the rate of growth of the German labor force had declined, its absolute growth was continuing; the potential labor force was estimated to have grown by about 171,000 in 1982 and by about 100,000 in 1983. The decline in the rate of growth reflected to some extent the weakness in labor demand, which was discouraging some workers from remaining in the labor force, as well as demographic factors, particularly the progressive aging of the German population.

The increase in the share of public employment in total employment was a related complex question, the staff representative went on. There had been an increase in the number of public employees between 1970 and 1983, but the increased share of public employment reflected in part the decline in total employment in the private sector. It was unclear whether the public sector had absorbed labor too rapidly, creating scarcities in the private sector and driving up real wages, or whether the lack of private demand for labor had encouraged workers to enter public employment or the Government to absorb labor that might otherwise have been unemployed. The latter explanation appeared more plausible.

The German authorities agreed that the effect of social security payments on the incentive to work constituted a potential problem, the staff representative added, and they had focused on reductions in social security entitlements in the process of fiscal consolidation. For example, they had reduced net increases in pension benefits, changed the base for pension calculations, reduced the percentage of net earnings paid out in unemployment benefits, and not adjusted the balance between unemployment benefits and other forms of relief payments for the unemployed.

The policy of encouraging foreign workers to leave Germany and the measures taken to encourage early retirement would not necessarily improve the workings of the labor market, the staff representative stated. Indeed, because such policies reduced the effective supply of labor, thereby reducing downward pressure on wages, they could be counterproductive. The staff had made a brief comment to that effect in SM/84/142.

On fiscal policy, the staff representative remarked, the authorities were forecasting a further reduction in the fiscal deficit of the Federal Government, from 1.7 percent in 1984 to 1 percent in 1988, which included the effects of the recently announced tax reform insofar as the details were available at present. It was also possible to estimate the course of general government finances. On the assumption that regional and local government spending would increase at the rate forecast for the Federal Government--by about 3 percent per annum--and that the proportion of revenues to GNP would remain the same, the portion of the General Government would move from a deficit of 1.7 percent in 1984 to a surplus of 0.6 percent in 1987, rising further to a surplus of 1.3 percent of GNP in 1988. The staff had discussed with the authorities whether they wished to produce a surplus on the fiscal accounts in the foreseeable future; the authorities had indicated that they did not intend to do so but had not committed themselves to a specific target. If a surplus did not emerge, there would nevertheless be further opportunities for tax reduction while fiscal consolidation proceeded on the expenditure side. However, it was not possible to say with any degree of accuracy what the appropriate fiscal deficit should be to allow sufficient room for private investment and to maximize noninflationary growth. To make such a calculation would require knowledge of the social rate of time preference. However, if an acceptable rate of noninflationary growth were achieved, the question of fiscal consolidation would no longer seem as urgent.

As some Directors had noted, the ratio of government spending to GNP continued to be high, the staff representative said. On present forecasts, spending was expected to increase at 3 percent per annum; if inflation continued at about 3 percent, government spending in constant terms would be stabilized, while its share in GNP would decline. However, its composition would be changing considerably. The authorities intended to cut back subsidies and reduce social transfers further. At the same time, wages and salaries were expected to increase at about 4 percent per annum, while investment by the Federal Government was expected to increase by about 6 percent per annum. Thus, within a constant expenditure total, there would be a shift from subsidies and transfers toward investment and income payments to civil servants.

The staff strongly endorsed the authorities' efforts to reduce fiscal subsidies, the staff representative stated. However, subsidies to manufacturing had increased relatively little in recent years; most of the increases represented subsidies to agriculture, mining, and housing, and would therefore have little impact on foreign trade in manufacturing goods. In that regard, the authorities had argued that the subsidies were basically defensive, and they hoped that they could be reduced in Germany as well as in other countries. The scope for privatization of industries currently owned by the public sector was not great, although it might be somewhat larger than indicated in SM/84/152, since some industries were controlled by local governments rather than the Federal Government. The distribution of revenues between direct taxes and social security contributions, a point raised by one Executive Director, had not shifted significantly in recent years, nor was it expected to in the near future. Finally, in the fiscal area, the authorities projected a decline in the profits of the Bundesbank; whether it in fact occurred would depend to a large extent on the course of interest rates, which was difficult to forecast.

In monetary policy, the staff representative commented, whether the Bundesbank should tilt toward the upper or the lower end of the target range for money growth was basically a matter of nuance. Views on the issue differed, partly on the basis of the weight that was attached to the role of monetary policy in stimulating the recovery in 1982 and early 1983. Those observers who believed that monetary policy had played a significant role tended also to argue that the rapid deceleration in the growth of the money stock during 1983 might have contributed to the decline in the rate of economic growth early in 1984. They would prefer, therefore, that monetary growth should be toward the upper end of the range. On the other hand, the explanation for the deceleration in prices in recent years deserved consideration. Observers who believed that the improvement in inflationary expectations could be traced to the success of monetary restraint would argue that there was little room for maneuver in monetary policy, and that it should continue to be relatively tight in order to maintain downward pressure on inflation. The difference of views on the question was quite narrow, particularly as the upper limit of the target range at present was lower than it had been in the previous two years, so that even if monetary growth reached that point, it would represent a slowing down from the growth of earlier years.

The question of the degree of independence of German interest rates from international rates in the longer term had also been raised, the staff representative from the European Department observed. The current relatively wide differential between German interest rates and U.S. interest rates reflected a perception that the deutsche mark/dollar exchange rate was unusually low; in other words, the dollar was expected to decline relative to the deutsche mark. Once the dollar began to depreciate, a point would be reached at which that expectation would begin to reverse itself, and the interest rate differential between Germany and the United States would narrow. However, it was difficult to be precise about the time frame in which such developments would take place. Because the differential had been widening at the short end of the market, it seemed that market expectations were that the dollar could begin to decline quite soon. The German authorities believed that underlying conditions, particularly the declining fiscal deficit, brought about the fundamental strength of the deutsche mark.

Mr. Laske stated that the question of the transfer of the Bundesbank's profits to the Federal Government's budget had a legal and an economic aspect. On the legal side, whatever net profits the Bundesbank made, after provision for special circumstances, particularly increases in the Bundesbank's reserves, had to be transferred to the Federal Government;

such profits were, therefore, a normal revenue item in the budget. On the economic side, it was worth recalling that there had been many years in which the Bundesbank had incurred losses on its operations. The losses had arisen primarily from the depreciation of foreign exchange reserves resulting from the appreciation of the deutsche mark. They had been carried over and covered when profits had eventually occurred, mainly as a result of rising interest income from the Bundesbank's foreign assets. Once the losses had been fully covered, the Bundesbank's net profits had been transferred to the federal budget, as the law required. The period of profit transfers had occurred at a time when the federal deficit had been fairly large; they had, therefore, made a welcome contribution to financing that deficit. An estimate of future Bundesbank profit transfers was included in the budget projections, although it was necessarily imprecise because it depended to a large extent on interest rate developments abroad. The estimate for the coming three years was relatively low, reflecting an appropriate degree of prudence and the consideration that the transfer of profits from the Bundesbank ought not to be seen as an item contributing to general expenditure, but rather as a financing item to reduce the Government's borrowing requirement.

At the time of the staff's discussions with the authorities, Mr. Laske continued, there had been a general expectation that the strike in the metals industry would be relatively brief, in keeping with German labor traditions. Although the conflict had lasted surprisingly long, the expected settlement had turned out to be less negative than it might have been. The unions had entered into the strike with the objective of an immediate cut in the workweek from 40 hours to 35 hours and no cut in take-home pay. In the course of negotiations, the unions had modified their position to the goal of setting a fixed timetable for the achievement of a 35-hour week over a number of years. In the end, the settlement had been much more moderate; there was to be a reduction to 38.5 hours in the workweek during the 18 months of the contract's life, with no assurance of further reductions in later years. He hoped that the next round of negotiations would be less dogmatic and antagonistic. As for the impact on other labor contracts, it appeared that unions in the public sector, where the most important negotiations in the remainder of 1984 would take place, would seek to achieve a settlement similar to that reached in the metalworking industry in terms of reduced working hours.

As to the incentives for foreign workers in Germany to return home and for early retirement, Mr. Laske remarked, the staff representative from the European Department had pointed out the relevant theoretical considerations. However, in practical terms, the general labor market climate could not be overlooked. There was considerable concern in Germany about high unemployment, including the fact that the prospects for its rapid decline were not bright. While the unemployment problem was partly structural, it was also partly related to high real wages in Germany. Nevertheless, the authorities had provided financial support for the schemes referred to in order to try to reduce the number of unemployed and to preserve the historically conciliatory atmosphere between labor and industry in Germany. In the longer run, however, such measures could not represent a permanent solution to the unemployment problem.

The German authorities fully accepted that it was disappointing that it had not been possible to reduce industrial subsidies in the past year, Mr. Laske stated. In agriculture, Germany was working within the framework of the European Community and of the Common Agricultural Policy (CAP). While the solutions reached within the Community were not always those preferred by his authorities, they valued the Community so highly for political reasons that they were willing to make some economic and financial sacrifices. When an initiative had been taken in early 1984 to begin reforming the CAP--including a reduction in the compensatory amounts, resulting in income losses for German agriculture--it had been necessary, for domestic considerations, to provide some compensation to farmers; for that reason, subsidies to agriculture had been increased. With regard to steel and coal, the share of subsidies in GNP had not changed much, as the staff representative had pointed out. The increased assistance in nominal terms was intended to support those ailing sectors, which were suffering from particularly high unemployment; his authorities strongly hoped that such measures would prove temporary and would help in the effort to bring about structural improvements in the German economy. Some subsidies had also been introduced for high technology, a subject under intense discussion among his German authorities, but they were relatively unimportant.

The staff had set out clearly the principles guiding Germany's monetary policy, Mr. Laske said. The question of how his authorities should react if U.S. interest rates continued to rise, which had been discussed at the time of the staff mission for the Article IV consultation, had become even more relevant in view of the increase in U.S. rates since then. The existence of a wide differential between German and U.S. rates suggested that underlying conditions in the German economy were strong and were perceived to be so by the market. Thus, his authorities had not felt compelled to take deliberate action in that area. As to trade policies, his authorities would continue their vigorous efforts to keep protection by the European Community at the lowest possible level; they were also keenly interested in the new round of trade negotiations within the GATT and, more generally, in the maintenance of an open trading system to the greatest extent possible.

The Chairman made the following summing up:

Executive Directors commended the German authorities for their consistent and remarkably successful conduct of economic policy, including their achievement of a low rate of inflation. The recovery in economic activity, which had seemed uncertain at the time of the 1983 Article IV consultation, was now better established. However, some uncertainties remained with regard to the sustainability of the recovery and its implications for employment. It was appropriate to consider how the authorities could best respond to these uncertainties.

Most Directors welcomed the fact that the recovery had been led by an increase in domestic demand supported by domestic policies. Several Directors noted that, while the recovery had in its initial stages been supported by a reduction in the savings ratio, it had increasingly been supported by growing export and investment demand. While the growth in investment was welcomed, concern was expressed that it appeared to be of a highly labor-saving character. Accordingly, it did not seem likely that the recovery would have much impact on the historically high level of unemployment. In that context, concern was expressed that the settlement in the metalworkers' dispute might serve to bias the recovery further in a labor-saving direction; the authorities were encouraged to continue with their support of wage moderation. A number of Directors, noting the structural aspects of unemployment and seeing in the current real wage structure a serious threat to a sustained recovery, suggested that the authorities should seek ways of increasing flexibility in the labor market.

Executive Directors strongly welcomed the medium-term orientation of fiscal policy toward reducing the size of the deficit through expenditure restraint. It was noted that there had been concern a year earlier that fiscal consolidation might have a dampening effect on activity in the short run. However, in the event, that policy had not hindered the recovery in Germany. Fiscal consolidation and the progressive reduction in the size of Government were considered by most Directors fundamental to a durable recovery in the private sector, and hence to an expansion of employment. It was noted that the German authorities were considering a tax reform package for 1986 and 1988, which was welcome, both because it would prevent a further increase in taxation by reducing fiscal drag and because it was intended to promote incentives by reducing the progressivity of income taxes. A number of Directors expressed concern that reductions in public expenditure had not been accompanied by progress in reducing subsidies; intensified efforts in this direction were encouraged, especially in agriculture.

As regards monetary and interest rate policies, Executive Directors welcomed the commitment of the authorities to restrain monetary growth and emphasized the importance of maintaining a stable rate of monetary growth, which was essential both for creating an environment conducive to economic growth and for the contribution that it would make to controlling inflation. In that context, a number of Directors stressed the skillful and flexible conduct of monetary policy, which had allowed, without rekindling inflation, the maintenance of stable interest rates and widening differentials vis-à-vis international rates. Directors hoped that monetary policy would continue to be moderately restrictive, and that such a stance would not represent an unnecessary constraint on the recovery. However, a major uncertainty was whether increases in U.S. interest rates would eventually call for increases in German rates, with the implications such increases would have for the German recovery.

Executive Directors commended the German authorities for their efforts to resist protectionist tendencies, both in Germany and elsewhere, and urged that such efforts should be intensified, particularly with respect to some industrial sectors and to agricultural products. It was hoped that, in spite of fiscal restraint, the ratio of official development assistance to GNP could be held constant or increased.

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

2. BANGLADESH - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Bangladesh (SM/84/151, 6/29/84; and Sup. 1, 7/18/84), together with a report on recent economic developments in Bangladesh (SM/84/160, 7/6/84; and Cor. 1, 7/16/84).

Mr. Malhotra made the following statement:

The Article IV consultation report covers the economic developments in Bangladesh in 1983/84 (July-June), subsequent to the 1982/83 program under the stand-by arrangement, and discusses the prospects for 1984/85 and the relevant policy issues. A brief but useful medium-term outlook has also been incorporated in the report. The staff's broad assessment is that the performance of the Bangladesh economy improved substantially in 1982/83 and 1983/84 and that prospects for 1984/85 are good.

Bangladesh is one of the least developed countries with a very low per capita income, a limited natural resource endowment, almost the highest density of population in the world, inadequate infrastructure, a heavy adverse trade balance, and vulnerability to recurrent natural disasters. In spite of these limitations, Bangladesh registered a real GDP growth rate of 6 percent in the decade through 1981/82. However, owing mainly to the severe impact of the world recession and other exogenous factors, the economy virtually stagnated in 1981/82. Inflation was high at 16 percent, and the balance of payments registered a record deficit of $297 million, lowering reserves to an unacceptable level equivalent to two weeks' imports. Comprehensive measures taken by the authorities in 1982/83 helped to reverse this situation. In addition to efforts to improve production and supplies, the measures included an increase in taxes, restraint in expenditures, lowering of subsidies, monetary restraint, flexible exchange rates, and incentives for investment. Aided by favorable weather, the economy recovered in 1982/83. Real GDP grew by 3.7 percent, inflation declined to about 10 percent, the current account deficit came down from 11.5 percent to 8.5 percent of GDP, and the overall balance of payments recorded a surplus of $342 million. There was no borrowing from the banking sector for budgetary support. The 1982/83 stand-by arrangement was successfully implemented.

In 1983/84, the authorities continued the policy stances of the previous year. In spite of severe flood damage to agriculture in May and June 1984, real GDP growth in that year is estimated at 4.5 percent: food production, at 15.5 million tons, though lower than originally expected, was 4 percent above that of the previous year, and the manufacturing sector grew by 5.7 percent. The balance of payments showed further improvement, with reserves reaching $518 million at end-June 1984.

Several revenue measures were taken in the year. These included modification of customs duties, sales taxes, and excise taxes, and further increases in electricity tariffs, railway fares, water rates, and health, postal, and telephone charges. The issue prices of rice and wheat from the public distribution system were also raised. The budget for 1983/84 sought to reorient expenditures toward development spending while maintaining the level of total expenditure as a proportion of GDP. The outturn of the budget enabled the Government to avoid borrowing from the banks, though originally some recourse to the banking sector had been contemplated. The overall budgetary deficit in 1983/84 is estimated at 10.6 percent of GDP, compared with 11.4 percent in the previous year.

As noted by the staff, the 1984/85 budget seeks to provide a further stimulus to economic growth while containing the overall deficit, which is expected to decline marginally from 10.6 percent to 10.3 percent of GDP. Revenue is expected to grow by 24 percent, mainly owing to larger imports and a consequent increase in customs receipts. Overall expenditures are expected to increase by 16 percent. Plan expenditures are planned to increase by 18 percent, i.e., 6-8 percent in real terms. No recourse to bank borrowing is planned. New tax measures include adjustments in customs tariffs and increases in excise duties (the excise duty on natural gas was increased by 10 percent), introduction of taxes on irrigation and shop areas, extension of the 2 percent turnover tax to cover certain services, increases in postal rates and railway fares, and a new ordinance for effective income tax collection. These measures are estimated to yield about Tk 1 billion in additional revenue--about 0.3 percent of GDP--and represent initiatives to broaden the tax base, rationalize the customs tariff with a view to improving the costs and competitiveness of industry, and improve tax administration.

To reduce the burden of subsidies, fertilizer prices have been increased by 10 percent from the first week of July 1984. The authorities intend to reduce the unit subsidy on fertilizer from 21 percent in 1983/84 to about 15 percent in 1984/85. For this purpose, an expert study on the likely impact of a further increase in fertilizer prices on agricultural production is under way. To promote agricultural production, the procurement prices of rice and wheat have been raised by 10 percent and 15 percent, respectively. Issue prices are expected to be revised later in the year. The Government plans to reduce the unit subsidy on foodgrains in the current year. To place the matter in perspective, total expenditures on food and fertilizer subsidies in 1983/84 amounted to Tk 2.5 billion, less than 4 percent of budget expenditures, and are likely to come down substantially in 1984/85. The authorities expect that the subsidy on food will decrease from Tk 1.6 billion in 1983/84 to Tk 1.09 billion in 1984/85.

The prices of natural gas have been increased from time to time are are well above the costs of production and delivery. At the present stage, the major objective of gas pricing policy is to promote substitution of the use of natural gas for petroleum products.

The authorities attach great importance to keeping inflation and inflationary expectations in check. In 1983/84, total liquidity and credit are estimated to have expanded by 31 percent and 20 percent, respectively, higher than originally projected. While the improved balance of paymetns contributed significantly to the growth of liquidity, the increase in credit was accounted for mainly by larger lending to the private sector, particularly agriculture. In view of the need to tighten monetary policy, the authorities intend to limit broad money expansion to 16 percent and total domestic credit expansion to 15 percent. Considering the improved financial performance of large public sector enterprises last year, credit to the public sector is expected to grow by only 3.5 percent and to the private sector by 26 percent. An important factor that will influence the level of liquidity will be developments in the external account. It is expected that the balance of payments surplus in 1984/85 will be limited to $50 million, as against $176 million in 1983/84. As indicated earlier, the Government does not intend to borrow from the central bank, except perhaps for increasing foodstocks should that become necessary. On the supply side, ample provision has been made for importing foodgrains and other food items. A liberalized import policy would also contribute to softening the pressure on prices. Inflation in 1984/85 is expected to remain at about the current rate, while GDP is projected to grow by 6 percent.

The authorities intend to pursue a pragmatic interest rate policy to ensure that adequate financial savings are mobilized and investment costs are kept at reasonable levels. Real interest rates are positive and are expected to remain so in 1984/85. While the authorities will keep their interest rate policy under review, they consider that at present interest rates are appropriate. In order to encourage term lending by commercial banks, the Government has recently decreased the statutory liquidity requirement from 25 percent to 23 percent.

The authorities are aware of the structural weakness of the external sector of the economy and the need for expanding and diversifying exports. This requires the strengthening and diversification of the productive base of the economy. To this end, the authorities will promote import substitution in areas of comparative advantage and improve import availability to nontraditional export-oriented industries. It is noteworthy that between 1977 and 1983, the share of nontraditional goods in total exports rose from about 15 percent to 35 percent. The authorities have been following a pragmatic exchange rate policy, keeping in view the need for maintaining the competitiveness of the taka so as to promote exports and encourage remittances from migrant workers. New regulations, effective July 7, 1984, have been issued for broadening participation in the secondary foreign exchange market. The import policy has been further liberalized, and the Government has drawn up "negative lists" for the new import policy to be implemented from January 1985 after considering comments from organizations of trade and industry.

My Bangladesh authorities note with satisfaction that the medium-term projections in the staff paper with respect to GDP growth--5 percent per annum--and the balance of payments indicate a better prospect than was envisaged in an earlier exercise. According to these projections, the debt service ratio is estimated to rise from 17 percent of exports of goods and services in remittances in 1983/84 to 24 percent in 1986/87 and to decline thereafter. More than 90 percent of the external debt of Bangladesh consists of loans on concessional terms, and its recourse to commercial credit is minimal. The authorities have been keeping the debt service liabilities under close scrutiny. Assuming that, in the medium term, the disbursement of external assistance will be at least maintained in real terms, the authorities consider that the debt service burden will be manageable. Continued recovery and growth in industrial countries and increased access of Bangladesh exports to their markets will be crucial to a sustained improvement in its balance of payments viability. Bangladesh is a least developed country. The authorities highly appreciate the support that they have been receiving form donor countries and multilateral institutions for economic development. Given the limited scope for raising domestic resources, the continued flow of substantial concessional assistance is essential to maintain a reasonable level of investment and growth in the economy. The overall budgetary and current account deficits of Bangladesh have to be viewed in the light of its crucial need to absorb foreign savings.

Extending his remarks, Mr. Malhotra said that the latest information from his Bangladesh authorities confirmed that during fiscal year 1983/84 there had been no bank borrowing by the Government, although recourse to bank borrowing had originally been thought necessary. The staff had said in SM/84/151, Supplement 1, that "the rate of expansion in public sector credit is now estimated to be substantially less due to a smaller borrowing requirement by the Government and a significant improvement in the financial positions of the major public enterprises." Table 1 in that Supplement included earlier estimates by the staff for 1983/84 as presented in SM/84/151. He would contact his authorities to reconcile those statements; it was perhaps a matter of definition.

In SM/84/151, Supplement 1, Mr. Malhotra concluded, the staff had stated that "in the past, foodstocking operations were financed by bank credit. Thus, the decision in respect of foodstocking operations marks a departure from previous practice." His authorities had notified him that they had decided not to resort to bank borrowing in 1984/85 except for any amount needed to increase food stocks at the end of the year over the currently planned level.

Mr. Hirao commented that the economy of Bangladesh had performed well for the second consecutive year in 1983/84. Real GDP growth was estimated at about 5 percent, compared with 3.2 percent the previous year; the rate of inflation was estimated to have remained under 10 percent; and the overall external balance of payments was expected to record surpluses in two successive years. Those impressive achievements stemmed in part from the favorable weather and improvements in the terms of trade, but were also attributable to the adjustment policies adopted by the authorities.

On fiscal policy, however, it was a source of concern that the adjustment measures implemented during 1983/84 had been less substantial than those implemented in the previous year, Mr. Hirao stated. Government revenue had been substantially lower than budget estimates, mainly due to a slower than expected increase in dutiable imports and a shift in import composition toward goods subject to lower duties. The staff had reported that the shortfall had been met mainly through sales of special two-year bonds to commercial banks, although more recent information indicated that the shortfall had been narrowed considerably. It was encouraging to hear from Mr. Malhotra that recourse to domestic bank borrowing had been avoided, and he invited further comment from the staff on that point. He shared the staff's view that those developments underscored the need to contain the growth of current expenditures, to set the Annual Development Program at a level consistent with available resources, and to diversify the tax base so as to lessen the heavy dependence on trade-related taxes. He welcomed, therefore, the recent move to reduce subsidies on fertilizer and other agricultural inputs. The authorities' intention to increase the flexibility of administered prices and to improve tax administration was also encouraging. He noted that the Fiscal Affairs Department had not extended any technical assistance to Bangladesh and he invited Mr. Malhotra to comment on the authorities' plans in that area. He welcomed the authorities' intention to avoid domestic bank financing of the overall deficit or foodstocking operations in the 1984/85 budget. He also shared the staff's recommendation that natural gas prices should be raised progressively to levels adequate to cover long-term development costs, although he understood the authorities' argument that the speed of progress toward that end must not be so rapid as to impede the growing substitution of natural gas for petroleum products.

Monetary policy in 1983/84 had been conducted to accommodate domestic credit demand, Mr. Hirao remarked. The Bangladesh Bank had taken measures, such as raising refinancing rates on agricultural loans, to curb the rate of domestic credit expansion. Those measures, however, affected only a fraction of overall credit demand. Given the strong demand for credit because of the increasing momentum of economic recovery, the rate of domestic credit expansion was estimated to more than double to 24 percent. Under those circumstances, he shared the staff's concern about the inflationary potential of the high liquidity growth. In the past two years, that potential had been partly mitigated by an increase in the demand for money as a result of the emergence of positive real rates of return on financial savings. However, as the staff pointed out, there was a strong possibility that inflationary tendencies could be rekindled. The pressure on the prices of food had increased because of higher liquidity, and the public sector wage adjustment had been announced in May, ahead of schedule. Thus, he agreed with the staff that appropriate steps had to be taken to control domestic credit expansion, and a more flexible interest rate policy had to be adopted that would not only permit a more active use of reserve requirements but also serve to attract funds into longer-term deposits.

It was encouraging to note that in recent years the authorities had pursued a flexible exchange rate policy aimed at maintaining external competitiveness, Mr. Hirao commented. Like the staff, he believed that further steps to liberalize the import regime, as well as to broaden the secondary exchange market with the objective of unifying the exchange markets at an appropriate rate, would benefit the economy over the long run. He invited the staff to comment on its assessment of the most recent change in the central bank regulations aimed at broadening participation in the secondary foreign exchange market.

On the medium-term outlook, Mr. Hirao noted, the illustrative scenario prepared by the staff underscored the fragility of the recent improvement in the balance of payments. At the same time, the external debt service burden was projected to increase significantly, despite the expectation that most debt would continue to be contracted on highly concessional terms. He agreed with the staff that those prospects pointed to the importance of continuing appropriate adjustment policies and the need for caution in planning the scale of development efforts in the future. In conclusion, he supported the proposed decision.

Mr. Clark recalled that at the previous year's Board discussion, his and many other chairs had emphasized the need for the Bangladesh authorities to consolidate in 1983/84 the gains made under the successful stand-by arrangement of 1982/83. The authorities had, in fact, exceeded that goal; the increase in real GDP, as well as gross reserves, although lower than the staff's original estimate, was particularly encouraging. While due in part to favorable external developments, it nevertheless represented a significant achievement on the part of the authorities.

However, Mr. Clark continued, he was concerned about the large increase in the monetary aggregates during 1983/84, which could erode the progress made in reducing the rate of inflation over the past few years. While the authorities' target of a 16 percent increase in broad money for 1984/85 was appropriate, it did not seem to be consistent with the staff's balance of payments projections. To ensure that the target was achieved, he strongly endorsed the staff's suggestion that the authorities implement a more flexible interest rate policy.

On government expenditure, Mr. Clark noted, the authorities intended to keep total expenditure nearly constant as a percentage of GDP for 1984/85, even allowing for a substantial increase in wages and salaries. A recent World Bank report stated that the authorities would embark on government decentralization. He asked Mr. Malhotra or the staff what progress had been made and whether such decentralization was likely to have budgetary implications.

With regard to government revenue, although he welcomed the measures taken in the budget, Mr. Clark remarked, they mainly involved trade taxes. That feature was of concern for two reasons: first, the possibility of a further shift in the structure of imports toward lower-rated goods, and a consequent revenue shortfall, could not be ruled out; second, the measures reinforced the overdependence of the tax system on trade taxes. In the longer term, an important objective would be to broaden the tax base, both to reverse that trend and to increase domestic savings.

The further improvement in the performance of the parastatals in 1983/84 was commendable, Mr. Clark said, noting that they had been able to reduce their borrowing from the domestic banking system for the second year in succession. He was also pleased that the authorities had set a timetable for eliminating fertilizer subsidies by the end of 1985/86 and that a 10 percent increase in fertilizer prices had been announced in the budget.

He welcomed the information that the authorities intended to increase the role of the secondary exchange market, Mr. Clark commented. That action would have the additional effect of increasing import revenue by reducing unrecorded imports. However, like the staff, he encouraged the authorities to aim for eventual unification of the exchange markets.

The medium-term prospects as outlined in the staff's projections underlined the difficulties that Bangladesh would face if it were to maintain growth, Mr. Clark observed, with real GDP growth of 5 percent giving rise to increasing current account deficits over the decade, a continuous decline in the already modest level of reserves, and substantial financing gaps in the latter part of the decade. The authorities had little room for maneuver, and Bangladesh would obviously require continued international assistance well into the future. For the authorities' part, it would be essential to ensure that domestic savings were increased where possible, and that policies were directed at encouraging the most efficient use of available resources.

In conclusion, Mr. Clark said, he wished to return to a recurring preoccupation of his chair. Bangladesh was one of the poorest countries in the world and was a major recipient of support from the World Bank Group, principally IDA. Yet the staff's treatment of World Bank involvement was sketchy; in the present case especially, it would have been helpful to see a more extended discussion of the objectives and time frame of World Bank involvement. It was a vital aspect of the medium-term prospects for the Bangladesh economy.

Mr. Finaish stated that he was in broad agreement with the staff appraisal and supported the proposed decision. As a result of the recent adjustment efforts, which were in part supported by a successfully concluded arrangement with the Fund, the economic performance of Bangladesh had improved encouragingly. Real growth had picked up while inflation had declined, and the overall balance of payments position had turned around from a deficit in 1979/80-1981/82 to a surplus in 1982/83 and an estimated surplus for 1983/84. The authorities recognized that continued prudence in financial policies and an emphasis on correcting the many deep-rooted structural problems would be needed to consolidate those gains and to build upon them. To that end, domestic efforts would need to be supported by adequate external assistance.

The recent adjustment measures had helped to arrest the earlier growth of public expenditures and the budget deficit, Mr. Finaish remarked. At the same time, some efforts had been made to shift the composition of public expenditures toward investment spending. However, because of the narrow tax base and the high variability of revenue on dutiable imports, revenues in 1983/84 had turned out to be lower than projected in the budget for that year. The authorities had also recognized the clear need to diversify the tax base and to improve and simplify the system as expeditiously as possible; in that connection, he noted inter alia the measures related to the administration of the land tax and the widening of the coverage of the income tax. During the implementation of those and other revenue measures, it would be prudent to continue to limit the growth in current expenditures and to set the Annual Development Plan targets at achievable levels. Moreover, as Mr. Malhotra had stated, the authorities would continue to avoid bank financing of the budget deficit.

On the monetary side, Mr. Finaish continued, it was encouraging that the growth in broad money, which had been accelerating in 1982 and 1983, had been reduced in the first half of 1984. Moreover, in recognition of the need to prevent a buildup of inflationary pressures, the authorities were planning a further deceleration in the growth of broad money and a reduction of growth in all credit categories. However, in view of the expected surplus in the balance of payments in the coming year, and the difficulties associated with the accurate prediction of that surplus, monetary developments in the next few months might need to be kept under careful review and adequate policy flexibility for dealing with any large unanticipated surges in liquidity would be important. Having noted the interesting discussion in the staff paper on the policy instruments for liquidity control, he invited the staff to elaborate on what factors in the Bangladesh economy made it particularly important for the authorities to seek greater flexibility in interest rates.

In addition to pursuing broadly appropriate monetary and fiscal policies, the authorities were continuing to take significant measures on the structural side, Mr. Finaish commented, citing the further liberalization of investment policy to allow a greater role for the private sector, the denationalization of some jute and textile mills, and the further simplification of import procedures. As to pricing policy, steps had been taken to reduce and rationalize subsidies and to introduce greater flexibility in public sector pricing. An appropriate pricing strategy was also being formulated for indigenous gas resources to achieve the twin objectives of conservation and adequate exploration and development. He had also noted Mr. Malhotra's comments on the most recent measures in structural reform, such as the efforts to liberalize the trade system.

In the external sector, Mr. Finaish continued, it was encouraging to note that the information presented in SM/84/151, Supplement 1 indicated a smaller current account deficit than reported in the staff paper. For the longer term, the objective of achieving adequate growth along with balance of payments viability would require sustained policy efforts over several years. The debt service ratio and balance of payments outlook presented in the staff's medium-term scenario pointed to the need for maintaining a prudent external policy. Moreover, further efforts to diversify the narrow export base and hence deal with the "structural weakness in the balance of payments" would need to be made. The pragmatic exchange rate policy that the authorities had been pursuing in recent years could play an important role in maintaining competitiveness.

In a discussion on Bangladesh's problems, Mr. Finaish concluded, it was helpful to reiterate Mr. Malhotra's concluding sentences: "Given the limited scope for raising domestic resources, the continued flow of substantial concessional assistance is essential to maintain a reasonable level of investment and growth in the economy. The overall budgetary and current account deficits of Bangladesh have to be viewed in the light of its crucial need to absorb foreign savings."

Ms. Lundsager stated that she agreed with the staff appraisal and could support the proposed decision. During the past two years, the Government of Bangladesh had taken strong adjustment measures that had contributed significantly to gains in economic performance. Economic growth had increased each year, inflation had decreased, and the current account deficit had fallen to less than 8 percent of GDP in 1983/84. Those developments, plus the maintenance of aid inflows, had led to an increase in official reserves to more comfortable levels. Exogenous developments, including better weather and a 26 percent increase in the terms of trade, had helped to generate those improvements over the past two years. Even more noteworthy, the Government of Bangladesh had implemented a wide range of policies that had initiated the structural adjustment needed to lead to a sustainable external position. The measures taken included improvements in the tax system, control over current expenditures, decreases in subsidies, increases in administered prices, increased interest rates on foreign currency deposits, flexible management of the exchange rate, and the establishment of an Annual Development Plan that recognized resource limitations. Some textile mills had been denationalized, and garment exports had been increased to take advantage of unfilled quotas under the Multifiber Agreement. A wider range of the economy had been opened up to private investment.

The measures taken were praiseworthy, Ms. Lundsager remarked; however, she joined the staff in urging caution in two areas. First, maintaining the price of natural gas below the long-run marginal cost could lead to inefficient use of that resource. In addition, it would make the servicing of the debt incurred to build that network a drain on the government budget and thus on the economy as a whole. Second, the rapid expansion of credit in the economy of close to 37 percent to the private sector for the first 11 months of the past year might lead to increased aggregate demand that could not be met by matching increases in supply. She was concerned that inflationary pressures might already be developing. She also supported the staff view that more flexibility in the interest rate structure would provide the authorities with better control over monetary policy and would generate long-term savings needed for investment.

The increase in revenues in the 1984/85 budget was a welcome development, given the very low ratio of revenue to GDP, Ms. Lundsager commented. However, she did not support the use of tariffs on trade to generate fiscal revenues, and she urged the authorities to continue to widen the tax base while avoiding an adverse impact on savings and private sector investment. She agreed with Mr. Hirao that it would be useful for the Fund to provide technical assistance in fiscal affairs. The recent 30 percent average wage increase appeared to be 10 percent higher than needed to compensate for inflation in the past two years. She supported the real increase in development expenditures, which demonstrated a commitment to expanding the productive capacity of the economy, but she urged the authorities to continue to coordinate closely with the World Bank the setting of development priorities in order to avoid projects that would not be able to reach economic viability. In that area, she encouraged the utilization of both domestic and foreign private investment.

Regarding the external sector, both the commitment to additional import liberalization and the widening of the secondary foreign exchange market were laudable, Ms. Lundsager said. She urged unification of the exchange markets as soon as feasible.

In sum, Ms. Lundsager concluded, she endorsed the wide range of measures taken during the past two years and urged the authorities to continue to broaden their scope. Given the projections of high debt service and the emergence of a financing gap for 1987/88, development should be prudent and budgetary programming should be cautious. Continued flexible management of the exchange rate would help to generate further diversification of the economy away from its dependence on traditional commodities for export revenues. For the foreseeable future, Bangladesh must rely on aid inflows to provide sufficient resources for development. Continued careful management of its economic policies would assure donors that their assistance was being put to good use.

Mr. Suraisry said that he was in broad agreement with the staff appraisal and supported the proposed decision. It was clear from the staff papers that the performance of the Bangladesh economy in the past two years had been satisfactory. All macroeconomic aggregates, except the overall budget deficit, had responded positively to the adjustment initiated in 1982/83 and had shown substantial improvement. Weather conditions and the terms of trade had been helpful, but much of the credit went to the authorities' persistent efforts and determination to bring the economy back on track. Particularly in 1982/83, the authorities had taken commendable and far-reaching macroeconomic and microeconomic measures to deal with past and present problems. He commended the authorities on the success that they had achieved and the courage that they had shown.

Unfortunately, however, the economic imbalances had not disappeared, Mr. Suraisry continued: inflation was still high, even though it had been successfully reduced from the 1981/82 rate; the overall ratio of the budget deficit to GDP was also high; and the balance of payments, despite achieving an overall surplus, was not sufficiently strong. There was a need for further measures in the monetary, fiscal, and external areas if the economy were to be more resilient to external shocks. The authorities were aware of those weaknesses and had taken further corrective measures to deal with them. In particular, they were making strong efforts to strengthen the private sector and increase its role in the development process. Denationalization of the jute and cotton textile mills and further liberalization in prices and the import regime were part of those efforts. Those steps should help to provide an environment conducive to strong private sector activity.

On fiscal policy, Mr. Suraisry remarked, the share of domestic revenue in GDP was low. Moreover, the economy depended very much on changes in foreign aid, terms of trade, and weather. Therefore, there was a case for increasing domestic revenue by indexing the tax base if the economy were to be insulated from unfavorable external developments. But he agreed with the authorities that in a country like Bangladesh, with a large population, a low resource endowment, and extremely low per capita income, that process could only be gradual, not only because of the hardships that it might bring but also because of the lack of sufficient conditions that would lead to its satisfactory completion. Like the staff, he believed that there was a need to exercise restraint over current expenditure and to avoid recourse to bank financing, especially as the inflation rate was just below 10 percent; he was encouraged by the authorities' intention to avoid such means of financing.

With regard to monetary policy, the recent increase in liquidity gave cause for concern, Mr. Suraisry commented. While it was comforting to note from Mr. Malhotra's statement and the staff paper that a major source of the credit growth was credit to agriculture, which should help to ease the inflationary pressures from the supply side, it was essential nevertheless to contain the growth of that variable. It was encouraging that the authorities had used offsetting measures and would strive to bring credit growth under control.

The external sector was characterized by its dependence on factors beyond the authorities' control, Mr. Suraisry observed. He was pleased to note from Mr. Malhotra's statement that the authorities intended to use a combination of import substitution and export-oriented industries based upon the law of comparative advantage to support the policies designed to strengthen the external sector. He also welcomed the authorities' intention to resort to a more flexible exchange system, which would be helpful in promoting such policies and provide a better chance for their success.

On the medium-term outlook, the Third Five-Year Plan correctly emphasized the development of productive and human resources, Mr. Suraisry remarked, the importance of which, in meeting the challenge of limited natural resources and a large and increasing population, could not be overemphasized. On the other hand, it was also important to be realistic about the financial resources allocated for the Plan, especially in view of the unfavorable developments projected in the medium term in the balance of payments and external debt. The external debt service was projected to increase to a level that might make it difficult for the country to meet its external debt obligations, especially if unfavorable exogenous developments should occur. It was therefore important to exercise vigilance and to continue the prudent policy of relying on loans contracted on highly concessional terms. The strong efforts made by the authorities to meet the challenge that they were facing had thus far resulted in significant progress; he hoped that those efforts would be continued.

Mr. Kabbaj noted that during 1983/84, the real sector of the Bangladesh economy had registered solid improvement. Production, both agricultural and nonagricultural, was estimated to have grown by 5 percent in an environment marked by stable prices. The rate of inflation had remained moderate, at about 10 percent in the past two years. The main impetus in the agricultural sector had come from crop production, where rice and wheat had both recorded considerable production gains. However, the production of raw jute, the most important cash crop, had declined slightly. It was encouraging that the Government had initiated programs with the support of the World Bank to diversify crop production. Since the process of diversification would take place through more intensive, rather than extensive, cultivation--nearly all arable land being already under cultivation--frequent fertilizer use would be crucial. It was therefore noteworthy that the authorities had devised a program aimed at greater employment of modern agricultural inputs.

On the industrial front, Mr. Kabbaj continued, production had increased, following the 1981/82 industrial recession, by almost 6 percent in 1983/84, with gains recorded mainly in the cement and iron and steel sectors. The new industrial strategy aimed to expand the manufacturing sector and to open to private investment certain sectors previously reserved for the public sector. He agreed with the staff that reform measures affecting jute production and the textile mills, together with greater participation by the private sector, would foster increased competitiveness and efficiency in the public sector.

Fiscal developments in 1983/84 had not fulfilled original expectations, Mr. Kabbaj observed. Mobilization of domestic resources required an expansion in the tax coverage and rationalization of expenditure. Excessive subsidization of agricultural inputs and fertilizer stocks would produce cost-price distortions. It was encouraging, however, that the authorities were conscious of the need to inject greater realism into agricultural policies by aiming gradually to reduce the subsidies. The overall budget deficit in 1983/84 would be about 10.2 percent of GDP--the share of the past several years--and, according to the new budget figures, would remain at that level, financed mainly through external aid. Given the size of the deficit, there would be a need to reduce the ratio gradually in the future.

With regard to monetary policy, Mr. Kabbaj said, there was a need to control liquidity and to channel surplus money market funds to long-term financial instruments. The authorities had agreed that price pressures could emerge as long as excess liquidity remained uncontrolled.

In the external sector, the authorities were cognizant of the need to continue the flexible exchange rate policy with a view to maintaining the competitiveness of exports, Mr. Kabbaj observed. Exports had recovered significantly from the lows recorded in 1981/82, but because of rising imports the trade deficit had increased. However, the overall balance had been in surplus in the past two years, owing mainly to grants and aid disbursements. He agreed with the staff that the balance of payments structure remained fragile and that the authorities should pursue a prudent policy, especially in view of the rising debt service burden in the next few years. Indeed, the medium-term scenario pointed to the need to take early precautionary measures to deal with future external shocks such as drought, flooding, instability in commodity prices, and other climatic or international developments. In conclusion, he supported the proposed decision.

Mr. Shaw stated that he was in broad agreement with the staff appraisal and supported the proposed decision. He commended the Bangladesh authorities for their continuing commitment to a strong adjustment effort and for the successful completion of the previous year's stand-by arrangement. There had been positive real growth of 5.1 percent in 1983/84, a surplus in the overall balance of payments in 1982/83 and 1983/84, and a reduction in consumer price increases to less than 10 percent since 1981/82. He welcomed those improvements but noted that the Bangladesh economy remained extremely vulnerable to external shocks, particularly to adverse movements in the terms of trade and to recurrent natural disasters. He invited the staff to comment on the possible effect of recent flooding in the northeast on staff estimates of growth, inflation, and the current account deficit.

Given the staff's medium-term projections for the balance of payments, the limited scope for domestic policy alternatives, and the dependence on external aid over the rest of the decade, the available policy measures must be fully deployed in a determined and sustained manner in Bangladesh, Mr. Shaw remarked. The size of the fiscal deficit was of considerable concern; as the staff had pointed out, the adjustments for 1983/84 were less substantial then those implemented in the previous year. The revenue base remained narrow and was subject to high variability because of the dependence on trade-related taxes. There was also a lack of adequate direct taxation and enforcement of tax legislation. He was therefore pleased that the authorities intended to revise the Income Tax Act and expand the coverage of the turnover tax in the corporate sector. The authorities would also need to work toward lessening public sector dis-saving; he encouraged the elimination of temporary sales of "special bonds" to the commercial banks, a measure that he understood the authorities were considering. The efforts to reduce expenditures in 1983/84 were commendable and must be sustained. He welcomed the reduction of subsidies, particularly on wheat and rice, and the increased flexibility in setting public sector prices. He recognized, however, that continued subsidies on foodgrains were necessary in a country like Bangladesh for those segments of the economy with low incomes.

He noted from SM/84/151, Supplement 1 that the 1984/85 budget deficit would improve marginally over the 1983/84 deficit, Mr. Shaw continued. The authorities had commendably offset the public sector wage increase through other measures in order to keep the deficit relatively flat, and it was encouraging that the authorities were keeping the fiscal correction on track. Government decentralization might be appropriate, but, like Mr. Clark, he would be interested in knowing whether it would put pressure on the fiscal policy of the Central Government. He urged the authorities to maintain tight control over total public expenditure, even in the case of decentralization. The authorities' policy of foodgrain stocking was appropriate and could avoid the problems that had arisen in the past. However, he hoped that the authorities would not continue the sales of special bonds, and he was encouraged by Mr. Malhotra's statement that they were temporary. He agreed with the staff that the development of gas wells had been hampered by inadequate funding; the generation of internal resources through price increases should help to alleviate that problem.

Monetary policy should be tightened significantly, as liquidity had increased rapidly in recent years, Mr. Shaw advised. Price pressures might already be developing, as evidenced by the public sector wage increases. He strongly supported the staff recommendation for a more flexible interest rate policy in view of the limited options available to the authorities to channel savings into longer-term instruments.

He commended the authorities for maintaining a flexible exchange rate regime, Mr. Shaw continued. However, he urged the authorities to eliminate the multiple exchange rate practices and the bilateral payments arrangements with Fund members, and he agreed that the Board should not grant approval of those practices. He welcomed the measures taken by the authorities to liberalize imports further, but agreed with the staff on the need for an import list that allowed maximum flexibility and transparency for the importer; the present negative import list led to uncertainty, which tended to discourage trade. The rising debt service burden, the projected deterioration in the medium-term balance of payments, and the fragility of recent improvements in the high current account deficits were sources of concern, and the authorities would have to continue domestic adjustment efforts in order to improve the Bangladesh economy.

With regard to structural adjustment, Mr. Shaw said that, like others, he welcomed the denationalization program and the increased scope for private sector participation in the economy under the New Industrial Policy (NIP). While the steps taken under that policy were commendable and would facilitate investment and growth, there remained a number of fundamental problems caused by the low savings rate. The authorities should focus on the growing inequality in income distribution, the lack of efforts to curtail conspicuous consumption, public sector dissavings, and capital flight. While progress had been made in encouraging nontraditional exports, additional structural corrections were needed particularly to diversify exports since an upper limit, although increased recently, existed on the quotas under the Multifiber Agreement.

In sum, Mr. Shaw concluded, the balance of payments remained structurally weak, despite the improvement in the past two years. Policies to strengthen the balance of payments would have to be pursued vigorously if a sustainable current account were to be achieved, especially as aid flows in real terms might not increase at the same rate as in the past. Adjustment policies to increase the rate of national savings would be needed. Debt service as a percentage of exports would continue to be relatively high over the remainder of the decade; a large part of that debt service was of particular concern to the Board because it would be due to the Fund. A close working relationship with the Fund would be required, along with substantial amounts of official assistance at very concessional terms.

Mr. Moerke stated that he was in broad agreement with the staff's assessment. Mr. Malhotra had reminded the Board of the severe limitations faced by Bangladesh as one of the least developed countries; given those constraints, Bangladesh's achievements in growth, inflation, and external accounts were highly commendable.

The balance of payments position would remain a major obstacle to growth for some time to come, Mr. Moerke commented. It was therefore essential that the mobilization of resources and savings be increased and that the traded goods sector be strengthened. The authorities had implemented suitable policy measures to achieve those objectives. For example, they had allowed public enterprises to charge more appropriate prices, flexibly adjusted administered prices, and increased incentives for nontraditional exports; interest rates, though impaired by a rigid structure, had become positive in real terms. He encouraged the authorities to continue that prudent policy stance.

With regard to fiscal policy, Mr. Moerke said, a basic weakness in the budget was the narrowness of the tax base. He therefore welcomed the authorities' intention to implement several reforms to increase taxation of the nonagricultural sector. The agricultural sector contributed only marginally to tax revenues although accounting for 50 percent of GDP, and improved tax administration and collection in that sector should increase tax revenue over time. He agreed with the authorities and the staff on the objective of eliminating input subsidies.

On monetary policy, Mr. Moerke noted with some concern that the recent rapid increases in liquidity carried the risk of rekindling inflationary pressures. He commended the authorities for ruling out the use of credit ceilings as a measure to tighten liquidity, and for emphasizing that credit ceilings would be detrimental to the more resourceful and competitive banks. The staff, however, had made a convincing case for a more flexible interest rate policy that could more effectively control liquidity than the instruments preferred by the authorities. In conclusion, he supported the proposed decision.

Mr. Polak commented that it was remarkable that Bangladesh--one of the poorest countries in the world--did not have an arrangement with the Fund, not because it did not qualify, but because it did not need one. The high quality of the economy's performance would be considered exceptional, even in countries with Fund arrangements. Policy measures implemented in several areas by the Bangladesh authorities had been impressive.

On the exchange rate, Mr. Polak continued, the policy of the authorities had been to maintain the external competitiveness of the traded goods sector through periodic adjustments of the taka to offset differentials between domestic inflation and inflation in Bangladesh's trading partners, and through reviews of that policy in the light of export performance and the progress of efficient import substitution. In addition, the authorities had introduced important improvements in the secondary exchange market. Real interest rates were positive and would remain so, and interest on nonresident deposits would be paid at 1 percent over the London interbank offered rate (LIBOR).

On subsidies, fertilizer prices had been increased by 10 percent from the first week of July 1984, and subsidies would be eliminated completely by 1985/86, Mr. Polak remarked. The subsidies on foodgrains would also be reduced, so that total expenditures on food and fertilizer subsidies--less than 4 percent of budget expenditures in 1983/84--were expected to decrease substantially in 1984/85. Another difficult measure had been the increase in procurement prices for rice and wheat by 10 percent and 15 percent, respectively. Trade had been liberalized, and a further new import policy had been announced to take effect in January 1985.

The 1984/85 budget should provide further stimulus to economic growth while containing the overall deficit, which was expected to decline marginally from 10.6 percent to 10.3 percent of GDP, Mr. Polak said. The emphasis would be on development expenditure on quick-yielding projects as opposed to current expenditure. Like Mr. Clark, he would have appreciated more information in the staff report on relations between Bangladesh and the World Bank. The budget deficit, although large, was not a matter for concern, because it was mainly the counterpart of foreign aid. The denationalization of certain jute and textile mills, and the sanctioning of private investment in areas that had been previously reserved for the public sector, would produce greater competitiveness and efficiency in the public enterprises.

With regard to monetary policy, Mr. Polak noted, the relatively high increase in liquidity in 1983/84 had been largely due to a balance of payments surplus. The Government had not used bank credit, and the public enterprises had reduced their access to credit because of the new measures that made it easier for them to raise rates. As a result, the expansion of credit had been mainly extended to the private sector, especially for agriculture. He did, however, agree with the staff that there were grounds for concern on monetary policy and reason for greater caution.

Unlike other countries whose policies were satisfactory but where the results were not, Bangladesh had made commendable progress, Mr. Polak commented. Although there had been disappointments, he noted that, in spite of severe flood damage to agriculture, real GDP growth in 1985/86 was estimated to increase by 4.5 percent and the staff foresaw future growth of about 5 percent, compared with 6 percent for the 1960s. Inflation, at about 10 percent, showed room for further reduction, but the exchange rate policy ensured that inflation would not harm the balance of payments, which was in surplus. The country had been able to build up its reserves to two and one-half months' imports.

Those successful policy results should not veil the fact that Bangladesh was an extremely poor country with a per capita income of about $140 and an aid flow of $1.5 billion, or about 10 percent of national income, Mr. Polak added. Furthermore, Bangladesh had an extremely vulnerable economy and balance of payments. From other Directors' remarks, he gathered that if Bangladesh's policies had been submitted as part of a Fund program, the Board would have been ready to endorse the program. What were the implications for Bangladesh's eligibility for a drawing under the compensatory financing facility? As Bangladesh's exports were on a rising trend, any question of assistance under the facility was only of theoretical importance at present, but factors beyond the country's control could change that situation. The record of the present discussion should show that the policies of Bangladesh were not, to say the least, "seriously deficient," ensuring its potential access to the compensatory financing facility without further action by the authorities.

Mr. Ismael noted with pleasure that, following a successful economic outturn in 1982/83, the Bangladesh economy had continued to enjoy another year of successful economic performance. Real GDP growth in 1983/84 had improved compared with the previous year, and the overall budgetary deficit had declined modestly. Although the ratio of the current account deficit to GDP was estimated to widen slightly, the overall balance of payments continued to record a surplus. All those developments had reflected not only the continued favorable weather, the improving terms of trade, and the recovery of the nonagricultural sector, but also the commendable efforts of the authorities in trying to restore financial discipline and to move toward the medium-term goal of achieving sustained growth with a viable balance of payments.

Nevertheless, Mr. Ismael continued, Bangladesh's external sector remained structurally weak, because of its vulnerability to external and climatic developments. Moreover, the value of imports needed to sustain a reasonable development effort was about four times higher than the value of current exports, and the country was very dependent on external aid. For those reasons, vigorous efforts would have to be made to expand and diversify exports while promoting import substitution.

The flexibility and pragmatism with which the authorities had managed exchange rate policy since late 1980 were appropriate and essential for maintaining external competitiveness, Mr. Ismael commented. The recent regulations to broaden participation in the secondary foreign exchange market and to expand import liberalization were steps in the right direction. Nevertheless, he encouraged the authorities to aim at unifying the exchange markets over the medium term so as to eliminate the complex system of exchange and trade controls.

Inflation had accelerated to about 11 percent in recent months, Mr. Ismael observed, and he therefore encouraged the authorities to control the currently high rate of money and credit expansion. In addition, interest rates should be kept under review to ensure that real interest rates remained positive in order to promote domestic savings mobilization.

With regard to the medium-term outlook, the broad outlines of the Third Five-Year Plan seemed appropriate, Mr. Ismael considered. Support from the World Bank in investment would help to improve the economic outlook. However, the current account deficit was expected to rise to 10 percent of GDP by 1988/89, which would create large financing gaps in 1987/88 and 1988/89; debt service payments were estimated to rise from 17 percent of exports of goods and services and workers' remittances in 1983/84 to 24 percent in 1986/87. Therefore, Bangladesh would continue to need sufficient aid flows and concessional loans to sustain its growth rate and keep its debt service at prudent levels. In conclusion, he supported the proposed decision.

The staff representative from the Asian Department explained, with regard to Mr. Malhotra's comment on the apparent inconsistency between the information received from the authorities and the staff statement on the Government's borrowing requirement, that the staff had based its estimates of the budgetary outcome on discussions with the Bangladesh authorities that had taken place during the mission. Although the staff had not had more recent discussions with the authorities, it had received monetary data for May 1984 that indicated some borrowing by the Government from the banking system as estimated by the staff. He agreed with Mr. Malhotra that there might be a difference of definition: in Bangladesh, the two-year special treasury bonds were not considered borrowing from the banking system. The budget figures did not provide for such borrowing to finance increases in food stocks unless it became necessary to do so, according to the long-standing policy of the Government.

It was too early to ascertain the impact of the July 7, 1984 circular permitting banks to buy and sell foreign exchange in the secondary market within a band set at 7-10 percent of the official rate, the staff representative commented. However, measures that permitted banks to buy and sell foreign exchange as principals in the secondary market, that introduced a 100 percent entitlement rate under the Export Performance Licensing Scheme, and that allowed the corresponding import entitlement certificates to be auctioned in the secondary market were consistent with the objective of broadening that market. The staff would monitor developments closely, and looked forward to a discussion with the authorities of their actual experience with the secondary exchange market. The premium in the secondary market indicated the true state of the supply of and demand for foreign exchange. By setting that indicator at a certain level, the Bangladesh Bank might find it necessary, if trading were at the upper end of the range, to intervene more heavily in the market and perhaps to use some of its reserves to maintain that rate. Early indications were that the broadening of the secondary exchange market had been a step in the right direction.

With regard to the budgetary implications of the decentralization program, the staff representative pointed out that the World Bank had prepared a document for the aid group meeting that treated the subject in some detail. The impact on the budget was difficult to isolate from the effects of infrastructure expenditures, sectoral allocations, and the Annual Development Plan. Although the authorities had allocated funds to local governments to be spent on infrastructure, the amounts were small and should not contribute to the overall deficit, especially as the Government had stated that it would contain other elements of recurrent expenditure.

On whether monetary expansion in 1984/85 would be consistent with staff estimates for the balance of payments, the staff representative noted that the authorities expected a lower overall surplus than the staff was projecting for 1984/85. The difference was attributable mainly to the authorities' forecasting higher imports than the staff.

The ratio of domestic savings was very low because Bangladesh, with a per capita income of less than $140, was one of the poorest countries, the staff representative commented. Rapid progress in raising the ratio could not be expected, and the country would continue to depend on foreign savings for development. The World Bank was heavily involved in Bangladesh and had an active resident mission in Dacca. The Bank had assisted the authorities for the past two to three years in formulating the Annual Development Plan--in particular, the core program--and in the review of the Plan in preparation for the aid group meeting. The World Bank staff was in general agreement with the thrust of development policies in Bangladesh. Further details on Bank activity would be reported in future staff papers on Bangladesh.

On the Annual Development Plan, the authorities had identified the projects in the core program as essential, the staff representative explained; those projects would be safeguarded in case of a shortfall in revenues. There had been a downward trend in the number of projects included in the Annual Development Plan--800 in 1984/85 compared with 1,200 in the previous two years--indicating that projects that were inadequately prepared would not be included in the program. Distinguishing between less urgent and more essential projects was a time-consuming but necessary exercise. There could be a change in the approach to development under the Third Five-Year Plan that would begin the following fiscal year.

The staff believed that a more flexible interest rate policy would be necessary for Bangladesh, the staff representative continued, as flexibility could serve several objectives. Owing to the excess liquidity in Bangladesh, a larger differential between short-term and long-term interest rates could help to channel domestic savings into longer-term investment. One problem was that the average cost of funds to commercial banks had increased in recent years because of the high deposit rates. Another objective of a flexible interest rate policy would be to enable the authorties to use the instruments of monetary policy, especially with regard to reserve requirements and the role of the banks, while safeguarding the profitability of commercial banks. In addition, specialized banks were authorized to accept deposits, but because of the high deposit rates they had been discouraged from increasing their role in channeling funds into long-term projects.

The authorities had benefited from technical assistance from the Fund, the staff representative remarked, and there was a Fund resident representative in Dacca. Any requests for technical assistance would be considered favorably; recent discussions had focused on fiscal policy and central bank statistics.

According to estimates by the Bangladesh authorities, as a result of the floods, spring crops would be 600,000 tons less than projected, the staff representative reported, implying an annual production of 15.5 million tons instead of 16.1 million tons. Although the total crops would represent an increase over the previous year, the loss of potential output would have budgetary and balance of payments implications. The Government had had to import additional grains at a budget cost of about Tk 760 million (approximately $32 million). Under normal circumstances, the authorities would not have imported foodgrains using their own cash resources but would have relied on food imports through aid programs, but in order to maintain stocks at an appropriate level--1.2 million tons--imports had been necessary. Nevertheless, stocks amounted to only 960,000 tons at present and it was anticipated that the authorities might have to import additional foodgrains in 1984/85 to raise stocks to the 1.2 million target.

It had been suggested that the sale of two-year special treasury bonds should be discontinued, the staff representative recalled; however, the sale was really a form of domestic borrowing. In general, the Government avoided domestic bank borrowing to finance the budget, but in 1983/84 it had had a dual objective: to finance the budget and to absorb some of the excess liquidity available to the banks, motivated by the desire not to impinge on the profitability of commercial banks. The authorities did not intend to discontinue the sale of those bonds, although they had not made any explicit provision for such sales in 1984/85.

Bangladesh's debt service was high at present because of debt service to the Fund, which would peak within the next two or three years, the staff representative commented. In general, however, most of the loans contracted by Bangladesh were concessional, and recourse to commercial borrowing had been taken only to finance food imports. Although factors such as actual developments in exports and workers' remittances would have an effect on the debt service ratio, staff estimates indicated that that ratio would be manageable over the next few years.

He could agree with Mr. Polak that Bangladesh would be entitled to have a program with the Fund, given its excellent record, the staff representative from the Asian Department said. However, the authorities did not intend to request a stand-by arrangement, in view of the improvement in Bangladesh's external position and its comfortable official reserves. As to a possible drawing under the compensatory financing facility, it would have to be determined at the time whether a shortfall existed and whether the policy stance was appropriate.

Mr. Malhotra recalled that Directors had expressed concern about the growth in money supply and the increase in bank credit. His Bangladesh authorities were concerned at the rate of growth of liquidity, but in 1982/83, while overall liquidity had been high, the credit increase had actually been below the rate of inflation and had been mainly due to the Government's and public enterprises' returning money to the banking sector. Credit to the private sector, especially for agriculture, had been growing and, with recovery, had picked up further. Because of the developments in 1983/84, the authorities had set conservative ceilings for the growth of money and credit which should help stabilize the situation and keep inflation under control.

Several Directors had commented on the need for interest rate flexibility, Mr. Malhotra said. Table 5 of SM/84/151 showed that the interest rate on fixed deposits for three months to less than six months was 12 percent, for one year to less than two years it was 14 percent, and for three years and over it was 15 percent, against an expected inflation rate of about 10 percent. There was no strong case for higher deposit rates, which would, in turn, entail an increase in lending rates. In agriculture, where demand for credit had been high in 1983, the lending rate had been raised from 12 percent to as high as 16 percent, an increase of 4 percentage points. Similarly, in the socioeconomic lending area, the lending rate had been increased from 13 percent to 15 percent. Decreasing deposit rates at lower ends or raising rates at the upper end would be counterproductive in an economy where there was need for diversifying the economic structure. However, his authorities would keep interest rates under review in the light of future developments. For the time being, they believed that the present rate structure was adequate because real deposit and lending rates were positive; as noted by the staff, deposits for more than three years had increased, and ample cash was available to banks as a result of the improvement in the balance of payments.

The price of natural gas had been increased several times and was at present well above the cost of production and delivery, Mr. Malhotra stated. The staff had suggested that prices could be raised further to cover investment and development costs. The Bangladesh authorities had prudently set prices of petroleum products at international levels. Although aware of the need to cover the long-term costs of developing domestic natural gas resources, their immediate policy objective was to encourage the substitution of imported petroleum products by domestically produced energy.

The authorities had significantly changed their policy stance on customs duties, Mr. Malhotra said. In the recent budget, a large number of reductions in customs duties had been announced, and, in his budget speech, the Advisor to the President had emphasized the benefit of reducing costs to industry and improving its competitiveness through increased and cheaper imports. The authorities had launched a package of taxes and charges in 1984 and, although their overall impact on revenue might not be large, the package represented initiatives that should improve the domestic tax base over the medium term. Measures had also been taken to improve the collection and administration of the income tax and other local taxes. He reminded Directors that the scope for substantial increases in savings was limited. His authorities recognized that the economy was vulnerable and had structural weaknesses that must be overcome over a period of time. The record of development over the 1970s--an average growth rate of about 6 percent--was commendable and showed that external aid had been used effectively. The authorities were pleased that the staff's medium-term scenario indicated a 5 percent rate of growth, compared with the previous scenario forecast of 2-3 percent. They appreciated the strong support given by the international community and hoped that it would continue. They had also noted the staff assessment that large financing needs might arise toward the end of the decade. Although the assumption underlying that forecast was that external assistance would not grow in real terms, it was hoped that positive increases might in fact occur. The evolution of the inflow of remittances over the coming years could not be forecast with certainty. Meanwhile, in view of the uncertainties of weather and the international environment, the authorities agreed that the stance of policies should be sensibly restrained.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal. They noted with satisfaction that the overall performance of the Bangladesh economy had continued to be favorable in fiscal year 1983/84. Real growth had accelerated, the rate of inflation had been contained at the previous year's level, and the balance of payments had continued to be in surplus, leading to a further and much needed buildup of reserves. These developments were mainly attributable to the prudent and effective policies pursued by the authorities, particularly those introduced under the 1982/83 economic program, continued favorable weather, a further improvement in the terms of trade, and a continued high level of workers' remittances. However, Directors stressed that the improvement in the economic situation was fragile, as the economy remained structurally weak and highly vulnerable to exogenous shocks.

Directors observed that in 1983/84 the authorities had decided not to slow down budgetary spending despite a revenue shortfall, thus necessitating some recourse to bank borrowing. Stressing the need to base expenditures on realistic resource estimates, Directors welcomed the authorities' intention to increase domestic resource mobilization through an expansion of the tax base, a reduction of subsidies, and increased flexibility in the setting of administered prices. They also welcomed the authorities' aim not to resort to bank borrowing. With respect to the 1984/85 budget, Directors observed that if revenues were to fall short of budget estimates, appropriate budgetary adjustments would need to be taken so as to limit financing requirements to available foreign and domestic nonbank resources. Directors cited the overdependence of the tax system on trade transactions and urged the authorities to intensify their efforts to broaden the tax base. The Fund would be ready to provide technical assistance in that field if that were agreeable to the authorities.

Noting that broad money has grown at a rapid pace for the second successive year, Directors expressed concern about the inflationary potential of the liquidity situation. They stressed the importance of a flexible interest rate policy, not only to enable a more active use of monetary instruments to restrain the growth of domestic credit, but also to encourage the channeling of surplus money market funds to medium-term and long-term financial instruments.

Directors considered that the balance of payments position is fundamentally weak and vulnerable to external shocks. The export base remains narrow, and export receipts finance only a small fraction of imports. Under these conditions, Bangladesh would need to sustain a strong adjustment effort over a number of years. Bangladesh would continue to rely on external assistance on highly concessional terms, and the role played by the World Bank was emphasized in this respect. Despite the concessional nature of most capital inflows, debt service payments had claimed an increasing share of scarce foreign exchange resources. Directors urged the authorities to continue to strengthen the traded goods sector, partly through continued flexibility in exchange rate management, and to exercise caution in contracting external debt at commercial terms. Directors welcomed the recent measures to broaden participation in the secondary foreign exchange market. Directors also encouraged the authorities to liberalize the import regime further and deepen the secondary exchange market in order to improve economic efficiency and pave the way for the establishment of a unified exchange market at an appropriate rate in the near future.

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

The Executive Board then took the following decision:

Decision Concluding 1984 Article XIV Consultation

1. The Fund takes this decision relating to Bangladesh's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1984 Article XIV consultation with Bangladesh, in the light of the 1984 Article IV consultation with Bangladesh conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Bangladesh maintains certain restrictions on payments and transfers for current international transactions and multiple currency practices as described in SM/84/160. The Fund encourages Bangladesh to eliminate the margin requirements on import letters of credit, to channel more imports through the secondary exchange market, and to terminate the bilateral payments arrangements with Fund members.

Decision No. 7760-(84/113), adopted
July 20, 1984

3. ECUADOR - STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERION

The Executive Directors considered a staff paper (EBS/84/154, 7/18/84) containing Ecuador's request for a waiver of the performance criterion under its stand-by arrangement and stipulating that purchases could not be made after November 1983 while the country had external payments arrears outstanding.

Mr. Robalino informed the Executive Directors that Ecuador had established an escrow account in the amount of $5 million to pay the various creditors of the Paris Club when Ecuador and the Paris Club could reach an understanding on the new rescheduling of $247 million of external debt that Ecuador had requested in May 1984.

Mr. Moerke said that he supported the proposed decision with the understanding that Ecuador's request for a waiver was justifiable only because of exceptional circumstances; the request should not constitute a precedent for the future.

Mr. Malhotra stated that he supported the proposed decision.

Mr. Polak said that he supported the decision, with the same understanding expressed by Mr. Moerke.

Mr. Mtei said that he supported the waiver. The Managing Director and the staff of the Western Hemisphere Department had shown the understanding and flexibility in Ecuador's case that had not been evident in Zambia's case. As he had mentioned during the discussion of the 1984 Article IV consultation and stand-by arrangement (EBM/84/110, 7/18/84), Zambia had met all the performance criteria in respect of its previous stand-by arrangement except--owing to the dramatic and unexpected drop in copper prices--the ceiling on external arrears, including those due to Paris Club creditors, so that it had not been able to make the last purchase. He agreed that Ecuador's case was exceptional; its inability to meet the payments arrears criterion had arisen because the start of the program had not coincided precisely with the timing of the rescheduling agreement with the Paris Club. Indeed, Ecuador did not lack foreign exchange, as it had been able to establish the escrow account, but he fully understood Ecuador's need to avoid pre-empting the terms of the agreements that it would reach with the Paris Club creditors.

Nevertheless, even if circumstances beyond the control of the Ecuadoran authorities were sufficient justification for the waiver recommended by the staff, Mr. Mtei continued, the drop in copper prices--by as much as 40 percent over 12 months--had also been proposed to enable Zambia to make full use of the stand-by arrangement.

An element of evenhandedness was needed, Mr. Mtei considered, and he assumed that management and the Executive Board would ensure uniformity of treatment. However, staff in different area departments might arrive at different judgments regarding the need for flexibility. For instance, the Board had adopted a sympathetic and flexible approach toward Honduras, under its stand-by arrangement, but not toward Liberia, which had been unable to make the last purchase under its stand-by arrangement because, for reasons beyond its control, agreement with commercial banks to reactivate an oil financing facility had not been reached.

The Chairman responded that the could assure Mr. Mtei that the staff upheld the principle of uniform treatment of member countries. There had been circumstances in the cases cited by Mr. Mtei that had influenced the staff's judgment and that explained the different courses of action taken. He would inform Mr. Mtei of those circumstances bilaterally.

Mr. Delgadillo, Mr. Feito, Mr. Hansen, Mr. Kabbaj, Mr. Orleans-Lindsay, Mr. Suraisry, and Mr. Wang said that they supported the proposed decision.

Mr. Leonard stated that he supported the proposed waiver, which he regarded as having arisen because of a timing problem outside the authorities' control. He wondered when the need for the waiver had become known, and whether it might not have been brought to the attention of the Board on June 20, 1984, when the program had been reviewed.

The Deputy Director of the Exchange and Trade Relations Department said that when the program had been reviewed, the Ecuadoran authorities had not requested the waiver. The staff had informed the Board that all performance criteria had been met, with the exception of the commitment to eliminate arrears. At that time, negotiations with commercial banks on the refinancing of arrears had not been concluded. Therefore a combination of progress in the discussions with the banks and the good faith shown by the Ecuadoran Government in setting up the escrow account had determined the timing of the request for the waiver.

Mr. Bernardo expressed agreement with the reasons cited for the requested waiver and support for the proposed decision.

The Executive Board then took the following decision:

> The Fund finds that, notwithstanding that all external arrears have not been eliminated as contemplated in paragraph 4(c) of the stand-by arrangement for Ecuador (EBS/83/91, Supplement 3, July 27, 1983), Ecuador may proceed to make purchases under the stand-by arrangement.

Decision No. 7761-(84/113), adopted
July 20, 1984

APPROVED: April 17, 1985

LEO VAN HOUTVEN
Secretary