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Minutes of Executive Board Meeting 84/114

10:00 a.m., July 25, 1984

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
	P. Péterfalvy, Temporary
B. de Maulde	
A. Donoso	
	M. K. Bush
M. Finaish	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
	L. Leonard
A. Kafka	
G. Laske	G. Grosche
G. Lovato	
R. N. Malhotra	
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	
A. R. G. Prowse	
	O. Kabbaj
	E. I. M. Mtei
M. A. Senior	
J. Tvedt	A. Lindø
N. Wicks	T. A. Clark
	Wang E.

J. W. Lang, Jr., Acting Secretary
C. J. Fairbairn, Assistant

Also Present

Asian Department: Tun Thin, Director; S. M. Schadler, B. J. Smith. European Department: B. Rose, Deputy Director. Exchange and Trade Relations Department: C. D. Finch, Director; S. Mookerjee, Deputy Director. Legal Department: G. P. Nicoletopoulos, Director; A. O. Liuksila. Middle Eastern Department: A. S. Shaalan, Director; A. K. El Selehdar, Deputy Director; S. H. Hitti, Z. Iqbal, E. M. Taha, S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, S. El-Khouri, G. E. L. Nguyen, I. R. Panday, D. I. S. Shaw, A. Steinberg, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, R. L. Bernardo, J. Bulloch, M. Camara, M. B. Chatah, Chen J., D. Hammann, H. Kobayashi, K. Murakami, E. Olsen, G. W. K. Pickering, M. Rasyid, J. E. Rodríguez.

1. GROUP OF TEN - DEPUTIES' MEETING - REPORT BY STAFF

The Economic Counsellor said that the Deputies of the Group of Ten had met in La Celle St. Cloud near Paris on July 17 and July 18, 1984, where they had discussed the management of international liquidity, the functioning of floating exchange rates, and surveillance of exchange rate policies.

The issue of the management of international liquidity had been discussed on the basis of two Deputies' papers and the staff paper entitled "Control of International Liquidity and Reserve Creation" (SM/84/147, 6/26/84), the Economic Counsellor continued. The argument of one of the Deputies' papers had been that, to the extent that there was a shortage of international liquidity, it had been focused on countries with no established access to credit markets or on those whose access had been interrupted by a loss of creditworthiness. The paper had argued that the first group should receive concessional aid in support of sound policies and development, while the second group should improve its policies and performance so as to re-establish creditworthiness. A global increase in liquidity would not be in the interests of either group.

The second Deputies' paper had been more analytic, offering a short series of comments on the nature of international liquidity and the demand for and supply of international reserves, the Economic Counsellor remarked. Deputies had, in general, been struck by the complexity of the subject of international liquidity, and had requested Fund staff to undertake further analytic work, although they had been unable to specify their needs except to request a framework within which the issues could be analyzed. The staff had agreed to attempt to define the problem more precisely, and to offer further analysis. The Deputies had not yet produced a list of suggestions on international liquidity from which to make proposals to their Ministers.

The discussion of floating exchange rates had focused on a Deputies' paper that had examined possible instruments to restore exchange rate stability in a progressive manner, the Economic Counsellor went on. Three instruments, in addition to those designed to achieve a compatible performance of major economies at satisfactory rates of inflation and growth, had been considered--the determination of real fundamental exchange rate levels among the five major currencies, the publication of target zones of 5 percent or 10 percent around the fundamental rates, and the occasional adjustment of the target zones to accommodate inflation differentials and balance of payments adjustment needs. The proposal to adopt target zones to achieve greater exchange rate stability had received little support, although some Deputies had considered the possibility of waiting until an acceptable pattern of exchange rates emerged, around which target zones could then be fixed. The purpose of such zones would be to stimulate surveillance of movements in exchange rates close to or across the zone boundaries. The broad conclusion of the group, which remained unchanged from May 1984, was that no viable alternative appeared to exist to the present mixed exchange rate system.

The discussion of surveillance had been the most focused phase of the Deputies' meeting, the Economic Counsellor remarked. A list of specific suggestions for improving surveillance had begun to emerge; it was intended that the Chairman of the Deputies would draft a statement of the suggestions and the arguments for and against them, from which, at a subsequent meeting, Deputies would select those particular suggestions they wished to include in their report. Among the suggestions from which the selection was to be made were plans to

1. improve the data, analysis, forecasts, and indicators used in judgments about policies;

2. be prepared to make more frequent use of special consultations between the Managing Director and senior policy personnel in member countries;

3. publicize the Fund's assessment of a country's economic situation and adjustment needs;

4. improve the follow-up to recommendations made in Article IV and other consultations; and

5. support and develop multilateral surveillance activities in bodies other than the Fund, including the Group of Ten itself.

The Deputies were planning a special meeting in Washington on September 21, 1984 to discuss items on the agenda of the Interim Committee, the Economic Counsellor continued. Their program of work on the functioning of the international monetary system was expected to conclude with a report to Ministers and Governors in the spring of 1985, significantly earlier than the spring meeting of the Interim Committee and the next economic summit meeting. They planned a further meeting on September 26, 1984 to review proposals regarding surveillance, and another in November or December to review various aspects of the role of the Fund, including the role of the SDR and Fund-Bank cooperation. Early in 1985, a meeting on international liquidity was planned, although there was no intention to discuss further the exchange rate system.

Mr. Nimatallah asked the Economic Counsellor to elaborate on the possibility of surveillance by organizations other than the Fund.

The Economic Counsellor replied that the Deputies had recognized that multilateral surveillance was conducted by groups such as the OECD, the EEC, and the Group of Five. A suggestion considered by the Deputies was that the Group of Ten might play a role in multilateral surveillance, although the outcome of that suggestion was highly uncertain.

2. SAUDI ARABIA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Saudi Arabia (SM/84/149, 6/27/84). They also had before them a report on recent economic developments in Saudi Arabia (SM/84/153, 6/6/84).

Mr. Nimatallah made the following statement:

My authorities wish to express their appreciation to the staff for the informative reports on Saudi Arabia. They are in general agreement with the staff's appraisal of the economic and financial situation in Saudi Arabia.

It is logical and appropriate to start by stating that Saudi Arabia's oil policy has been successful in realizing its objectives. My authorities are determined to stabilize oil prices as an important aspect of providing the world economy with the right climate for recovery and smooth functioning. Saudi Arabia has accepted the role of swing oil producer, even if that leads to faster depletion of a non-replenishable resource at times, and low revenues at other times. The role of a swing producer is a difficult one, but to reach the objectives of stabilizing oil prices and supplying the world with the oil it needs, my authorities believe that it is worth the trouble.

Short-Term Policies

Some observers believe that it may have been a stroke of luck that the world recession reduced oil revenues in Saudi Arabia when it did. By that time, a very important phase of the development strategy had been substantially accomplished--namely, the putting in place of the essential infrastructure. During the decade 1972-82, Saudi Arabia was determined to establish most of the physical infrastructure and the economic and financial institutions necessary for the economy to function effectively. For example, even though the capacity for generating electricity, the water supply system, and the communications network may need to be expanded somewhat more over the next five years, the present capacity of roads, seaports, and airports is enough to sustain the growth of the economy for at least the next decade. Another example is that all the industrial areas in the major provinces are now fully equipped with the necessary infrastructure and are already hosting more than 2,000 operational industrial plants. Moreover, infrastructure is already in place in the two heavy-industry towns of Yanbu and Jubail, where steel and petroleum-related industries, such as refineries and petrochemicals, are located.

As a result, when revenues declined during the last two years, my authorities were able to reduce expenditures without disrupting the basic functioning of the economy. They acted prudently, but firmly, to adjust to the new financial situation. However, they realized that a sudden and substantial reduction in government spending would have serious, disruptive effects, not only on the domestic economy, but also on the international adjustment process. That is why budgetary expenditures were reduced by a cumulative amount of only about 22 percent during 1982/83 and 1983/84 compared with a decline of about 60 percent in oil revenues. The deficits were financed by drawing down reserves which had accumulated as a result of prudent financial management.

Both current and capital outlays of the budget were reduced. The reductions in current expenditures reflected restrictions on the filling of vacancies in the civil service, a freeze on new positions, tighter control of allowances and benefits, lower procurement costs for services and supplies, and a decrease in subsidies. The decline in capital expenditures was achieved by postponing some new projects of low priority, by stretching out the implementation of some of the ongoing projects, and by reducing costs as a result of a decline in world inflation and improved methods and procedures of performance. As indicated in the staff papers, these adjustment policies have worked well and have succeeded in putting the economy on a course of stability and sustainable growth.

Medium-Term Policies

My authorities are now emphasizing a medium-term development strategy aimed at accelerating the development of the private sector. Great importance is attached to strengthening the private sector and encouraging it to play a more effective role in the functioning of the economy. There are two main reasons for this emphasis: one, we believe that a free market system promotes efficiency; and two, a relatively larger private sector would tend to reduce the impact on the economy of possible future fluctuations in government expenditure.

Between 1974/75 and 1983/84, the private sector increased seven times in size, and its contribution to GDP increased from 13 percent to about 32 percent. Its capital formation has been much higher than the oil sector. For example, during the fiscal year 1982/83, gross fixed capital formation in the private non-oil sector amounted to SRIs 38.3 billion, compared with only SRIs 15.2 billion in the oil sector. The assets of the commercial banks during the past five years have grown from SRIs 52.6 billion to SRIs 138.1 billion. These banks have increased their credit to the private sector over the same period from SRIs 19.7 billion to SRIs 49.4 billion.

The Government has promoted private sector growth by providing that sector with an atmosphere of political and financial stability, supported by the appropriate legal and administrative framework. Economic and financial policies have been framed to promote this objective. For example, in view of the unsettled conditions in the international foreign exchange markets, Saudi Arabia has pursued an exchange rate policy to stabilize the riyal rate against the major currencies as much as possible. In real effective terms the riyal has been remarkably stable.

The labor and wage policy has also been helpful to the private sector. The Government has provided adequate means for training Saudi Arabian workers and avoided sudden sharp reductions in expatriate labor. Due to the great success in eliminating inflation, wages and other labor costs have been stabilized markedly over the last two years.

Moreover, given the importance attached to the objective of promoting the private sector, the means of encouragement would not have been complete without the establishment of specialized lending institutions to provide initial credit, as needed by new businesses, at affordable costs. It should be emphasized here that only viable projects and businesses can benefit from these soft loans and only at the initial stage of establishment.

Businesses have to resort to other sources of credit for their borrowing after the initial stage. Commercial banks have been contributing to the credit supply needed for the private sector. As mentioned earlier, bank credit to the private sector has grown over the last five years from about SRIs 20 billion to about SRIs 50 billion.

The staff has expressed concern that the development of the private sector should not become dependent on what they call "excessive protection," or on "permanent subsidies." I would like to assure my colleagues and the staff that Saudi Arabia is aware of the dangers of excessive dependence on protective tariffs and subsidies; and we are far from such excessive dependence. Domestic producers may be protected for an initial period by a 20 percent import duty only. As normal import duties are 4 percent, the imposition of a 20 percent duty can hardly be called excessive protection. This 20 percent is imposed on a temporary basis and only selectively for certain qualifying infant industries. There are strict qualification requirements: the products of these industries should be of high quality and priced at internationally competitive levels. Moreover, the imposition of a 20 percent duty on an exceptional basis to protect an infant industry is certainly not high compared with duties imposed by many other countries on a normal basis. It is important to emphasize here that there have never been any quantitative import restrictions in Saudi Arabia. All kinds of imports flow in freely from all countries. We hope that the industrial countries will treat our petrochemical exports, for example, the same way and allow them free access to their markets.

As far as the subsidies are concerned, the Government has already started reducing them gradually, as indicated in the staff papers. However, it seems likely that the low-cost loans provided to industrial and agricultural businesses in their formative period may have to continue for a while, to permit a reasonabe time for Saudi Arabian business to gain maturity.

Nevertheless, there is reason for optimism because the climate for business is enhanced by the expanding market for the products of Saudi Arabian business. The effective use by the Government of its oil income in support of its domestic operations has resulted in a sharp rise in the purchasing power of the Saudi Arabian consumer.

Moreover, another important development will improve the market, and, therefore, the climate for the private sector. This is the establishment of the Gulf Cooperation Council (GCC) with the important objective of creating an integrated regional market. Since the formation of the GCC in February 1981 by Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates, significant steps have been taken to foster close cooperation among the members. In March 1983, the impediments to the movement of goods, labor, and capital among members of the GCC were virtually eliminated. In September 1983, steps were taken to harmonize customs duties in member countries within a range of 4 percent to 20 percent. Furthermore, studies are being conducted on the possibility of establishing common exchange arrangements among the member countries. These measures have already started to show results, and private sector investments with regional implications are increasing. It is significant that large percentages of huge government corporations are already being sold to the private sector in all of the GCC countries. For example, 30 percent of total equity of the Saudi Basic Industries Corporation (SABIC) was recently sold to the private sector, with nationals of the GCC countries being permitted to acquire shares.

Longer-Term Policies

My authorities have also been following structural adjustment policies aimed at diversifying the productive base of the economy and raising the standard of living of the people of Saudi Arabia. Substantial progress has been made in achieving these goals under the three five-year development plans, the first of which was launched almost 15 years ago. As can be seen from Table 2 of the report on recent economic developments, growth in the non-oil sectors under the three development plans has been substantial and well above the plan targets.

But the process of development and diversification is long and tedious. On the supply side, the Government emphasized the development of the factors of production while developing the productive sectors. A great deal has been spent on education and training to improve labor skills over the last decade. Enhancing the availability of raw materials and usable land has also helped speed the development of the productive sectors. Today, there are many industries based on raw materials related to oil and gas, or based on agricultural raw materials or sea products. All these are run by skills in the private and public sectors. With all this emphasis on the supply side, the non-oil sector has grown at an average annual rate of about 12 percent over the past decade.

On the demand side, as mentioned earlier, the diversification process needs the enlargement of the market. As noted, the purchasing power of the Saudi Arabian market has been strengthened immensely. And in the last four years, efforts have been intensified to join the market of neighboring Gulf countries with that of Saudi Arabia through the economic ties of the Gulf Cooperation Council.

The Fourth Five-Year Development Plan covering the period 1985/86-1989/90 is currently under preparation. The Fourth Plan will attempt to build on the gains that have been attained so far. With the completion of the major infrastructural projects, the emphasis in the Fourth Plan will continue to be, as it has been in the past two years, on investments in the productive sectors; on health, education, and other social services; and on improving the quality of life in small towns and rural areas.

My authorities would like to repeat that, in pursuing their domestic policies, they continue to take into consideration the interests of the international community. They will continue to pursue their prudent oil and foreign asset investment policies. They will also continue to help the developing countries directly and indirectly through regional and international organizations. Furthermore, my authorities adhere to the policy of free payments and transfers for international transactions. They stand firm against the imposition of controls or restrictions of any kind on trade and payments, including capital flows.

Finally, Saudi Arabia believes that the Fund plays an effective role not only in helping individual members to adjust but also in promoting the smooth functioning of the international financial system. My authorities will continue to cooperate fully with the Fund and its members to develop and maintain a sound international financial system.

Mr. Lovato said that the Saudi Arabian authorities were to be commended for their flexibility in adjusting their fiscal policy stance, for their highly responsible policies in oil production and pricing, and for sustaining their generous program of assistance to developing countries despite Saudi Arabia's current account deficit of more than $14 billion.

The bulk of budgetary revenues came from oil and investment income, as indicated in Table 5 of the report on recent economic developments, Mr. Lovato continued, while revenues from other sources, although increasing, were still modest, perhaps as a result of the system of revenue collection, which could be further improved. However, significant diversification of the revenue base would depend on diversification of the economic base, because the output of the non-oil sector remained small. To promote diversification, the authorities were placing more emphasis on the role of the private sector, as evident in the Fourth Five-Year Development Plan, covering the period 1985/86 to 1989/90, which again emphasized the need and willingness to further diversify the economy through the expansion of the productive base, the encouragement of private sector participation in the development process, and the implementation of small industrial projects and agricultural development.

The Saudi Arabian authorities were experiencing the common dilemma of whether to protect enterprises against foreign competition to promote import substitution in domestic industries, Mr. Lovato commented. Subsidies could be useful for a short period of time, but prolonged protection could be costly in terms of economic efficiency, competitiveness, and the cost of living. He therefore welcomed the emphasis that the Saudi Arabian authorities intended to give to the rationalization of subsidies. It was encouraging that the authorities were aware of the dangers of excessive dependence on protective tariffs and subsidies, which were already being gradually reduced. Exchange rate policy could also facilitate diversification of the economic base, although it was not clear how such a policy could be implemented in a country in which the bulk of foreign resources came from one sector. He asked the staff to comment on whether the current exchange rate was appropriate for a policy of diversification, and if so when it should be used for such a purpose.

Mr. Finaish said that economic policy in Saudi Arabia in 1983 had continued to focus on adjustment to the changing oil situation while continuing the process of economic development and diversification. Significant progress had been achieved on both fronts through the pursuit of prudent oil policies and the adoption of a fiscal stance which had alleviated the strain on the non-oil sector that had been associated with curtailed public expenditure.

The oil sector had undergone a fundamental change since 1982, with far-reaching implications for the fiscal and external balance as well as for non-oil economic activity, Mr. Finaish continued. The Saudi Arabian authorities had responded in an effective and flexible manner to the changes in the demand and supply structure in the oil market, aiming to maintain stability in the international oil market. As a result, Saudi Arabia had absorbed the major part of the sharp fall in demand, and had assumed the role of swing producer to supply the balancing quantities to meet market requirements. Consequently, Saudi Arabian production of crude oil had been cut by one half to 5 million barrels a day, and even to 4 million barrels a day in early 1983. It should be noted that OPEC had been instrumental in restoring stable market conditions since early 1983, thereby serving the interests of both producers and consumers. In addition, the Saudi Arabian authorities intended to support the price structure if it were threatened by unanticipated market developments. It could be argued that Saudi Arabia's assumption of the role of swing producer had been natural given its dominant production level and large financial resources that had enabled it to absorb sharp cutbacks in production, but, as indicated by Mr. Nimatallah, the role of swing producer was costly, as the potentially large fluctuations in revenue it entailed complicated the process of economic management and planning.

Fiscal policy over the past two years had sought to strike a balance between the need to respond to the 60 percent drop in oil receipts since 1981 and the need to avoid an undue disruption of domestic activity, Mr. Finaish commented. Budgetary expenditure had been reduced accordingly, particularly in the area of new development projects and current expenditure, while non-oil budgetary revenue had been almost doubled between 1981/82 and 1983/84. Among the specific measures taken were a freeze on new positions in the civil service, a tighter control of allowances and benefits, and a reduction in direct subsidies. However, oil revenue had declined even more sharply than expenditure over the past two years, because the authorities had opted for smoother adjustment, even though it had entailed a drawdown of official foreign assets. Furthermore, in the 1984/85 budget, some easing of restraint on government spending was envisaged in the light of improved prospects for revenue, the stability of the price level, and the need to maintain steady growth in the non-oil economy, although the authorities recognized that expenditure must be kept in line with the longer-term prospects for revenue.

Concerning development planning, Mr. Finaish remarked that the shift in emphasis away from the building of basic infrastructure was appropriate, since it was now virtually complete. The manpower training program was particularly important and should help to increase the participation of Saudi Arabian nationals in the labor force. Increased emphasis on economic criteria and cost efficiency in public sector programs and on the efficient operation of completed projects was welcome. An enhancement of the role of the private sector was also emphasized in the current development strategy and was particularly important at the present time when the products of large public enterprises were about to come on stream; buoyancy in the private sector could establish linkages between those new products and the existing markets. Subsidies to the private sector were not a cause for concern, particularly as the Saudi Arabian authorities were fully aware of the dangers of excessive or prolonged dependence on government protection.

An important development in the area of diversification would be the coming on stream of petrochemical products in Saudi Arabia, Mr. Finaish said. The country had built an impressive complex of industries designed to diversify the economy and to use natural gas, and various facilities had been established to ensure the growth of local private enterprises linked to those industries. Given Saudi Arabia's comparative advantage in petrochemicals and the authorities' intention to market the products at international prices, Saudi Arabian petrochemical exports should not be impeded by unjusified trade barriers in major export markets. Such barriers would also adversely affect other members of the Gulf Cooperation Council and other oil countries in their efforts toward export diversification.

The petrochemical market had come under scrutiny recently, Mr. Finaish noted, as indicated in Mr. Nimatallah's statement which had emphasized that Saudi Arabia had no trade restrictions, and in which the hope had been expressed that industrial countries would allow Saudi Arabian petrochemical exports free access to their markets. Although the petrochemical industry was depressed, the current low prices were not the result of any influx of Saudi Arabian petrochemicals into the market since that situation had been prevailing before Saudi Arabia came on the scene.

Furthermore, the size of Saudi Arabia's competitive advantage in petrochemicals should not be exaggerated, Mr. Finaish remarked. It was true that Saudi Arabia used previously flared natural gas as a feedstock, which was cheaper than feedstock in Europe and the United States. He noted, however, that the price paid by Saudi Arabian-based companies was high enough to cover the cost of the gas-gathering system. Moreover, Saudi Arabia had compensating disadvantages in terms of high labor and management costs, high charges for depreciation inasmuch as the petrochemical industry required new capital, and exceptionally high transportation costs. Unless Saudi Arabia's advantages were weighed against its disadvantages, its competitive advantage would be overstated, particularly because it would meet only a small portion of world demand. The difficulties facing the petrochemical sectors in industrial countries, especially their profitability and competitiveness, ought to be dealt with in their structural context and in terms of their adaptability to the changing circumstances in the world economy, not by resorting to protectionism.

It was remarkable that Saudi Arabia had maintained a high level of financial assistance to developing countries despite the sharp turnaround in its external position in the past few years, Mr. Finaish remarked. In fact, foreign aid as a percentage of total current account earnings had increased significantly from 1981 to 1983, and the role played by Saudi Arabia in support of international organizations, and the Fund in particular, was extraordinary by any standard. That role by a developing country largely dependent on a depletable asset should provide encouragement to rich industrial countries to revive their aid efforts, which were particularly needed in the present circumstances of tight credit in the capital markets and severe strains suffered by a large number of low-income developing countries.

Mr. de Maulde noted that the Fund's consultations with Saudi Arabia were an important exercise, given the role played by Saudi Arabia on the world's economic and financial stage. Saudi Arabia's development process was original; the country's rich resource base had allowed it to construct basic infrastructure to the standard required to cover development needs for at least a decade, enabling the country to move into a second phase of the development process.

The Fourth Five-Year Development Plan stressed two areas of high priority, Mr. de Maulde continued. The first priority was the development of the industrial base, particularly of export-oriented industry, with particular emphasis on the role of the private sector. The problem was to enhance that role cautiously and progressively in order to avoid the emergence of private enterprises that were viable only with public protection, and to promote a parallel development of the commercial banking system. The second longer-term objective was to develop the "social infrastructure," mainly in health and education. In that connection, the emphasis placed by the authorities on manpower training to increase the participation of Saudi Arabian nationals in the labor force was welcome. It was clear from Appendix III of the staff report that further progress could be achieved in the provision of statistics, perhaps with assistance from the Fund.

Concerning short-term prospects, Mr. de Maulde commented that the Saudi Arabian economy remained sound and under control. The current account deficit in 1984 was projected to remain at its 1983 level of $14 billion, a figure which should cause little concern, as it could easily be financed through a new drawdown of financial assets, which remained at a comfortable level. Besides, the outlook for oil exports in 1985 might now appear more favorable given the prospects for economic recovery in Europe. He asked the staff to comment on its more recent views on that subject.

The remarkable flexibility with which the authorities had adjusted their fiscal policy in response to decreasing oil revenue had been impressive, Mr. de Maulde continued. Mr. Nimatallah had listed the main actions taken by the authorities to reduce budgetary expenditure by 22 percent in only two years. Unfortunately, it was unavoidable that such a sharp decrease in overall expenditure should retard to some extent the level of economic activity in the non-oil sector. It was particularly notable that non-oil GDP had increased by only 5 percent in 1983/84 compared with a 12 percent increase in the early 1980s. For that reason, and because the 1984/85 budget was providing for a 60 percent expansion of domestic revenue, primarily through new domestic oil taxes, he shared the staff's view that an easing of the restraint on government spending was fully justified in order to ensure successful implementation of the forthcoming five-year plan.

The Saudi Arabian authorities were to be commended for the important and responsible role they had played, and continued to play, in the pattern of global financial adjustment, Mr. de Maulde said. They had exercised their responsibility in three major ways. First, they had played the role of swing oil producer, by supplying an adequate balancing quantity of oil to meet the requirements of consumer countries. Saudi Arabia had pursued a flexible production policy, despite its negative impact on the internal economy, and had maintained official selling prices. Such responsible conduct had helped to restore stable market conditions and to pave the way for a sustained world recovery.

Second, Saudi Arabia had continued to play a crucial role in development financing at a time when commercial bank flows and bilateral and multilateral aid had been diminishing, Mr. de Maulde noted. Despite the sharp decline in oil exports from $73 billion in 1982 to $45 billion in 1983, official development assistance had only decreased from $4.4 billion to $4.1 billion so that, in terms of percentage of GDP, Saudi Arabia remained among the most generous of all aid donors, and by far the most generous among OPEC countries. He hoped that other countries would follow that example, particularly those enjoying economic recovery. Third, Saudi Arabia had remained a centerpiece of the financial system in providing large loans to the Fund to support its policies during a crucial period.

Mr. Hirao said that the Saudi Arabian authorities should be congratulated for the skillful management of their economic policies and their impressive achievements during 1983. Although the growth rate in real non-oil GDP, at an estimated 5 percent, had been somewhat slower than in previous years, growth in the industrial and agricultural sectors had been maintained at a high level. The rate of increase in the non-oil GDP deflator was estimated to have declined to about zero from 4 percent in the previous year, while the increase in the cost of living index had also slowed from 1 percent to 0.3 percent, indicating that domestic prices had been virtually stable in 1983/84. He was in general agreement with the staff appraisal.

The authorities were to be commended for the marked adjustment of their fiscal policy stance in the wake of a sharp drop in oil revenue, Mr. Hirao continued. Budgetary expenditure had been reduced by 14 percent in 1982/83 and by 9 percent in 1983/84, following annual increases averaging almost 25 percent in the three preceding fiscal years. The authorities had reduced less essential outlays and had introduced tighter control mechanisms over government expenditure, such as restrictions on the filling of vacancies in the civil service, more stringent control of allowances and benefits, and some reduction in direct subsidies. The increase in domestic revenue, excluding oil and investment income, of more than 90 percent from 1981/82 to 1983/84, had been particularly impressive, and had been due primarily to improved collection methods, increased receipts from government services, and an increase in the minimum rate of custom duties from 3 percent to 4 percent. He encouraged the authorities to continue their efforts to diversify the revenue base and to improve the cost efficiency of government projects and programs.

Concerning monetary policy, Mr. Hirao noted the introduction by the Saudi Arabian Monetary Agency (SAMA) in February 1984 of the Banking Security Deposit Account, which was intended to provide the commercial banks with a new domestic investment outlet in local currency, thus helping to reduce the buildup of their foreign assets. The facility could evolve into a useful monetary tool.

Investments in health, education, and other social services were now receiving higher priority in development policies, Mr. Hirao observed, as the basic infrastructure building program was virtually complete. He endorsed the authorities' new policy stance and their emphasis on the efficient operation of completed projects. The stress on growth of the private sector and manpower training, in order to increase the participation of Saudi Arabian nationals in the labor force, appeared highly appropriate.

On external policies, Mr. Hirao noted with satisfaction that the authorities' reserve management policy continued to be consistent with the interests of the international community. He also welcomed the authorities' intention to continue policies to avoid large and sudden shifts of assets between currencies. The major turnaround in the balance of payments position in 1983 had entailed a significant decline in official foreign assets held by SAMA, but he agreed with the staff that the drawdown was not a cause for concern. The authorities were to be commended for their generous program of assistance to developing countries and to multinational institutions such as the Fund. They should also be complimented for their adoption of the vital role of swing producer, thereby contributing to stability in the world oil market.

He was encouraged by the authorities' efforts to eliminate data problems, Mr. Hirao said. He strongly endorsed the recent technical assistance to Saudi Arabia from the United Nations and the Fund, which should be continued.

Ms. Bush said that Saudi Arabia provided an example of the advantages of long-term economic growth and development that would result from careful financial management. Oil wealth had eased the problems of economic management, but had not eliminated the need to respond promptly to large and unexpected changes. The immediate problem of a dramatic reduction in oil revenue had been met by both a curtailment of priority outlays and a broadening of the non-oil revenue base.

Saudi Arabia's development strategy was also changing following completion of basic infrastructure projects, Ms. Bush continued. The next development phase was likely to be more complex, requiring a careful approach to the establishment of new industries and services. Fortunately, the authorities seemed fully aware of the need to avoid creating industries that were fully dependent on subsidies and protection; the review of existing subsidies was therefore welcome. However, she had reservations concerning concessional credits from specialized credit institutions, because initial start-up costs did not necessarily justify large-scale subsidized credit. She did, however, note from Mr. Nimatallah's statement that soft loans were to be reserved for viable projects and restricted to start-up costs.

The increased emphasis to be given to the private sector was appropriate for tapping entrepreneurial skills and financial resources, Ms. Bush commented, in particular for investment in small and medium-sized industry and the services sector. The considerable progress in improving the comprehensiveness and timeliness of statistical data was encouraging, and should continue.

Saudi Arabia had become an important participant in the world economy, so that developments in its economy and policies were of great interest, Ms. Bush said. The maintenance of a liberal trade and payments system and the pursuit of an oil production and pricing policy focused on the long-term interests of Saudi Arabia and on stable conditions in world oil markets were policies of particular interest to the international community.

Mr. Alfidja remarked that Saudi Arabia had continued to cope with a reduction in oil prices remarkably well by successfully implementing adjustment policies. The fact that Saudi Arabia could have resorted to reliance on its financial resources made the major cuts in expenditure all the more remarkable. He agreed with Mr. Nimatallah that a more drastic reduction of expenditure, in line with the 60 percent decline in oil revenue during 1982/83 and 1983/84, would have had serious disruptive consequences, owing to multiplier effects, at both the national and international levels. The authorities had therefore acted wisely in moderating their expenditure cuts and in drawing on their reserves to finance the deficit.

Concerning the 1984/85 budget, Mr. Alfidja said that the authorities should probably continue their restraint in government spending given the uncertainty surrounding oil prices. However, intensification of efforts to increase domestic revenue by improving collection methods and by introducing new revenue-increasing measures were advisable.

Saudi Arabia had acted in the interests of the international community in its oil pricing policies, Mr. Alfidja noted. It was important that Saudi Arabia should continue to display such a positive attitude during the economic recovery when upward pressure on petroleum product prices could emerge. The emphasis placed by the Saudi Arabian authorities on agriculture was commendable. The further expansion of agricultural output in 1983/84, besides promoting self-sufficiency, would contribute to prosperity in rural areas, and thereby prevent excessive urbanization.

On a more general level, he welcomed the increased emphasis on economic criteria and cost-efficiency in government programs in the Fourth Plan, Mr. Alfidja said; the authorities should ensure strict adherence to such principles. Furthermore, the elimination of impediments to factor flows and the attempts to harmonize customs duties among members of the Gulf Cooperation Council to promote an integrated regional market should prove beneficial to all members of the Council. Finally, he commended the authorities for their exemplary cooperation with the Fund and for their generous foreign aid policy.

Mr. Wicks commented that Saudi Arabia's impressive economic performance over the past few years had been a result of the sound and consistently implemented economic management policies of the authorities, who had continued to take into consideration the interests of the international community in pursuit of their domestic policies. As swing producers within OPEC, the authorities had maintained a responsible and constructive role, while, in the management of their financial assets, they had pursued a policy of balanced and gradual movement in order to avoid market disruption. Their record of generous bilateral aid was commendable, and their strong support of the Fund was demonstrated by the new borrowing agreement with SAMA and the commitment under the General Arrangements to Borrow (GAB).

He welcomed the emphasis placed by Mr. Nimatallah in his statement on the medium-term and longer-term policy developments, Mr. Wicks continued; it was particularly appropriate for an economy that had already completed three five-year development plans and was shortly to embark on a fourth. In fact, he would have found the staff report more useful if it had also considered Saudi Arabia's longer-term prospects; although the paper on recent economic developments contained a great deal of information, the staff report itself gave only superficial treatment of the future prospects for the economy as the authorities moved into the next phase of development while continuing to respond to changes in the oil market. He hoped that the staff would take a more medium-term approach in future Article IV consultation reports on Saudi Arabia and on other oil producing economies.

On fiscal policy, Mr. Wicks said that the authorities were to be commended for their considerable restraint in public spending over the past two years in response to declining oil revenue; budgetary policies should continue to show such flexibility. For example, as recognized by the authorities, the revenue estimates in the 1984/85 budget were based on a projected level of oil production that was subject to a large margin of error as a result of Saudi Arabia's role as swing producer and of the present uncertainties surrounding the prospective demand for oil. In the past, it had been possible to reduce capital expenditures to ensure the adjustment. For example, Table 7 in the report on recent economic developments showed that project spending had declined by 42 percent over the past two financial years, while current expenditure had declined by only 6 percent over the same period, and within that, spending on government wages had increased by 12 percent, exceeding the rate of inflation. The indication was that less essential outlays should be reduced in the future.

He also wondered whether there was scope for further reductions in subsidies, Mr. Wicks continued. For example, a review of public utility and government service pricing was currently in progress; given the virtual elimination of inflation, a reduction in fuel subsidies might be appropriate. He asked the staff or Mr. Nimatallah to comment on the likely policy response of the authorities should further expenditure cuts become necessary.

The introduction in February 1984 of the Banking Security Deposit Account was an interesting development, Mr. Wicks commented, and could be used to fund the budget deficit, to stem the outflow of funds to offshore banking institutions, and as an additional instrument of monetary control. He asked the staff or Mr. Nimatallah to comment on the authorities' latest views on the potential development of the new facility.

On development policies, Mr. Wicks remarked that it was appropriate that the Fourth Five-Year Development Plan should focus on strengthening the private sector, and he welcomed the authorities' intention to prevent the private sector from becoming dependent on excessive protection or permanent subsidies. It would have been interesting if the staff had analyzed more fully the medium-term prospects at the present very interesting phase of Saudi Arabian economic development. The necessary infrastructure had been virtually completed and new industries were being constructed, in particular petrochemical industries. The Master Gas System provided the underpinning of much of Saudi Arabia's current program to develop basic industries and to diversify the economy. He had noted Mr. Finaish's interesting comments on Saudi Arabia's comparative advantage in petrochemicals, and asked the staff to comment on that comparative advantage and on Saudi Arabia's pricing policies for petrochemicals.

Mr. Laske said that Saudi Arabia had made remarkable progress in recent years in developing its non-oil economy. However, the authorities still faced the task of transforming the country's oil-based wealth into other forms of financial and real assets to gradually broaden and diversify present and future streams of national income, thereby enhancing the development prospects for the country and reducing its dependence upon fluctuating oil revenue. The task was formidable, requiring skillful demand management and imaginative structural policies to serve both short-run and long-run needs. Those policies would be facilitated by the maintenance of stable domestic prices, a progressive increase in opportunities for private sector activity, sound fiscal policy, and flexible exchange rate management. With regard to Saudi Arabia's long-term development needs, less emphasis should be placed on special incentives, subsidies, and administrative regulation. The authorities were correct to offer guidance to prevent distortions, but over time the private sector should stand on its own feet, and respond to market signals.

The authorities' flexibility in the conduct of their fiscal policy was commendable, Mr. Laske continued. They had reacted promptly to recent variations in oil receipts by considerably restraining government spending. Although the tightening of fiscal policy had dampened non-oil sector economic activity, especially construction, growth in the industrial sector had been maintained while agricultural output had continued to increase strongly. Overall, the efforts of the authorities had yielded rewarding results.

On structural policies, Mr. Laske said that he agreed with the view of the Saudi Arabian authorities that more emphasis should be placed on the private sector in the future, with the present policy approach representing no more than a first step in that direction. He encouraged the authorities to minimize the number of subsidized items and areas, even during the transitional period before the market could assume the important function of regulating demand and supply. The use of specialized incentive schemes and credit facilities on concessionary terms should also be minimized, because they carried the inherent risk of becoming permanently institutionalized. They caused distortions to emerge and to survive, thereby protracting the desired development process. The assurances given by the authorities and Mr. Nimatallah that subsidies designed to support private sector activities would be reviewed on a regular basis was therefore welcome. He also welcomed the intended review of the prices of public utilities and the tariffs for government services; they should reflect relative scarcities as well as underlying demand and cost conditions.

There appeared to be differing shades of opinion between the authorities and the staff as to whether the exchange rate could play a more useful role in diversifying the economy, a subject that had been discussed in the 1983 Article IV consultation, Mr. Laske noted. A basic structural feature of the Saudi Arabian economy was the discrepancy between the contribution of the non-oil sector to GDP, 53 percent, and to total exports, only 2 percent. A more flexible exchange rate policy could probably free more resources for the tradable goods sector. He asked the staff to comment on possible measures that could be taken in that area. Saudi Arabia's current account deficit in 1984 should give no cause for concern, because it could easily be covered from Saudi Arabia's ample international reserves.

The comprehensiveness and timeliness of Saudi Arabia's balance of payments statistics should be improved, Mr. Laske commented, because early knowledge concerning developments in the trade accounts would enable the authorities to detect immediately any deviations from trend or other sudden shifts. The authorities should therefore attempt to improve their statistics, and to continue to avail themselves of technical assistance from the Fund.

The prudent and sound reserve management policy pursued by the Saudi Arabian authorities was appreciated, Mr. Laske continued. Although its policies had been complicated by Saudi Arabia's assumption of the role of swing producer, SAMA had avoided sudden and large shifts in the currency composition of its assets, thereby contributing to international monetary stability.

Mr. Kabbaj remarked that the economic performance of Saudi Arabia in the past three years had been markedly affected by the unstable conditions of the world oil market. Largely owing to the strong structure of the Saudi Arabian economy and its ample foreign assets, the adverse effect of those conditions had been much less severe in Saudi Arabia than in most oil exporting countries. The effect had been further cushioned by the cautious adjustment policies introduced by the authorities, particularly in the fiscal area, that had been aimed at adjusting both the economy and the budget to a lower level of income while minimizing the damage to other economic objectives, such as diversification and expansion of the non-oil sector.

He broadly shared the staff's analysis and appraisal of Saudi Arabia's economic performance and policies, Mr. Kabbaj continued. The assessments of the staff and the authorities appeared to be broadly consistent. Although the strong fiscal performance in 1983/84 had been facilitated by the completion of major infrastructural projects, the authorities' adjustment efforts had been considerable. Current outlays, as well as development expenditure, had been contained while domestic non-oil revenue had been significantly augmented. The policy instruments had been diverse, including a freeze on new positions in the civil service, tighter expenditure control mechanisms, a reduction in direct subsidies, improved collection methods, and an increase in the rate of customs duties. For 1984/85, the authorities were seeking to relax some of the contractionary policies implemented in the past two years while intensifying their efforts to broaden domestic non-oil revenue. The new projects, which should further improve the efficiency of the Saudi Arabian economy and civil service, mainly concerned social and rural development, while the new revenue measures included a significant increase in the prices of domestic petroleum products.

On monetary policy, Mr. Kabbaj noted that, although credit was not an important instrument of demand management in Saudi Arabia, the authorities had kept inflation down in recent years. A high volume of credit was still extended by specialized credit institutions while the rate of expansion of domestic lending operations had remained below that of the deposit base, resulting in a high ratio of foreign assets to total assets in the banking system. In that context, the establishment of the Banking Security Deposit Account should provide commercial banks with a welcome new outlet for domestic investment that could also be useful as a monetary instrument.

The aim of economic policy in Saudi Arabia was to promote diversification of production away from the oil sector, and to strengthen the role of the private sector in the economy, Mr. Kabbaj commented. He welcomed the authorities' program for gradually transferring major public enterprises' ownership to the private sector while establishing new incentives for domestic private investment. The authorities' intention to ensure that assistance would be provided only to viable enterprises and their assurance that it would not result in permanent subsidization or protection was also welcome.

Saudi Arabia's balance of payments would obviously continue to be affected by conditions in the world oil market, Mr. Kabbaj continued. The 1984 current account deficit should be of the same magnitude as in 1983, despite a recovery in oil export earnings. Considering the authorities' reserve management policy, the financing of the deficit would create no strain on the economy nor would it jeopardize the economy's prospects for rapid growth.

He commended the Saudi Arabian authorities for their responsible and generous contribution to Fund resources, Mr. Kabbaj said, and for the maintenance of substantial assistance to developing countries despite its reduction in oil revenues and investment income.

Mr. Kafka said that he was in general agreement with the staff appraisal and Mr. Nimatallah's evaluation of the Saudi Arabian economy. The authorities had adapted imaginatively and prudently to the external environment while sustaining their policy to stabilize oil prices. They had been faced with fluctuating, as well as steeply declining, oil revenue. They had been able to compensate partly for the reduction in oil revenue by cutting expenditure because the crucial elements of infrastructural investment had already been completed, while excessively abrupt declines in expenditure had been avoided by drawing down international reserves, a process which could continue for some time. The authorities had begun to diversify their revenue base and had followed prudent monetary policies. They should be commended for dealing with the difficult external environment without an increase in the domestic price level while maintaining growth in the non-oil sector. The increased emphasis on the private sector, bolstered by appropriate incentives and growth in the financial sector, was also welcome in the current stage of Saudi Arabia's development.

Economic theory indicated that price subsidies were not the most welfare-effective form of expenditure, Mr. Kafka commented. However, when a country could afford subsidies and did not allow them to fluctuate erratically, the international community should not view them as a cause for concern. He suggested that the staff should prepare a paper on subsidies and their international implications. Saudi Arabia's important contributions to official development assistance and the careful management of its external assets were appreciated.

Mr. Leonard said that it was clear from the staff report that the Saudi Arabian economy was well managed. Its resources were substantial even by international standards, and it was notable that the authorities had sought to develop the domestic economy along sound and efficient lines while contributing to a more stable international economy, an approach that had been maintained in spite of the economic and financial constraints associated with a 60 percent fall in oil export earnings between 1981 and 1983.

Through its role of swing producer within OPEC, Saudi Arabia had underpinned the stability of the international oil market, Mr. Leonard commented. Domestically, government expenditure had been decreased in line with lower revenue by improving the efficiency of public spending. Inasmuch as public spending accounted for more than 50 percent of GDP, considerable long-lasting benefits should be reaped from the current program of rationalization and from its continuation in the future.

Nevertheless, he concurred with the views of Mr. Nimatallah and the staff that some easing of the current fiscal restraint was required in the 1984/85 budget, Mr. Leonard continued. The absence of inflationary pressures, the clear commitment of the Saudi Arabian authorities to flexible and sound fiscal management, the continuing need for a substantial government role in the pursuit of economic and social development, and the availability of substantial official financing reserves provided ample justification for the easing of fiscal restraint. Recent progress in strengthening and diversifying the revenue base and the continued efforts to improve revenue collection and the removal of the implicit subsidy on domestic consumption of petroleum products should augment the authorities' room for maneuver.

Diversification of the economy away from dependence on the export earnings of a single commodity had been a major development objective, Mr. Leonard said. Toward that end, the authorities' encouragement of a larger role for the private sector was appropriate, and he was reassured by Mr. Nimatallah's statement about his Government's awareness of the dangers of excessive protectionism. If the considerable incentives provided by the Government for industry and agriculture were to become embedded in the economy, the result would be institutionalized rigidity rather than flexibility, which would seriously threaten the objective of creating a diversified and robust economy. Under the circumstances, close monitoring of industrial financing, the bulk of which was now provided by specialized credit institutions at negligible charges, appeared warranted.

The orderly development of the banking and financial system was encouraging, Mr. Leonard said, particularly the creation of a new investment outlet in local currency provided to commercial banks in the form of a 91-day deposit facility with SAMA. Over time, the facility could provide SAMA with a stronger market-based instrument of monetary control.

His authorities continued to be interested in the exchange rate implications of financing government budgetary deficits by running down foreign assets, Mr. Leonard continued. He asked the staff to comment on whether the exchange rate effects were indeed minimal, because the large foreign currency component of government expenditure diminished the need to convert foreign currency assets into domestic currency funds, and if not, to give an indication of the implications for the exchange rate and domestic finance.

He commended the Saudi Arabian Government for its strong and continuing support of international financial institutions, Mr. Leonard concluded, and for the foreign aid program which had been maintained despite declining oil revenues.

Mr. Senior said that the Saudi Arabian authorities were to be congratulated for their continued success in implementing prudent domestic and cooperative international policies. The authorities had judiciously adjusted their economy to the severe external environment and Saudi Arabia's diverse development needs, while maintaining their commitment to international cooperation.

The Saudi Arabian economy had faced only mild adjustment because for several years the authorities had pursued prudent demand and wealth management policies designed to make the economy less vulnerable to external shocks, Mr. Senior continued. In response to a sharp shift in the current account and the financial position, expenditure restraint had been combined with a diversification of the revenue base, resulting in a degree of fiscal adjustment that had been sufficiently moderate to avoid a drastic fall in the rate of real non-oil economic growth, while keeping inflationary pressures under control. The substantial progress in establishing a solid basic infrastructure during the three five-year development plans had played a key role in promoting those favorable developments.

The prudent stance of fiscal policy had been accompanied by adequate monetary policies, Mr. Senior remarked. Important structural changes had been adopted in the monetary area, such as the new banking security facility introduced in February 1984 that would allow SAMA to control domestic monetary expansion more effectively in the future.

The strategy planned for the next five-year development plan was clearly appropriate and consistent with existing achievements, Mr. Senior commented. Nevertheless, given the role to be played by the private sector in the development process, and the priorities given by the authorities to health, education, and other social services, the medium-term prospects would clearly involve further major efforts in the macroeconomic field, such as monetary and exchange rate policies, to promote diversification of the economy and to facilitate the realization of the plan's objectives.

Like previous speakers, he commended Saudi Arabia for its outstanding role in the international economy, Mr. Senior said. Not only had it continued to contribute to economic recovery by playing the role of swing oil producer, but Saudi Arabia had also provided substantial flows of multilateral and bilateral financial aid to developing countries, and strong support to the Fund.

Mr. Mtei said that he agreed with the staff appraisal of the Saudi Arabian economy, and he complimented the authorities for their sound and pragmatic policies, their generosity in assisting developing countries in their development efforts, and their contribution to the viability of the international monetary system.

Saudi Arabia was a classic example of a country largely dependent on one commodity, crude oil, that had been able to use the revenue from that commodity to broaden the productive base of its economy, Mr. Mtei continued. As a result of its three well conceived and properly executed five-year development plans, the country's diversification policy had made considerable headway. Thus, while output in the oil sector had declined due to falling demand, the non-oil sector had grown from 16 percent of GDP in 1973/74 to 53 percent in 1983/84. Private sector investment in small industrial plants had multiplied and the country was nearing self-sufficiency in a wide range of products, including cement, petrochemicals, and iron and steel, reflecting an improvement in absorptive capacity and a liberal economic policy that had encouraged private initiative and foreign private investment. Provision of agricultural infrastructure, such as grain storage, dams, and irrigation, and heavy subsidization had increased the area under cultivation so that agricultural output had risen significantly. Self-sufficiency, which had already been achieved in poultry production, was expected in wheat in 1984, with an output of 1.3 million tons compared with an average of 145,000 tons in 1978/79-1979/80.

Heavy subsidies and guaranteed prices, which in many cases were several times higher than world market prices, had contributed to those achievements, Mr. Mtei remarked. Clearly such levels of subsidization, with the accompanying distortions in resource allocation, could not continue indefinitely, and he welcomed the authorities' undertaking to review them. However, he recognized the need for some subsidization to ensure that the general populace would enjoy the benefits of the exploitation of the country's natural resources. The authorities should act with caution in phasing out the subsidies to avoid a concomitant decline in production when considering the issue in its fourth plan, which emphasized a consolidation of past gains and the achievement of stable and well balanced growth.

On fiscal policy, Mr. Mtei said that the ability of the authorities to respond quickly to changing conditions, as indicated by cuts in government expenditures of 14 percent and 15 percent in 1982/83 and 1983/84, respectively, and a broadening of the revenue base to increase non-oil revenue, was encouraging. The authorities' intention to continue their prudent fiscal policy was also welcome given the continuing uncertainties surrounding the world oil markets; it was an approach worthy of emulation by other countries whose financial positions were more difficult.

The authorities intended to consider the staff's suggestion that the exchange rate could be used over the medium term to encourage investment by the private sector in import competing and export-oriented industries, Mr. Mtei said. However, the effectiveness of the exchange rate to achieve that end should be treated with caution in Saudi Arabia, since there had been a depreciation in the real effective exchange rate of the riyal, as indicated on page 14 of the staff paper "Indicators of Real Effective Exchange Rates" (EBS/84/116, 5/23/84), showing that between 1978 and March 1984 the index of the real effective exchange rate of the riyal had fallen from 100 to 85. The implied depreciation of the riyal had already provided a sufficient spur to competitiveness for export-oriented investment. It should also be recognized that the exchange rate was not the only determinant of private investment, and that Saudi Arabia's natural environment and resource endowments were probably the crucial factors in the diversification of its economic base.

He thanked the Saudi Arabian authorities for their economic assistance to other developing countries, which, as a percentage of GNP, had been for many years the highest of all aid donors, Mr. Mtei concluded. It was notable that most of the aid was untied and had been provided in the form of general and balance of payments support. Saudi Arabia also deserved credit for the responsible manner in which it had cooperated with international financial institutions, including the Fund.

Mr. Tvedt said that he was in broad agreement with the staff appraisal. As indicated by the staff, the performance of the economy over the past year had been impressive, particularly when note was taken of the swing producer role adopted by Saudi Arabia to stabilize the world oil market, with consequently large fluctuations in Saudi Arabia's oil income that had complicated demand management policy. He commended the Saudi Arabian authorities for the implementation of a flexible fiscal policy in a medium-term context. As inflation and the balance of payments were under control, there might be room for a moderate easing of the fiscal stance in 1984/85. The emphasis currently placed by the authorities on enhancing the role of the private sector in developing the economic structure was welcome.

Saudi Arabia played an important role in the world economy, Mr. Tvedt noted. The assurance by the Saudi Arabian authorities that they would continue to consider the interests of the international community when pursuing their economic policy, with regard to both oil and international reserve management, was welcome. He appreciated the stated intentions of the authorities to assist the developing countries both directly and indirectly through regional and international institutions. He thanked Saudi Arabia for its cooperation with the Fund, and felt certain that the Saudi Arabian authorities would continue to see the Fund's role as vital to the financial community, especially as large balance of payments needs by developing countries were expected in coming years. Their firm stand against the imposition of restrictions on trade and payments was also welcome.

Mr. Polak said that Article IV consultations with Saudi Arabia were particularly interesting, not only because Saudi Arabia had the sixth largest quota in the Fund and was the largest lender to the Fund, but also because certain developments in its economy were highly relevant to other members. Few countries had built a complete economic infrastructure within a decade, or had faced a decline in their exports and government revenue of about 20 percent in two years without devastating results for their economies. Clearly, such changes had created important adjustment problems, the solutions to which the Fund could perhaps apply to other members. He would therefore have preferred a fuller consultation report on Saudi Arabia, since the current report contained no charts, no monetary survey, and few tables. For example, per capita income in Saudi Arabia in U.S. dollars was not included in the reports, although the report on recent economic developments included data from which it might be calculated; in fact, per capita income was $12,000.

Appendix III of the staff report indicated many delays in the provision of statistics, Mr. Polak noted, which might in part be due to technical problems, although that could not be the case for the foreign assets of SAMA, which were available only for September 1983. He encouraged the authorities to take a more positive attitude toward the supply of data.

He agreed with the staff and other Directors concerning Saudi Arabia's responsible oil policy and the flexibility shown in the adjustment of government finance while avoiding overshooting in response to sharp changes in oil revenue, Mr. Polak continued. However, the nature of Saudi Arabian exchange rate policy was not clear from the staff report. In the Fund's 1984 Annual Report, the Saudi Arabian riyal was classified as having limited flexibility against the U.S. dollar; from Table 49 of the Appendix (SM/84/153), the fluctuation of the value of the riyal vis-à-vis the dollar did indeed appear to be moderate, at about 3.5 percent. A chart indicating exchange rate movements would have been useful. However, Appendix I of the staff report (SM/84/149) stated that the riyal was pegged to the SDR with margins of 7.25 percent, which were not observed. That description of Saudi Arabia's exchange rate policy was not very helpful, especially as the text of the report stated that the authorities' primary objective of exchange rate policy was to maintain a relatively stable relationship with respect to major currencies, a point repeated by Mr. Nimatallah in his statement. Insofar as the SDR approximated an average of the major currencies, that situation clearly did not apply, as was evident from Table 49. There was also a further observation by Mr. Nimatallah that in real terms the riyal had been remarkably stable. Exchange rate stability was a reasonable policy objective, but there was no information in the staff report on either the effective exchange rate or the real effective exchange rate.

The staff stated that they had investigated the possibility of using the exchange rate as an instrument of diversification, but had met with a negative reaction from the Saudi Arabian authorities, Mr. Polak remarked. He shared the views of the authorities in that respect, because Saudi Arabia possessed a tremendous comparative advantage in the export of oil. The production of other competitive tradable goods should be confined to those items in which there existed a combination of skill and market expertise to ensure their efficient production. To promote the export of commodities other than those few items, a large devaluation of the riyal would be required, which would be counterproductive in raising the price level without altering the basic structure of comparative advantage. However, if diversification could not be achieved using the exchange rate, he shared the view of the staff against wholesale support of tradable goods through other means, such as soft loans and modest tariff protection of a temporary nature. He noted that the price at which petroleum inputs entered the production of various industries, such as fertilizer and feedstock, was being used to promote diversification. He asked the staff to what extent the prices of petroleum and gas as intermediate products differed from world market prices.

It was stated in the staff report that non-oil tradable goods would not be limited to the home market but would also be exported, Mr. Polak continued. He asked the staff to explain its suggestion that the Gulf Cooperation Council arrangements and the strength of Saudi Arabia's relations with other developing countries might enable Saudi Arabia to export its non-oil tradable goods, inasmuch as it was not clear why good relations should enhance exporting ability. Finally, he commended Saudi Arabia on its continued high level of foreign aid.

Mr. Malhotra said that he agreed with the thrust of the staff report, with which the Saudi Arabian authorities were also broadly in agreement. Over the past decade, Saudi Arabia had made wise use of its oil and had established a large infrastructure while introducing increasing sophistication in planning and resource allocation. The first two five-year plans had concentrated on the construction of physical infrastructure and the institutional framework, while promoting diversification of the economy, particularly by maximizing the value added of the oil sector itself through larger refining capacity, important new pipelines, and exploitation of gas production under a well-conceived Master Gas System. Subsequently, two large petrochemical industrial estates had been established. Now at the threshold of the Fourth Five-Year Development Plan, Saudi Arabia was appropriately reorienting its focus toward social services, the consolidation of existing progress, and greater efficiency in its capital stock. The authorities also intended to emphasize human capital investment, particularly the training of skilled personnel.

The mix of policies adopted by the Saudi Arabian authorities in response to the steep decline in oil exports and revenue over the past two years had been impressive, Mr. Malhotra remarked. First, they had reduced expenditure, both current and investment, by about 14 percent in 1982/83, and by 9 percent in 1983/84. At the same time, they had begun to diversify their revenue base, a process which was to continue. A tax on petroleum products distributed domestically had been imposed. The substantial investment in the diversification of its economic structure should, over the medium term, enable Saudi Arabia to effectively diversify its domestic revenue base. The scope for such diversification was substantial, especially if appropriate pricing policies were pursued. It was an important area to which the Saudi Arabian authorities would doubtless continue to devote attention.

Saudi Arabia's comfortable reserve position had enabled it to strike an appropriate balance between expenditure reduction and the maintenance of a satisfactory growth rate, Mr. Malhotra continued. Although the rate of growth in the non-oil sector had declined from about 11 percent in 1981/82 to about 5 percent in 1983/84, it remained substantially positive, indicating that there could be compatibility between adjustment and growth when economic resources allowed.

In the Saudi Arabian case, subsidies had generally proved beneficial, Mr. Malhotra commented. First, they had not put an undue strain on the budget. Second, they had promoted income redistribution, possibly contributing to the stability of the sociopolitical system. Third, they had accelerated modernization, particularly with respect to electricity consumption. Fourth, subsidies were assisting the authorities in realizing their objective of expanding the private sector. At an early stage in its development, incentives to the private sector need not be regarded negatively. Industrial entrepreneurship was new in Saudi Arabian society and could be strengthened through the use of subsidies. Nevertheless, the authorities should avoid the creation of industries that were viable only through the provision of long-term subsidies. He was pleased to note from Mr. Nimatallah's statement that the Saudi Arabian authorities would avoid such a development.

The authorities intended to afford protection through import duties in a selective and temporary manner in the order of 4-20 percent, Mr. Malhotra noted. By international standards, that level of protection was hardly excessive. Furthermore, there was no reason why Saudi Arabia should not exploit its comparative advantage in petrochemicals. He was not certain whether barriers against the exports of Saudi Arabia's petrochemical industries were likely to be imposed, but it should be noted that Saudi Arabia itself imposed no trade restrictions, and its absorption of goods from both the developing and developed world had been high. It was to be hoped that Saudi Arabian petrochemical exports would be afforded similar access by its trading partners.

He agreed with Mr. Polak that, given the dominance of oil in Saudi Arabia's exports, the denomination of oil prices in dollars, and the present degree of industrial diversification, the role of exchange rate policy in promoting exports could not be large, Mr. Malhotra said.

He commended Saudi Arabia for its role in the international oil market and in the financial system, as noted by Mr. de Maulde, Mr. Malhotra said. Its policies had been consistent with its long-term perceptions of the oil market. Saudi Arabia had contributed to the stability of the market through its role of swing producer, even though that role had created adjustment difficulties. Reserve management policy had, by avoiding large switches of reserves between currencies, ensured against significant disturbances in the financial markets.

Saudi Arabia's record in providing substantial official development assistance despite a serious decline in oil income was commendable, Mr. Malhotra concluded, while its cooperation with the Fund had enabled the institution to play an effective role in a difficult period for the international financial system.

Mr. Donoso said that Saudi Arabia appeared to have no major problems continuing its development program, primarily because of the authorities' ability to manage the economy in a manner consistent with the long-term interests of Saudi Arabia. In the fiscal field, the authorities had restrained expenditure and attempted to raise non-oil revenue in response to the more difficult conditions in the oil market. Although facilitated by the completion of major infrastructural projects, the cumulative decline of 20 percent in budgetary expenditure in the past two years, following annual increases of about 25 percent in the three years previously, reflected a marked adjustment, involving cuts in current outlays and direct subsidies and implementation of expenditure control measures. The increase in domestic revenue by 90 percent from 1981/82 to 1983/84, although rising from a low base level, also reflected a serious effort to adjust the economy's fiscal position as oil export earnings had declined from $111 billion in 1981 to $45 billion in 1983.

Fiscal restraint had stemmed the deterioration in the current account of the balance of payments, which had shifted from a surplus of $44 billion in 1981 to a deficit of $14 billion in 1983, Mr. Donoso continued. Given the high level of official foreign assets held by the monetary authorities, that position appeared sustainable. Some easing of the restraint on government spending was contemplated for 1984 and would increase the budget deficit to $13 billion, which would maintain the current account deficit at the same level as in 1983 while requiring a smaller reduction in official foreign assets in 1984, about $10 billion, than had been necessary in 1983.

Monetary developments had contributed to basic economic stability, Mr. Donoso remarked. Moderate liquidity expansion, improved supply, and a liberal policy toward foreign workers had reduced domestic inflation, in line with the falling rate of price increases abroad. The apparent ability of the authorities to moderate fiscal expenditure and to maintain stable monetary conditions provided reassurance that economic development would continue, especially as the authorities intended to incorporate the private sector more fully into the economy. The Saudi Arabian authorities should be commended in particular for their efforts to stabilize the oil market, which would help to attract private enterprise. Avoidance of a disruptive change in prices was in the long-term interest of both the oil industry and Saudi Arabia; to that end, Saudi Arabia had undertaken a difficult role among the main oil producers, but one which was consistent with its approach to economic development.

The Saudi Arabian authorities were moving efficiently toward their goal of transforming and modernizing their economy, Mr. Donoso commented, with consequently high rates of growth of non-oil GDP in the recent past, and with increasing participation by the private sector. Recent difficulties stemming from reduced oil revenue had slowed the growth of the economy but had not affected its ability to resume a rapid growth path. Success in consolidating a modern economy would depend not only on the adoption of appropriate macroeconomic policies but also on decisions at the microeconomic level. He therefore welcomed the attempts to rationalize the existing scheme of subsidies to specific industries, and he encouraged the authorities to further simplify the system of incentives in order to ensure efficient resource allocation. The complexity of a combination of credit incentives, exemptions from tariffs on imports, and subsidies could make it difficult to judge whether the final level of support to a specific industry was appropriate, particularly given the existence of some statistical weaknesses. It was clear, however, that the Saudi Arabian authorities were managing successfully both the problems of development and the adjustment to short-term difficulties.

Mr. Ismael observed that Saudi Arabia had undertaken great responsibilities in its support of the global economy, and that support had become an additional policy constraint given the weakening world demand for oil. However, the authorities had succeeded in preserving the resilience of their economy through the adoption of appropriate adjustment measures. Although falling from its peak of a few years earlier, non-oil economic growth had been maintained at a satisfactory level, while inflation had remained under control. More important, the authorities were now in a position to concentrate more on the longer-term objectives of accelerating the development of the private sector and of expanding the productive base of the economy.

The acceptance by Saudi Arabia of the role of swing producer of crude oil in an effort to stabilize world oil prices entailed potentially large variability in its oil revenue, Mr. Ismael commented. As a result, the country had chosen to adopt an austere fiscal policy stance, despite its comfortable reserve position. Although the adjustment had been facilitated by the completion of major infrastructural projects, the restraint on government spending had involved a considerable adjustment effort which had dampened the growth of the non-oil sector.

He agreed with the staff that some easing of the restraint on government spending in 1984/85 was justified, Mr. Ismael continued, particularly since inflation was expected to remain low in 1983/84, and the 1984/85 budget had provided for a 12 percent increase in revenue. The revenue measures, such as the tax on domestic sales of oil products and improvements in tax collection, should lead to a significant increase in domestic revenue, which currently accounted for only a small portion of the total revenue. However, oil revenue had been targeted to increase by 18 percent in 1984/85, and he wondered whether the price assumption used in the estimate was the same as that used by the staff. He also asked the staff to comment on the likelihood of achieving the oil revenue target, particularly in light of recent developments in the oil market.

On longer-term strategy, Mr. Ismael said that he welcomed the new emphasis on accelerating the development of the private sector, which was an appropriate response to the considerably smaller impetus expected henceforth from the public sector compared with the 1970s and early 1980s. The shift in emphasis was also well timed, since the basic infrastructural development had been substantially accomplished. However, like the staff, he urged the authorities to exercise great caution in designing an incentive system to promote development of the private sector. To ensure that it did not lead to resource misallocation, it was essential to create an environment conducive to the growth of private business, requiring both political and financial stability and the creation of a legal and administrative framework, as mentioned in Mr. Nimatallah's statement. Development of a well functioning market mechanism and an expanding market were other objectives essential to an efficient allocation of resources among industries. He shared the staff's view that the authorities should continue to avoid excessive protection and permanent subsidies, which tended to develop uncompetitive, unviable, and unproductive enterprises. The same principles applied in pursuit of diversification of the productive base of the economy. He therefore welcomed the intention of the authorities to rationalize the system of subsidies.

He also welcomed the current policy of upgrading skills of the national labor force while maintaining a flexible policy toward foreign labor, Mr. Ismael continued. The employment of about 1 million foreign workers, mostly from other developing countries, was important, not only for overcoming Saudi Arabia's labor shortage but also for relieving unemployment and balance of payments problems in their countries of origin. He hoped that the authorities would continue to pursue a judicious labor market policy by avoiding the imposition of unnecessary restrictions. The present exchange and trade systems, which were free from restrictions, and the continued pursuit of a responsible reserve management policy would also provide sound footing for a well functioning and fast developing economy. Finally, he commended Saudi Arabia for its sound economic management, its strong financial support of the Fund, and its continued generous assistance to developing countries.

Mr. Prowse said that he shared the views in the staff appraisal, but agreed with Mr. Wicks that there should have been more analysis of the medium-term prospects for the Saudi Arabian economy. He also shared Mr. Polak's view that more depth in the consideration of immediate policy issues would have been appropriate; but there was a clear constraint on the extent to which an Article IV consultation report could cover medium-term and long-term development issues.

Concerning the medium term, Mr. Prowse remarked that, because about 60 percent of Saudi Arabia's GNP accrued from oil revenues, the public sector held a dominant position in the economy. The pre-eminence of the public sector made redistribution a key objective in the Saudi Arabian economy, particularly as the tax structure did not provide a major instrument for redistribution. The issue of the pricing policies of public enterprises was therefore at the forefront of decision making, and the legitimacy of those policies as a method of redistribution when other methods were limited was an important concern.

Another basic element of the Saudi Arabian economy was that its basic infrastructure was largely complete, Mr. Prowse commented, raising the question of what type of economic structure should be sought. It appeared that the authorities were in favor of a market economy, in which private ownership of resources would be more extensive than at present. The next question concerned the speed at which the economy could move to reliance on the market mechanism to allocate resources, and to what extent that would require a transfer of resources from the public to the private sector, which should help attain the redistribution objective. In that respect, the sale of 30 percent of the equity of the major development corporations should be helpful, although the transfer of ownership of the public enterprises would be insufficient in itself to achieve the sound policy objective of economic diversification.

Other measures to encourage private sector activity, such as subsidies, were therefore necessary, Mr. Prowse continued, although they were costly and the extent and duration of their use should be limited. The authorities had adopted temporary incentives and protection, which might entail excessive costs through their interference in the price mechanism, even in an economy so rich in resources. It was therefore crucial that the incentives should be temporary, particularly the assistance to agriculture, which was heavily subsidized. In manufacturing industries, subsidization was less explicit than in agriculture. For example, the authorities required that 30 percent of the costs of major projects should be subcontracted to Saudi Arabian firms. He wondered what impact that requirement would have on the overall cost of such projects, and whether it should be regarded as a method of redistribution or as a means of stimulating local activity.

He was disappointed in the treatment of Saudi Arabia's exchange rate policy in the staff report, Mr. Prowse continued, although he recognized that the extent to which an Article IV consultation report should consider such issues was limited. He endorsed Mr. Laske's suggestion that the 1985 staff report should provide a thorough examination of exchange rate policy options. He asked the staff to consider the hypothesis that Saudi Arabia should best be considered as an extreme example of a narrowly based commodity export economy, subject to the same theoretical analysis applied to other such exporters. In that framework, he questioned whether the maintenance of a steady real exchange rate was in fact the optimal medium-term and long-term objective. With that hypothesis in mind, he asked the staff to elaborate on its statement that exchange rate policy could be used to incur a further diversification of the economy because it was an interesting theoretical proposition which was of relevance to the economic development of other commodity exporters faced with strong markets. The response of those in that position had been, in general, to allow market forces to determine both the exchange rate and the distribution of resources, or, in some cases, to consider the temporary implementation of a dual exchange rate.

Finally, he commended the Saudi Arabian authorities for their support of the Fund, Mr. Prowse said. They had backed their verbal statements with a financial commitment that was unparalleled among Fund members.

The Director of the Middle Eastern Department said that Directors had commented on the lack of information in the staff papers on effective exchange rates. In fact, that information was contained on page 3 of the staff report and on page 48 of the report on recent economic developments. Charts had not been included in the report, but would be included in the 1985 consultation report. There were, however, two charts in the report on recent economic developments.

He agreed with the speaker who had noted a long time lag in the availability of some key statistics in Saudi Arabia, the Director continued. The lag was partly the result of the different fiscal years used by SAMA and the Government. The Government fiscal year ended at the midpoint of the Hijri year while that of SAMA fell at the end of the Hijri year. SAMA was unable to finalize its balance sheet until the government accounts were closed, which for fiscal year 1983/84 was in April. SAMA's balance sheet, covering the period up to February 1984, had recently been received. The lag was still too long, but progress was being made; the Saudi Arabian authorities were fully aware of the need to improve their statistics and were currently receiving Fund technical assistance.

When considering Saudi Arabia's use of subsidies, the Director noted, it was important to remember that in the initial years of the oil price increase the authorities had wished to distribute the benefits to the population. Consumer subsidies had been essential for income redistribution, because there had been insufficient time to invest in the type of productive activities that would have channeled those resources to the mass of the population. They had also been necessary in the mid-1970s when inflation had been very high in Saudi Arabia; since price stability had been achieved, food subsidies, particularly on meat, rice, sugar, and vegetable oil, had been reduced by one half, while the subsidy on animal feed had been totally eliminated. The authorities were now considering the important issue of subsidies for government services, such as public utility pricing, electricity, transportation, and telecommunications. In cooperation with the Gulf Cooperation Council, the Government was in the process of making final a scheme to reduce subsidies to public services.

Production subsidies were more controversial, the Director remarked. Initially, they had taken the form of concessional or interest-free loans for start-up costs. The authorities had given repeated assurances that production subsidies would be allocated prudently, and they were aware that excessive subsidies could cause resource misallocation.

Concerning oil production and the balance of payments, it was important to note the unusual uncertainties surrounding the oil market when considering projections for 1985, the Director said. In the first half of 1984, Saudi Arabia had been producing about 5.1 million barrels a day, and was expected to increase production to 5.3 million barrels a day by 1985, thereby meeting the target implicit in the budget for the 1984/85 fiscal year. For 1985, the staff did not expect a significant increase in oil exports because a strong worldwide demand was not likely. However, a decline in imports was expected, suggesting that the current account deficit might decline moderately in 1985.

It had been asked by Mr. Ismael whether those projections were still valid, given the softening of oil prices, the Director continued. Spot prices for Arabian light crude oil were $2 below the official price, at $27 instead of $29 a barrel. However, it was understood that the Saudi Arabian authorities were continuing to sell their crude oil at $29 a barrel; that being the case, no revisions in the balance of payments estimates had yet been made.

The question asked by Mr. Wicks on the pricing and subsidization of petrochemicals touched on a difficult area, the Director commented. Gas, which was used as feedstock, was priced at the cost of gathering it, below international prices. Whether that pricing policy represented a subsidy was an open question, because it could be argued that inasmuch as the gas had been flared in the past, the opportunity cost was zero. A second question was whether it could be exported in the form of liquefied natural gas. The staff had no information on the feasibility of that alternative.

Many Directors had raised the issue of exchange rate policy in Saudi Arabia, the Director recalled. It had been agreed by the staff and the Board that the exchange rate for Saudi Arabia had not been a useful tool for balance of payments adjustment after 1973. Saudi Arabia's policy before 1980 had been to appreciate the riyal when the dollar was depreciating, in order to contain domestic inflation. After 1980, inflation had ceased to be a problem, and import prices abroad had fallen. Since 1980, Saudi Arabia's policy appeared to have been the maintenance of a stable SDR/riyal exchange rate, as indicated in the report on recent economic developments. The Saudi Arabian authorities had emphasized the stability of the riyal in order to avoid the adverse impact of a fluctuating exchange rate on private sector activity. Contrary to Mr. Laske's suggestion, there was no disagreement between the staff and the Saudi Arabian authorities on exchange rate policy.

The staff believed that the current exchange rate was appropriate for Saudi Arabia, the Director said. The meaning that the staff had attempted to convey in the staff report was that the exchange rate should be considered as a tool to encourage diversification in areas of potential comparative advantage. That was not to imply that the exchange rate should be devalued, or that it should be used as a policy instrument immediately. It should be used once the private sector had assumed a more dominant role in the economy.

More information had been requested by Mr. Wicks on the deposit security scheme which had been introduced recently into Saudi Arabia's banking system, the Director continued. The background to the development had been the limited investment outlets in Saudi Arabia compared with banking deposits, which had increased sharply in recent years. The Banking Security Deposit Account had been created by the authorities as an outlet for the banking system in which it could invest its excess deposits, in order to prevent the internationalization of the riyal, and to reduce riyal holdings abroad. Additionally, the new facility would reduce the drain on official foreign exchange in Saudi Arabia, because the banks had the option at present of investing their excess deposits domestically or converting them into a foreign currency to invest abroad. The foreign currency would be supplied by SAMA, thus preserving official foreign exchange reserves.

It had been noted by Mr. Wicks that Table 7 of the report on recent economic developments indicated that current expenditure as a percentage of budget expenditure had declined over the past two years, the Director recalled. However, prior to 1983/84, expenditure for operations and maintenance had been mainly included in project expenditure, so that the two series on which he based his analysis were not comparable. Once they were made comparable, as in the basic data table, it emerged that project expenditure had declined by 23 percent, not 42 percent, over the past two years, and current expenditure by 20 percent rather than 6 percent.

The staff statement that Saudi Arabia's exports would be promoted by friendly relations between Saudi Arabia and the rest of the world had been meant to imply that Saudi Arabia had a liberal import policy, and that it expected the rest of the world to give access to its exports in the same way as it gave access to those of other countries, the Director said.

Mr. Nimatallah observed that, with regard to subsidies to petrochemicals, it was important to consider all factors when comparing different industries and the possibilities for comparative advantage, as had been pointed out by Mr. Finaish. For example, Saudi Arabia was disadvantaged in its labor skills and markets, while possessing a comparative advantage in gas and oil-related factors from which the world should be able to derive benefit. It was unreasonable to expect Saudi Arabia to supply gas at high prices to the petrochemical industry, because the whole rationale behind comparative advantage was to supply an input to an industry at a reasonable cost with the objective of benefiting the international consumer. If all prices were set at the highest international level, comparative advantage would be lost. Saudi Arabia's comparative disadvantage in other factors of production should be weighed against its comparative advantage in gas. Furthermore, Saudi Arabia produced only 3 percent of U.S. demand for petrochemicals.

A second benefit of an increase in the Saudi Arabian production of petrochemicals was that it would improve the efficiency of the petrochemical industries in the United States, Mr. Nimatallah continued, which could be significantly enhanced by additional investment to enable them to compete more effectively.

Consumption subsidies had been used to raise the standard of living of the Saudi Arabian people, Mr. Nimatallah remarked, because it was their oil, of which the Government was only a custodian, and they possessed a right to benefit from the oil surplus. Subsidies for consumption had ensured an improvement in the standard of living for those citizens whose income had been fixed during the period of high inflation. Those subsidies were now being superseded by producer subsidies which were crucial to improving the efficiency of the private sector. They were currently being reviewed, and would disappear over time.

He emphasized that there was no disagreement between the staff and his authorities concerning exchange rate policy, Mr. Nimatallah said. The only issue was to choose the right time to use exchange rate policy to induce economic diversification; currently, it was not appropriate.

With regard to the requirement that foreign contractors subcontract 30 percent of their projects to local contractors, Mr. Nimatallah explained that, on average, it was cheaper to enforce that requirement, as local contractors were more familiar with the conduct of business in Saudi Arabia, and could even procure their imports at lower costs. In general, therefore, the 30 percent requirement did not inflate costs.

Mr. Prowse asked the Director of the Middle Eastern Department whether he regarded Saudi Arabia as a clear example of a narrowly based commodity exporter, for which the policy prescriptions might be extended to other such economies.

The Director of the Middle Eastern Department said that the major difference between Saudi Arabia and a country specializing in the production and export of a commodity such as cotton was that, in the case of the former, oil was a depletable resource. Precisely because oil was depletable, Saudi Arabia wanted to diversify its economic base. Furthermore, it had the resources to do so, in contrast to many other one-commodity export countries. The issue to be emphasized in the case of Saudi Arabia was that the authorities had chosen a policy of diversification, leaving most of the investment to the private sector while the government gradually reduced its role. It was in that context that the staff was urging them to consider exchange rate policy as one policy option that could contribute to diversification.

The Chairman made the following summing up:

In considering the 1984 Article IV consultation with Saudi Arabia, Executive Directors commended the authorities for the policies they pursued in response to the difficult circumstances arising from the markedly weakened world demand for oil. These policies have been timely, effective, and appropriate. Directors complimented the authorities for their balanced and highly responsible approach to external policies.

Directors commended Saudi Arabia for successfully conducting its role as swing producer to restore orderly and stable conditions in the oil market, thereby serving the interests of both producers and consumers of oil. The authorities' commitment to maintain orderly market conditions by continuing to pursue a flexible oil production policy as dictated by conditions in the oil market was highly appreciated.

Despite difficulties caused by the steep decline in oil revenue, the authorities have pursued effective economic and financial policies. Budgetary expenditure in 1983/84 was further reduced by 9 percent following a 14 percent reduction in the previous year through streamlining of expenditures and a curtailment of less essential outlays. At the same time, increased efforts were made to raise additional non-oil revenue from domestic sources. Directors felt that there was room for further effort in that respect. Directors commended the authorities on adjusting quickly the fiscal policy stance and noted that this was achieved while maintaining satisfactory growth in the non-oil sector. They also noted with satisfaction that the required adjustment had been associated with no increase in domestic price levels. There was general agreement that the fiscal policy stance for 1984/85, which calls for some easing of the restraint on government expenditure in order to avoid any further reduction in the real growth of the non-oil sector, was appropriate. Directors observed, however, that the increase in expenditure should be linked to a realistic revenue outlook in the medium term.

Directors agreed with the shift in development policy, which places greater emphasis on the private sector in supporting the development effort in the future. While recognizing the need for temporary official encouragement of private sector activities, Directors cautioned that such official action should be kept to moderate proportions and should not be allowed to become a permanent feature of the economic setting. They noted that the authorities were cognizant of this and were determined to keep their economy open and to prevent inefficiencies in resource use. They also supported the authorities' intention to review and rationalize the existing system of subsidies. Some concern was expressed by several Directors on the degree of subsidization of oil-related and public utility prices. Directors generally endorsed the new facility under which banks could place funds with SAMA and agreed that the facility could develop into a useful monetary tool.

With respect to the external sector, Directors noted that Saudi Arabia's balance of payments position is unlikely to show a significant change during 1984 and 1985 vis-à-vis present trends. However, in view of the substantial official foreign assets, this development should not be cause for concern. While Directors generally agreed wih Saudi Arabia's approach to exchange rate policy, some Directors showed some interest in further examining ways in which exchange rate policy might encourage greater diversification of the economy.

Directors complimented Saudi Arabia for its continued generous program of providing concessional assistance to developing countries. They noted that, despite external payments pressures over the past two years, such assistance had been steady. In fact, as a percentage of total current account receipts, foreign aid increased significantly from 1981 to 1983. Directors also expressed great appreciation of Saudi Arabia's continued close cooperation with the Fund and the strong support exhibited by the provision of substantial resources for the enlarged access facility and through their commitment under the GAB.

The authorities were encouraged to continue improving their statistical data base, and to enhance its complete and timely communication to the Fund.

The next Article IV consultation discussions with Saudi Arabia will be held on the standard 12-month cycle.

3. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Hirao on completion of his term of office.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/113 (7/20/84) and EBM/84/114 (7/25/84).

4. GHANA - EXCHANGE SYSTEM

The approval of Ghana's exchange restrictions in the form of external payments arrears under Decision No. 7485-(83/118), adopted August 3, 1983, is extended until September 30, 1984 or the completion of the 1984 Article IV consultation with Ghana, whichever is earlier. (EBD/84/198, 7/19/84)

Decision No. 7762-(84/114), adopted
July 24, 1984

5. GRENADA - EXCHANGE SYSTEM

The approval of Grenada's multiple currency practice under Decision No. 7498-(83/122), adopted August 24, 1983, is extended until December 31, 1984 or the completion of the next Article IV consultation with Grenada, whichever is earlier. (EBD/84/197, 7/18/84)

Decision No. 7763-(84/114), adopted
July 23, 1984

6. MALI - REPRESENTATIVE RATE FOR MALI CURRENCY

The Fund finds, after consultation with the Malian authorities, that the representative exchange rate for the CFA franc, the official currency of Mali, under Rule O-2, paragraph (b)(ii), against the U.S. dollar is the rate obtained on the basis of the relationship between the CFA franc and the French franc, and the representative rate of the French franc. The Fund will be informed immediately of any change in the representative exchange rate.

Decision No. 7764-(84/114) G/S, adopted
July 24, 1984

7. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 84/20 are approved. (EBD/84/196, 7/17/84)

Adopted July 23, 1984

8. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/84/157 (7/20/84) and by an Advisor to Executive Director as set forth in EBAP/84/157 (7/20/84) is approved.

APPROVED: April 17, 1985

LEO VAN HOUTVEN
Secretary