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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/127

3:00 p.m., August 10, 1984

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	T. Ramtoolah, Temporary
	H. G. Schneider
	G. E. L. Nguyen, Temporary
	J. Delgadillo, Temporary
	M. Lundsager, Temporary
M. Finaish	
H. Fujino	
J. E. Ismael	
R. K. Joyce	
A. Kafka	
	G. Grosche
	N. Coumbis
	A. S. Jayawardena
	S. El-Khouri, Temporary
	T. de Vries
	L. Ionescu, Temporary
	A. J. Tregilgas, Temporary
G. Salehkhou	
	M. Camara, Temporary
	J. L. Feito
	A. K. Juusela, Temporary
	J. Bulloch, Temporary
	Wang E.

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

African Department: M. Dairi, Y. Fassassi, C. A. François, S. L. Rothman, E. Sacerdoti, L. Schmitz. European Department: P. de Fontenay, Deputy Director; H. B. Junz, L. L. Pérez, K. A. Swiderski. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; E. H. Brau, G. Oliveros. IMF Institute: J. R. Gomez, Participant. Legal Department: J. K. Oh. Middle Eastern Department: A. Ouanes. Research Department: A. Penati, P. Wickham. Advisors to Executive Directors: S. R. Abiad, A. A. Agah, H. A. Arias, A. Steinberg, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: E. M. Ainley, M. B. Chatah, D. Hammann, H. Kobayashi, S. Kolb, K. Murakami, J. E. Rodríguez, A. Yasseri.

1. SPAIN - 1984 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/84/126, 8/10/84) their consideration of the staff report for the 1984 Article IV consultation with Spain (SM/84/172, 7/17/84). They also had before them a report on recent economic developments in Spain (SM/84/183, 7/27/84).

The staff representative from the European Department remarked that the Government had come to an agreement with the railroad company, whereby some unprofitable routes would be discontinued, wage increases would be limited, and the labor force would be reduced. Nevertheless, operating losses would be reduced by only about 25 percent and were projected to be large for the next three or four years. The Government would continue to cover those losses by current transfers and would pay some of the bills of the railroad company.

With respect to the question whether the Japanese experience of lifetime employment in exchange for wage and benefit moderation could offer lessons for the Spanish authorities, the staff representative said that capital/labor ratios in Japan were more favorable than those in a number of European countries, particularly Spain. Furthermore, wages in Japan had not been high enough to erode the profitability of the private sector companies to such an extent that they could not expand their operations. In addition, Japanese workers retired relatively early and moved to other occupations where their remuneration was about two thirds lower. It was difficult, however, to make international comparisons without a full analysis of institutional arrangements.

Mr. Kafka commented that the wage payment system in Japan was different from that in Europe. A relatively large share of wages was paid at six-month intervals, often depending on the financial outcome of the enterprise.

Mr. Feito remarked that Directors had recognized the difficulties facing the authorities and had given them due credit for the success achieved with respect to inflation and the balance of payments position. A number of speakers had been concerned that those improvements would not last, given the public sector's claim on the resources of the economy. His authorities were aware of the need to reduce the budget deficit further in order to strengthen the progress already made in correcting the monetary imbalances. They also recognized the medium-term conflict between the current fiscal position and their external objectives and, consequently, attached priority to narrowing the fiscal imbalance.

To reduce the public sector deficit, Mr. Feito continued, measures affecting both expenditure and revenue were being implemented or were contemplated. On the expenditue side, first, the social security system was being reformed; benefits would be scaled down and distributed more equitably. The effects of the reform would begin to be felt during 1985, but given demographic trends, the measures to improve social security finances would, at most, prevent a deterioration in the social security accounts. However, the rationalization of social security benefits and contributions would undoubtedly have a significant, positive effect on employment. Second, the losses of the public sector enterprises would be reduced. The deterioration of those enterprises had taken place during the transition of the economy from a dictatorship to a democracy, a fact that might help to explain why the financial erosion of public enterprises had not been arrested at an earlier stage. The authorities were aware of the need for determined action because transfers by the Government to the public enterprises had diverted resources from the more productive sectors of the economy. Social resistance to the reform of the public sector enterprises, however, was greater than expected. The privatization of some enterprises would not be a realistic option until their financial structure was improved considerably.

On the revenue side, measures taken to improve tax collection and to tax income from financial assets more equitably were expected to yield significant public revenues as well as to equalize the tax burden, Mr. Feito went on. To sum up developments in the fiscal area, there seemed to be an increased awareness in Spain that the Government could not continue to maintain either the level or the composition of public expenditure. However, the current improvement in the economy, particularly if accompanied by wage moderation and increased employment and output, could help to ameliorate public finances.

High unemployment was undoubtedly the gravest problem facing the authorities, Mr. Feito remarked. The nature and magnitude of the problem in Spain, particularly when compared with the situation in other European countries, reflected severe deficiencies peculiar to the institutional framework regulating the country's labor market. Some of those deficiencies had developed under the previous regime; for example, a legal framework had been established to prohibit the dismissal of workers. Those restrictions had not discouraged either employment creation or labor mobility, because the wage structure as well as average wage rates had been flexible at that time. But with the growing importance of the trade unions and the spread of wage bargaining practices, wage flexibility had been lost as the unions pursued aggressive policies in order to strengthen their role in the political arena, while the institutional rigidities prevailing under the old regime had been retained, resulting in high unemployment. The problem had been exacerbated by the world economic recession and rapid technological advance in many countries; those developments had placed a high premium on the ability of institutions to cope flexibly with unforeseen events. The persistence of institutional rigidities in the labor market in the face of an increasingly uncertain world economic environment had had damaging effects on the creation of employment opportunities. Thus, wage moderation and further efforts to increase the flexibility of the labor market were essential for the resumption of adequate employment. In the recent past, real wages had been impervious to market forces. Action to moderate the growth in real wages should be taken prior to the adoption of more liberal labor legislation because, if the labor market became more flexible while wages were inappropriate, the most probable outcome would be an acceleration of the displacement of labor by capital with respect to the current stance of the social agreement, the possible outcome of current negotiations between the Government and unions was unclear.

Directors' comments on the high degree of effective protection in Spain and in favor of efforts to liberalize the trade system were well taken, Mr. Feito said. Although it might seem appropriate, in connection with Spain's integration into the European Communities (EC), to reduce trade arrears, trade diplomacy seemed to militate against that course of action. However, the positive balance of payments outcome had eased the resistance of some pressure groups and had permitted the adoption of some measures to liberalize the trade and payments system. For instance, Spanish residents had been allowed to invest in fixed income securities denominated in foreign exchange, issued by either Spanish institutions or international organizations of which Spain was a member. In addition, the tax rebate on exports had been reduced by 3 percentage points.

In relation to some Directors' comments on the reversal of the trend toward liberalization of the Spanish financial market, Mr. Feito noted that there were two approaches to liberalizing that market. The compulsory investment coefficients could be reduced by a small amount each month--a system used by the authorities in the past--or the interest rate on capital assets used to meet those coefficients could be moved closer to market rates; once the difference between the interest rates on such assets and market interest rates was negligible, the coefficients could be eliminated in one step. The Government was aware that, under the second approach, the public sector borrowing requirement would have to be reduced gradually to avoid the risk of increasing, rather than narrowing, the differential between regulated and market interest rates.

The Acting Chairman made the following summing up:

> Directors generally agreed with the staff assessment of the Spanish economy and supported the general direction and orientation of government policies. They noted the deceleration in the inflation rate, the containment of the fiscal deficit in 1983 and the lower budget deficit targeted for 1984, and the improved external position that had been established in 1983 and the first half of 1984. Despite those positive developments, Directors expressed considerable concern regarding the serious structural deficiencies in industry, the labor market, the financial system, and the structure of government expenditure financing. They stressed that, in addition to following appropriate revenue and expenditure policies, the Spanish authorities would have to make sustained efforts to reduce the structural rigidities in order to establish the basis for a sustainable recovery of output and employment.
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> All Directors stressed the paramount need for determined and continuing efforts to control and reduce the budget deficit and the extent to which the Government intermediates the flow of

resources to both public and semipublic enterprises. There was concern that large and growing public sector borrowing requirements would make it more difficult for the monetary authorities to achieve their monetary targets and inflation objectives. In addition, Directors felt that the pre-emption of credit availabilities by the public sector constituted a threat to the recovery of private sector productive investment, without which both competitiveness and employment opportunities would erode. Directors also stressed that the impact of the large government borrowing requirements on the credit markets had contributed to upward pressure on the exchange rate, thereby reducing competitiveness and limiting the contribution that the external sector could make to economic recovery.

Turning to more detailed fiscal recommendations, Directors recognized that efforts to increase the tax base and reduce tax evasion were helpful and that some room existed for increasing taxes. But they warned against too much reliance on tax increases, since the excessively rapid expansion of government expenditure was viewed by all Directors as the root of the budget deficit problem. Hence, they considered that the stress of budgetary policy should be on controlling expenditures. Two crucial areas attracted extensive comments in that regard: the social security system and the public enterprises. Directors urged the Spanish authorities to act promptly and decisively to reform the social security system so as to scale benefits to a level that the economy could afford, eliminate abuses within the system, and generate an appropriate stream of revenues without further increasing nonwage labor costs. Directors also expressed concern about the rapid growth of the financial resources absorbed by those public sector enterprises operating at a deficit or on the margin, particularly since the problem seemed to be an endemic one. They urged the authorities to move without delay to reduce the losses of those enterprises and to withdraw financial support from ailing industries.

Directors commended the authorities for achieving their monetary targets and for avoiding the monetization of the budget deficit in 1983, but noted the dangers to the monetary targets raised in 1984 by the large public sector borrowing requirement. They welcomed the development of a treasury bill market, which would facilitate the direct channeling of private savings to the financing of the public sector deficit. However, they regretted that the need to finance the public sector deficit and to reduce its financing costs would interrupt recent moves toward deregulation of the financial system. Directors saw the increase in the share of the administratively determined banking assets as adding to the distortions in the allocation of financial resources. They urged the authorities to reinitiate their efforts to liberalize the financial system as further progress was made to reduce the budget deficit and government borrowing.

Directors expressed satisfaction with the progress that was expected to be made in reducing real wages in 1984 and the efforts being made at present to achieve a social consensus for the 1985-86 period that would continue this trend and improve employment prospects. In that connection, Directors emphasized the need to increase the flexibility of the labor market, particularly with respect to measures to reduce the costs and time involved in dismissing workers, as under current circumstances employers were discouraged from taking on new employees.

Directors noted the improvement in the current account and urged the authorities to continue to maintain a competitive exchange rate. A number of Directors felt that the authorities could or should take this opportunity to liberalize imports, a course of action supportive of needed structural changes and also likely to smooth the effects of entry into the European Communities. They also urged the authorities to monitor closely the increase in foreign borrowing so as to avoid an unduly heavy debt service burden. In that connection, they said, attention needed to be paid to maintaining the current trend toward significant improvement of the current account position.

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

The Executive Board then took the following decision:

Decision Concluding 1984 Article XIV Consultation

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Spain, in the light of the 1984 Article IV consultation with Spain conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Spain continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Decision No. 7783-(84/127), adopted
August 10, 1984

2. TUNISIA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Tunisia (SM/84/118, 5/23/84). They also had before them a report on recent economic developments in Tunisia (SM/84/130, 6/11/84; and Cor. 1, 6/19/84).

The staff representative from the African Department made the following statement:

The following information on recent developments has become available to the staff subsequent to the issuance of SM/84/118 and SM/84/130.

Over the first quarter of 1984 there was a slight easing in the rate of increase in credit to the economy (the private and nongovernment public sectors). Nevertheless, for the year ended March 1984 the expansion in credit and monetary aggregates continued to be rapid, with domestic credit rising by 19 percent and broad money by 21 percent.

During the period January-April 1984 the official consumer price index was 7.7 percent above the level during the corresponding period in 1983; this compares with the 9 percent average annual rate of increase for all of 1983. In the policy area, thus far there has not been any announcement of general wage and salary increases, and, as anticipated during the consultation discussions prices of cereal products, which are heavily subsidized, were increased in July, according to press accounts, by 10-20 percent.

Through the first half of 1984, owing in part to seasonal factors, Tunisia's gross official international reserves declined by SDR 267 million to SDR 281 million (equivalent to 1.3 months of projected 1984 imports). Data for the first quarter of 1984 indicate that the trade deficit was about SDR 140 million smaller than during the corresponding period in 1983. The value of exports in terms of SDRs was almost 15 percent above the January-March 1983 level, attributable entirely to a rise in the volume of petroleum exports, which were particularly low in early 1983. Moreover, imports through March were some 13 percent below the level of the first quarter of 1983.

Over the period January-June 1984, the nominal effective exchange rate for the dinar depreciated by 1 percent while, vis-à-vis the SDR, the dinar declined further by 2.7 percent.

Mr. Salehkhou made the following statement:

Despite an encouraging recovery of real economic growth in 1983, the performance of the Tunisian economy during this year showed only modest improvement over the last. Slower expansion of real GNP, higher inflationary pressures, and widening domestic and external financial imbalances contrasted with the strong economic results achieved by Tunisia in the last decade when, benefiting from a significant improvement in the terms of trade, which was mainly the result of higher international petroleum and phosphate prices, and strengthened by cautious management and financial policies, the Tunisian economy experienced rapid economic growth, relatively low inflation, and generally comfortable fiscal and balance of payments positions. Tunisia also benefited from a high level of foreign direct investment.

The less satisfactory performance in 1982 and 1983 was, to a large extent, the result of adverse exogenous developments, the effects of which were exacerbated by the generally expansionary stance of financial policies and by strong domestic demand pressures. These developments included, in particular, a severe drought affecting most of the agricultural areas, the impact of the world economic recession on exports and tourism receipts, and a large deterioration in Tunisia's terms of trade which reversed the favorable trend of the 1970s, while the domestic front was mainly characterized by expansionary credit and fiscal policies.

The economy resumed real growth in 1983 with a real GDP increase of 4.5 percent compared with the near-stagnation of 1982. Such a performance was all the more encouraging as agricultural production continued to be adversely affected by bad weather conditions and as tourist activity remained slack. The planned reduction in public investment to curb domestic demand should not prevent noticeable real growth in 1984 and beyond, considering the efforts being made to strengthen private investment and the better prospects for the expansion of manufacturing and agricultural output. In this regard, structural reforms have been introduced in the agricultural sector, including the provision of remunerative producer prices and the establishment of an agricultural investment code and the National Bank for Agricultural Development. These and other measures should enable Tunisia to maintain a satisfactory performance of the real economy while efforts are made to correct and strengthen its financial position.

In early 1984, being aware of the adverse effects of a widening budgetary deficit on both inflation and the balance of payments position, the Tunisian authorities attempted to contain and reverse the deteriorating trend of public finances by a series of corrective price measures.

Subsequent developments, however, made it necessary for the authorities to roll back many of the announced fiscal measures and to adopt a more gradual process of adjustment. They made it clear, in this regard, that the slower pace does not affect their commitment to fiscal adjustment, containment of domestic demand, and the re-establishment of a strong balance of payments position. They consider that such objectives could be achieved and would be sustainable only through policies that take into account Tunisia's economic and sociopolitical constraints.

The Tunisian authorities recognize that, in view of the already high revenue burden, fiscal adjustment will have to concentrate on expenditures, with only a modest contribution from new revenue-enhancing measures, such as the tax on travel abroad, increased import duties, additional taxes on a number of nonessential goods, and other nonrecurring receipts. Enhanced revenues are also expected from the tax reform currently being implemented, which is aimed at increasing the direct tax base and extending the application of value-added taxation.

On the expenditure side, besides a series of adjustments in the prices of consumer products, which should gradually reduce and ultimately eliminate the huge subsidies supported by the Government's budget, the Tunisian authorities' efforts are focused on restraining the wage bill and somewhat trimming capital outlays. The authorities are also directing their adjustment efforts at streamlining public enterprises and improving their management and financial positions so that direct transfers to parastatals can be significantly curtailed and eliminated in the medium term. In this context, like the staff, they believe that a flexible pricing and employment policy could significantly improve the financial position of public enterprises and substantially reduce related pressures on the Government's budget and the structure of credit to the economy. They are convinced, however, that in view of their adverse impact on the main objectives of containing wages and ensuring a stable social and economic environment, such policies should be implemented only gradually. Thus, their efforts in this area are concentrated primarily on the restructuring of public enterprises and improving their efficiency and management.

It should be noted that despite the set of revenue and expenditure measures implemented, the Central Government's consolidated deficit is projected to widen further to 7.6 percent of GNP in 1984, to be financed through bank borrowing and recourse to external credit, including international capital markets. Such additional foreign borrowing is not expected, however, to significantly affect Tunisia in view of the country's low debt service ratio, which is projected to increase by only 1.6 percentage point to 18.1 percent over the next five years. On the other hand, budget financing requirements are expected to decline significantly over the next two years as the tax reform is fully implemented and in view of the authorities' plans to scale back government direct investment in 1985-86.

With regard to external developments and policies, it should be noted that the impact of the limited recovery in Western Europe on the Tunisian economy was rather insignificant as it did not prevent further extension of protectionist practices which particularly affected North African exports. In this context, my Tunisian authorities are very concerned with the excessive recourse to protectionism by their traditional trade partners in the European Communities (EC), which, in their view, adversely affects Tunisia's ability to diversify its economy away from the petroleum sector and to resume the liberalization of the trade system.

It should also be noted that, although the external current account deficit is projected to increase to 8.1 percent of GNP in 1984 and should remain above 8 percent of GNP through 1988, no financing problems or strain on Tunisia's strong balance of payments position is expected, and, as indicated in the report, its debt service burden will remain manageable over the period. The external account deterioration reflects mainly the projected decline in net energy exports and underlines the need for Tunisia to speed up the diversification of its economy through the development of agriculture and the promotion of industrial exports.

The promotion of nonenergy exports has been a major objective of successive Tunisian development plans. In this context, the authorities are not convinced that a discretionary depreciation of the exchange rate would be the most appropriate course of action to enhance Tunisia's competitive position. They are concerned about such a decision's possible adverse consequences for foreign investment, inflation, public enterprises, and external debt. Furthermore, they believe that competitiveness will be equally strengthened through the promotion of domestic price and wage stability and by pegging the dinar to an extended currency basket. Other export-promoting measures recently introduced include the creation of specialized companies, favorable financing arrangements, and export insurance facilities. Obviously one major bottleneck facing export promotion in Tunisia is the expanding protectionism in the EC which will be further compounded by the future entry of Spain and Portugal into the Communities.

On the staff's recommendation of "a relaxation of import quotas for consumer goods," the Tunisian authorities believe that it does not sufficiently take into account the objectives of containing the external deficit and promoting savings. Indeed, the aim of this category of import restriction is to control the importation of unneccessary luxury products and limit the growth of domestic consumption which has been increasing at a faster pace than GDP in recent years.

Regarding monetary and credit policies, while efforts are being made to slow the expansion of credit to the economy, inter alia, by improving public enterprises' finances, the Tunisian authorities view these policies as essential to achieve the objectives of regional and sectoral development. Moreover, in view of the adverse impact of further interest rate liberalization on economic activity, particularly on the financial position of public enterprises, attempts to generate more savings focus on special schemes directed at particular categories of income.

Wage policy plays an essential part in Tunisia's efforts to contain domestic demand and slow the growth of real salaries experienced in recent years. To encourage general restraint, the authorities are not providing for any general wage and salary increases in the Government's budget. They are also maintaining close supervision over retail prices. Such restraint should help reduce the rate of inflation in spite of adjustments in the prices of consumer commodities.

On pricing policy, for which the staff recommends a further liberalization, it should be noted that the Tunisian authorities remain attached to that orientation. Moreover, an important reform was adopted in 1982 and resulted in a significant relaxation of price formation mechanisms. They nevertheless consider that discretion and caution should prevail on this matter so as to contain inflation within tolerable limits.

In conclusion, despite the recent deterioration in Tunisia's domestic and external financial positions, it should be noted, on the one hand, that projected deficits will remain manageable through the decade, and, on the other hand, that a relatively strong economic recovery has taken place in 1983 while the prospects are for a continued satisfactory expansion of output in the medium term. Economic and financial policy is geared to stop and gradually reduce financial deterioration with a minimum adverse impact on the authorities' broad objectives of diversifying and strengthening the economy in an environment of social and political stability. Policy is also geared to preserving external confidence in Tunisia's economic and financial management and achieving development objectives without external debt service becoming too heavy a burden on the budget or the balance of payments.

Extending his remarks, Mr. Salehkhou commented that on a net basis, oil exports had clearly increased in 1982, compared with 1981, reflecting lower imports of oil.

Mr. Finaish remarked that, given the difficult external environment and offer adverse exogenous factors, the performance of the Tunisian economy in 1983 had been generally satisfactory. Progress had been made in several areas; the rate of growth of real GDP had increased from 0.3 percent to 4.5 percent, while the rate of inflation had been reduced from 14 percent to 9 percent. The current account deficit of the balance of payments had been brought down from 8.3 percent of GDP to 7.8 percent although a further reduction was clearly needed. Those impressive results had been made possible by a combination of favorable weather conditions and the adoption of several corrective measures to deal with the economic deterioration of 1982. However, those measures had been insufficient to correct the financial imbalances, as the fiscal deficit had widened slightly. The further increase in public sector wages, subsidies, and other current transfers, which appeared to have been unavoidable, had contributed to that outcome.

The prospects for 1984 seemed to be mixed, Mr. Finaish observed. While there were indications pointing to a stronger growth performance, the financial situation was expected to remain under strain. The staff had drawn attention to the policy areas where action was needed to reduce the domestic and external imbalances, one of which was the need to arrest the deterioration in the fiscal situation, primarily by containing expenditure, given the high ratio of revenue to GNP in Tunisia of about 35 percent. While he did not necessarily disagree with the staff on the need for expenditure cuts, he was not sure whether it had used the most appropriate definition of the fiscal burden. A more relevant measure would be the tax ratio, excluding government revenue from oil, which had been about 28 percent of GNP in 1983. How did that ratio compare with that in other countries at the same stage of development as Tunisia? Referring to Table 12 of SM/84/130, he wondered whether the contribution to total revenues of taxes on net income and profits, at less than 5 percent of GNP, was not small relative to that in comparable economies.

The rationalization of consumer price and subsidy policies was clearly desirable to improve resource allocation by providing adequate producer incentives, especially in agriculture, and to promote fiscal discipline, Mr. Finaish said. But careful consideration should be given to the pace and timing of the necessary adjustment in sensitive areas, such as subsidies on food commodities that were a basic necessity for the poorer segment of the population. In that respect, he noted that the authorities had already begun to reduce subsidies, the prices of some commodities having been increased by 10 percent. It was also encouraging to note the authorities' awareness of the need to pursue a policy of wage restraint in the period ahead in view of both the high unemployment and the objective of promoting exports.

On monetary and credit policies, Mr. Finaish continued, given the recent sharp increase in domestic liquidity, further efforts to restrain monetary expansion might be necessary to prevent the rekindling of inflationary pressures. Could the staff elaborate on its observation, which seemed to be based on an assumed relationship between quasi-money holdings and the distribution of income, that over the past five years households' quasi-money holdings, relative to GNP, had been rising in response to a shift in income distribution toward wage and salary earners. How had that shift in the sectoral distribution of income affected personal income distribution?

The balance of payments and debt projections suggested that the external situation would be manageable over the medium term, despite the existing imbalances, Mr. Finaish observed. The forecasts had been based not only on the pursuit of appropriate supply and demand adjustment policies but also on favorable export prospects, which were uncertain owing to the current and potential protectionist barriers in Tunisia's main European export markets. Such barriers could seriously impede the country's sustained efforts to promote nonenergy exports. It would be helpful if the staff could elaborate on the extent to which the balance of payments and debt forecasts were sensitive to EC trade policies.

On exchange rate policy, Mr. Finaish noted that the authorities shared the staff's view regarding the importance of maintaining export competitiveness for reducing the external imbalance. It was with respect to the desired means of offsetting the relatively modest real appreciation of the dinar that the authorities and the staff appeared to have their main difference of view. The authorities' preference for reversing the erosion in competitiveness through greater wage and price stability and the adoption of a larger currency basket to which to peg the dinar might also be appropriate and could possibly lead to a better management of the exchange rate. Moreover, measures taken recently to promote exports would strengthen that exchange rate policy. He noted from Chart 3 of SM/84/118 that only the real effective rate based on the wholesale price index had appreciated in the past few years, whereas the rate based on the consumer price index had been broadly stable since 1981 and had actually depreciated from an earlier benchmark. Neither of those indicators might be fully satisfactory, but the staff seemed to rely on the exchange rate based on the wholesale price index when judging the need for exchange rate action. Given the composition of Tunisia's external trade and the importance of tourism and oil exports as major sources of foreign exchange earnings, the question arose whether a real effective rate based on the wholesale price index was the most appropriate indicator of competitiveness. Competitiveness in the tourism sector might be related more to movements in the consumer price index than the wholesale price index, while oil receipts were clearly determined by an entirely different set of factors.

Although capacity in the tourism sector had been increasing in response to investments over the past four years, real value added had declined in the past two years, Mr. Finaish noted. Improvements were being made in those areas over which the authorities exercised control, such as the quality of services offered. However, exogenous developments, including the international recession and exchange restrictions in some European countries, had contributed to the instability of receipts from tourism. Moreover, another factor to be considered was the import content of the tourist industry. Such factors, in addition to social and other noneconomic considerations, would have to be given due attention in plans for future investments in that sector and in allocating resources among various sectors of the economy, including agriculture, which was particularly important for a more regionally balanced economic development. In conclusion, the authorities had been able to overcome their economic and financial problems in the past through the pursuit of pragmatic policies adapted to the circumstances, and there was no particular reason to doubt their ability to do so in the period ahead.

Mr. Nguyen commented that Tunisia's current situation had both good and bad aspects. On the positive side, GDP had increased by 4.5 percent in 1983, with a further increase of 5.5 percent expected in 1984. On the negative side, the current account and budget deficits had been growing. Those imbalances clearly called for corrective measures, but it was easier to adjust in a favorable environment than in a recession. The difference of opinion between the staff and the authorities regarding the pace of implementation of an adjustment policy was demonstrated by the staff's statement that "The Tunisian authorities generally shared the mission's assessment but emphasized the political and social constraints on making rapid progress." While he understood the authorities' point of view, any delay in adjustment could endanger the medium-term prospects. Nevertheless, he had confidence in the authorities' capacity to respond appropriately to unforeseen or adverse developments. He was in broad agreement with the thrust of the staff appraisal.

The most important objective of domestic policy was to reverse the increase in the budget deficit, mainly through expenditure cuts rather than by increases in revenues, given the already high tax burden and the nonrecurring nature of some taxes, Mr. Nguyen went on. Together, the subsidies and other recurrent transfers would reach 13 percent of GNP in 1984. There might be a strong case for arguing that, given the real growth of the purchasing power of the population in the past few years, an increase in prices for some commodities would be less painful at present. In that connection, he noted that the prices of cereal products had been increased in July 1984. On the revenue side, perhaps more progressivity in income taxes could be introduced.

The increase in budget transfers to the public sector enterprises from 3.8 percent of GNP in 1981 to an expected 5 percent in 1984 was a worrisome development, Mr. Nguyen said. Could the staff or Mr. Salehkhou elaborate on the prospects for those transfers? With respect to wage policy, the Government's objective of limiting the rate of increase to 8 percent was commendable and should be strictly observed, not only to improve the budgetary situation but also as an example for the private sector.

The excessive liquidity in the Tunisian economy justified a more restrictive monetary policy, Mr. Nguyen considered. Interest rates could be streamlined, and the staff had also advocated an increase in interest rates in order to boost domestic savings. The authorities had followed that advice in part by increasing to 9 percent the interest rate on convertible dinar accounts to attract a larger flow of workers' remittances. The question was whether that increase would be sufficient to attract further remittances, as it barely kept up with the increase in the consumer price index.

The importance of maintaining a high rate of growth of real GDP was evident from the prospects for the balance of payments and external debt, Mr. Nguyen went on. The authorities should pursue a flexible exchange rate policy so as to avoid the loss of competitiveness. The relaxation of controls on some imports could introduce more competition or reduce bottlenecks in the economy.

Such adjustment measures, which were intended to deal with short-term problems, should be strengthened by structural reforms, especially with respect to taxation and industrial policy, Mr. Nguyen added. A comprehensive reform of the tax system was being implemented. He asked whether the staff or Mr. Salehkhou could indicate how much additional revenue would be generated from the comprehensive reform of the tax system that was being implemented.

In view of the somewhat ambitious export goals, enterprise competitiveness and production would be of crucial importance, Mr. Nguyen said. Given the important role of the public sector enterprises in the economy and the large share of public finances that they absorbed, measures should be taken to improve the sector's efficiency. He welcomed the application of a more flexible pricing policy and greater autonomy in the public enterprise sector, although the effects on employment and inflation had to be kept in mind.

More generally, it would be preferable if the burden of restraining demand for credit was not borne by productive investments, which were projected to decline from 30 percent of GNP in 1983 to 26 percent of GNP in 1984, Mr. Nguyen commented. However, the latter figure was still respectable by international standards, provided that those resources were invested more carefully. The emphasis of investment in the Sixth Development Plan on the agricultural and manufacturing sectors seemed appropriate, as did the greater share directed toward the private sector.

He appreciated the crucial role of the World Bank in essential areas of the economy, such as rural development, transportation, and water supply, Mr. Nguyen said. While it was necessary to increase the pace of adjustment, it should be underlined that Tunisia was facing the task of adjustment and economic development without Fund financial support. He was confident that, if necessary, the authorities would take further appropriate action in the course of the year.

Mr. El-Khouri indicated his general agreement with the staff appraisal and his support for the proposed decision. Developments in the Tunisian economy during 1983 had been generally encouraging. After the virtual stagnation in economic activity during 1982, real GDP was estimated to have increased by 4.5 percent during 1983, mainly as a result of a rise in manufacturing output and energy production. Inflation, whether measured by changes in the consumer price index or the GDP deflator, had declined significantly in 1983. Projections for 1984 indicated continued strong economic growth and a further decline in inflation. He commended the authorities on those positive developments.

However, the financial strains that had emerged during 1982 had remained, Mr. El-Khouri continued. The budget deficit had doubled to about 5 percent of GNP in 1982, increased to 5.5 percent in 1983, and was expected to rise further to about 7.5 percent in 1984, despite commendable efforts by the authorities to raise revenues. Furthermore, the authorities were increasing their reliance on domestic bank financing of the budget deficit; such financing was expected to cover about 30 percent of the projected deficit for 1984.

Looking ahead, the pressure on the balance of payments was expected to increase, as Tunisia faced a possible decline in its net energy exports, Mr. El-Khouri continued. In addition, unemployment remained an important social problem. It was therefore important that the authorities intensify their adjustment efforts in order to achieve sustained noninflationary growth in the medium term, which would increase the chances of maintaining a viable external payments position while increasing employment opportunities.

The budget deficit must be kept under control to limit the need for both domestic and external financing, Mr. El-Khouri considered. Thus far, the adverse effects of the deficit on the balance of payments had been somewhat mitigated by the restrictions on imports. But as those restrictions were eased to help increase efficiency and improve the allocation of resources, a reduction in the domestic financing of the deficit would be essential to relieve the pressure on the balance of payments. In addition, there would be less need for foreign borrowing if the deficit was reduced. It was important that the manageable debt situation not be jeopardized.

The financial performance of the public sector enterprises should be strengthened further to reduce both the burden on the budget and competition with the private sector for domestic bank credit, Mr. El-Khouri stated. Progress had already been made in restructuring some of those enterprises, and a more flexible pricing policy had been pursued by enterprises in the transportation and utilities sectors. Those efforts were commendable and should be maintained.

The pursuit of prudent wage policies was important in ensuring a sustained noninflationary growth that was conducive to employment, Mr. El-Khouri commented. Excessive wage increases would aggravate demand and cost pressures, and would reduce competitiveness. He commended the authorities on their efforts to convince the social partners to limit wage increases in relation to productivity gains in 1984.

In the external sector, a number of measures--including the establishment of export-promotion companies, favorable financing arrangements, and export insurance facilities--had been implemented in recent years to enhance export performance, Mr. El-Khouri noted. Furthermore, the authorities had been following a flexible exchange rate policy aimed at maintaining competitiveness. Those measures had allowed for a rapid diversification of the export base. But he shared the authorities' concern about the impact of more restrictive policies by the EC on Tunisian exports.

The authorities were to be commended for their success thus far in implementing the Sixth Development Plan, 1982-86, Mr. El-Khouri remarked. The emphasis in the Plan had been appropriately placed on the development of the agricultural and manufacturing sectors. It was encouraging that actual investments had been broadly in line with the Plan's targets. The authorities' efforts to strengthen the agricultural sector--including the implementation of various institutional changes and the steady increase of producer prices for cereals and vegetables--were commendable. In conclusion, the authorities had been following prudent policies that had resulted in an encouraging economic performance and had helped to attract foreign capital to Tunisia, especially from the Arab countries. They needed to strengthen their adjustment efforts in some areas--particularly financial policy--to ensure the sustainability of noninflationary growth.

Mr. Grosche stated that he was in broad agreement with the staff appraisal and that he could support the proposed decision. Tunisia had emerged somewhat from the no-growth situation of 1982. However, substantial internal and external imbalances had emerged during previous years, partly as a result of adverse external circumstances, but primarily as a result of relaxed financial policies, insufficient structural adjustment, and inflexible external policies. Private and public consumption had increased, while savings and investment had declined. Interest rates remained negative in real terms. The budget for 1984 would again show a large increase in subsidies and transfers. The external position was weak, and an even larger deficit of the current account could be avoided only by tightening import controls. A further deterioration of the current account of the balance of payments was projected for the medium term. Thus, without major policy corrections, Tunisia might move farther away a viable balance of payments position. It was regrettable that after a promising start, the Government seemed to have abandoned its efforts to liberalize the economy and allow more room for market forces.

On fiscal policy, despite efforts to cut capital spending and restrain wage increases, total public expenditure was projected to grow by 21 percent in 1984, compared with 15 percent in 1983, as a result of rising subsidies and transfer payments, Mr. Grosche observed. He was aware of the social unrest that had followed the authorities' attempt to double bread prices in January 1984, but an increase of 50 percent in subsidies and transfers between 1983 and 1984 was a serious cause for concern. In view of the political difficulties, a more gradual approach to phasing out subsidies and transfers would be appropriate. According to the latest information provided by the staff, the authorities were moving gradually in the right direction by increasing the prices of cereal products by 10-20 percent. That first step was welcome, but it needed to be followed by further increases. High priority should be given to a thorough rehabilitation of the public sector enterprises; more autonomy and flexibility in setting prices and employment levels would be indispensable to that end.

As for monetary policy, he fully concurred with the staff that a less accommodative credit policy was appropriate, Mr. Grosche indicated. Real interest rates should be raised to positive levels so as to mobilize savings and allow for a more efficient allocation of financial resources. That action would also restrain the access to credit of the public enterprises. He would favor a monetary policy characterized by less discretionary intervention by the Government. Monetary policy was an overall instrument and was not well suited for sectoral purposes.

The authorities had favored a strong dinar and had tolerated, or even induced, an appreciation of the currency, probably because of the positive repercussions on the general price level, Mr. Grosche commented. The concomitant growth of imports had been held back by increased restrictions. He encouraged the authorities to review their approach. The slight depreciation of the dinar since January 1984 might be a sign of a more flexible exchange rate policy, which would stimulate exports and restrain imports by nonadministrative means, and would act as a check against the medium-term deterioration of the balance of payments position. A more flexible exchange rate would also be helpful in promoting nontraditional exports. Such a policy should be supplemented by sound fiscal and monetary policies.

Mr. Ionescu stated that he agreed with the staff appraisal and supported the proposed decision. After almost no economic growth in Tunisia in 1982, GDP had increased by 4.5 percent in real terms in 1983. Although it was commendable that manufacturing, with an increase of 9.3 percent in value added, had been the second most important activity contributing to the growth in GDP, he was concerned that the greatest increase in value added had been in construction materials and glass, which were energy-intensive industries. In that respect, he noted that in 1981-83 energy consumption had increased by 5.5 percent on average and that it was expected to increase by 8 percent a year in 1983-88. That rise in energy consumption was greater than the growth in national income for 1981-84. Average domestic prices for energy were close to international prices, and it was the authorities' intention to bring them in line with world prices by 1986. But he wondered to what extent the public enterprises, which he supposed were among the major users, were encouraged to save energy if their operating losses were met from the budget. A reduction in transfers from the budget to cover their losses was essential.

The authorities had recently examined ways to improve the efficiency of the public sector enterprises and reduce their reliance on budget transfers, Mr. Ionescu went on. However comprehensive those measures might be, their implementation would not be immediate. More convincing details about the reorganization of public enterprises in various countries had been given in other staff reports. Mr. Salehkhou had indicated that the authorities were in favor of pursuing flexible pricing and employment policies in public enterprises. While he could understand the authorities' intention to implement such reforms gradually in order to avoid socioeconomic disruptions, the reduction of the subsidies to public enterprises should be a priority objective.

The difference of opinion between the staff and the authorities about lending rates was related to their attitude toward the financial viability of the public enterprises, Mr. Ionescu observed. The authorities considered that raising lending rates would mean that public enterprises would have to be compensated by increased budgetary transfers, an observation that, in his view, demonstrated the urgency of improving the financial performance of the public enterprises.

Revenues were high in Tunisia, representing 26 percent of GDP, but there was also widespread tax evasion, Mr. Ionescu noted. In that respect, there were contradictory developments in the economy. On the one hand, liquidity had increased and imports of consumer goods had risen significantly in 1983. On the other hand, the poorest segments of the population had been unable to accept an increase in the price for bread. In his view, those developments indicated that fiscal policy was affecting the population unevenly, with the lower-income segments being burdened unfairly. He therefore agreed with the staff that elimination of tax evasion should be a priority.

He shared the authorities' concern over the excessive recourse to protectionism by Tunisia's traditional trade partners in the EC, Mr. Ionescu said. To achieve a sustainable external position in the medium and long term, Tunisia must increase its nonenergy exports. It was therefore essential that Tunisia have fair access to the markets of the EC. He was concerned that while nonenergy exports were projected to increase by 13.7 percent in 1984 the entire growth in exports during the first quarter of that year had been attributable to a rise in petroleum exports. Finally, he welcomed the authorities' intention to take the steps necessary to preserve external confidence in the economic and financial management of the economy and to achieve the development objectives without relying too heavily on foreign borrowing.

Ms. Lundsager stated that she was in broad agreement with the staff appraisal and could support the proposed decision. The current economic situation in Tunisia reflected the cumulative effects of both external developments and domestic economic policies. While the external events had been beyond the control of the authorities, they nonetheless had required decisive responses to cushion their impact on the domestic economy. Regrettably, the inability of the Tunisian Government to successfully implement a comprehensive adjustment package might have led to the recent deterioration in the economic situation, which had contributed to the sharp decline in official reserves thus far in 1984. The situation would only worsen if action were not taken soon.

The difficulties associated with the imposition of austerity measures on the country's population highlighted the need for developing a social consensus, Ms. Lundsager went on. However, it appeared that the authorities now had the opportunity to make some changes without inducing severe hardships, given the lower inflation rate and the increase in economic growth to 4.5 percent in 1983 and to a projected 5.5 percent in 1984. Initial changes had been made in some government policies, but they should be strengthened.

More serious problems were to be found in the fiscal sector, Ms. Lundsager observed. The recent expansion of the fiscal deficit, which had doubled as a ratio to GDP in 1982 and was projected to increase by 2 percentage points in 1984, represented a serious burden on the economy. In fact, the deficit in 1984 might be even higher, as projections had not assumed any public sector wage increase. The large deficit was draining resources from the private sector and increasing the need for the Government to turn to external borrowing, contracted at market rates. Those funds were used to cover current expenditures and were not being used for productive investment; thus, they were not increasing the country's capacity for future debt repayment.

As taxes were already high, she concurred with the staff suggestion that the authorities should concentrate on reducing expenditure, Ms. Lundsager said. More specifically, budgetary problems centered around the high degree of subsidization in Tunisia. Subsidies and transfers were projected to reach 13 percent of GNP in 1984; the cereal subsidy alone was estimated to reach the equivalent of 4 percent of GNP. Besides straining the financial resources of the economy, that high degree of subsidization encouraged wasteful consumption. Those concerns would be met if the domestic price of petroleum products was raised to match the world price, as the staff suggested. On the positive side, she was encouraged by the 10-20 percent increase in the price of cereal products in July and hoped that a further adjustment could be made in the near future. She welcomed the fact that government wages had not been increased. Given Tunisia's high unemployment, the emphasis in the Sixth Development Plan on labor-intensive development and private sector investment was appropriate. However, she urged the authorities to scale back planned expenditure so that the highest priority goals could be reached. She noted that there had recently been a World Bank mission to Tunisia and hoped that the midterm review of the Plan would help to set priorities.

She concurred with the staff recommendation that monetary growth should be tightened, especially the growth of credit to the Government, Ms. Lundsager continued. A more restrictive monetary policy would permit the authorities to reduce some subsidies without generating a dramatic increase in overall inflation. In addition, there had been no change in interest rates on deposits in the past few years, leaving rates slightly negative in real terms. Higher interest rates would stimulate savings, making it more palatable to reduce consumption.

The policy mix currently being used to regulate the external sector was also contributing to inefficiency in the economy, Ms. Lundsager commented. The wide spectrum of import controls protected domestic industries, giving them little incentive to operate efficiently. The real appreciation of the dinar since 1981, based on the wholesale price index, also hindered the production of exports and import substitutes. The authorities indicated that they did not wish to devalue the dinar, fearing that it would discourage direct investment in Tunisia. She would suggest that, in fact, foreign investors might be anticipating a devaluation and therefore postponing their investments to such time as the equivalent local currency cost of the investment would be less. Given Tunisia's admirable stance toward direct investment, it would be regrettable if an inappropriate exchange rate were to hinder the investment flow.

In sum, the medium-term projections included in the staff report were based on the assumption that "the authorities could effect major macrostructural changes," Ms. Lundsager noted. Even so, they showed a gradually widening current account deficit and increasing debt service ratio. She urged the authorities to take heed of the warning embodied in those projections; if adequate adjustment measures were not implemented, the deterioration would worsen in the near future.

Mr. Jayawardena commented that after strong growth over a long period, the Tunisian economy had suffered a setback in 1982, largely owing to adverse exogenous developments. However, performance in 1983 had improved substantially, and projections for 1984 indicated further improvement, mainly as a result of the introduction of several corrective adjustment measures. The widening fiscal deficit continued to be a matter of concern, as was the financing of that deficit by domestic bank and foreign borrowing. Given the rising debt service ratio, he was sure that the authorities did not consider resort to foreign finance to be an easy solution to the fiscal imbalance. Moreover, domestic bank borrowing could rekindle inflationary pressures.

The medium-term balance of payments scenario showed that the current account deficit would remain at about 8 percent of GNP in the foreseeable future, Mr. Jayawardena observed. He welcomed the institutional measures taken to promote exports, and he was pleased that the authorities did not regard those measures as sufficient by themselves, but would consider the option of aligning domestic and international prices through exchange rate flexibility. Such action would help the authorities in their efforts to diversify the economic base. The easing of protectionist barriers abroad was particularly important in that respect. On a related point, the authorities should consider the economic costs of the distortions resulting from trade and price controls. An appropriate exchange rate and tariff regime, and greater reliance on market forces, should help the authorities to achieve greater economic efficiency.

He was aware of the social and political constraints involved in improving fiscal performance and freeing the economy of current distortions, Mr. Jayawardena stated. A cautious approach, rather than inaction, was called for, as the medium-term balance of payments and the debt service outlook did not indicate an adequate cushion for potential external shocks or adverse exogenous developments.

The staff representative from the African Department stated that the medium-term projections for the balance of payments and external debt were based on a number of assumptions, including normal access to external markets. Tunisia had been particularly affected by the EC restrictions on textile imports, applied since 1981. More recently, those restrictions had been extended to cover textiles processed in Tunisia with raw materials imported from the EC. There were, at present, no other restrictions on goods exported by Tunisia to the EC, but the authorities feared that restrictions on mechanical and electrical products might be imposed in the future. With respect to exports of olive oil, which accounted for a large proportion of Tunisia's total exports, Tunisia would be able to obtain an import quota of at least 50,000 tons, which was close to its actual export capacity, after Portugal and Spain joined the EC. Overall, the medium-term balance of payments scenario presented in the staff paper would not be greatly influenced by EC trade restrictions, but would depend more on domestic factors.

There had been considerable divergences in the behavior of the indices of real effective exchange rates, depending on the indicator used to measure domestic cost and price developments, the staff representative noted. The real effective rate based on the consumer price index had shown a modest appreciation over the past three years. However, the significance of that index was reduced by the existence of price controls and subsidies, and it was not a good measure of the change in competitiveness of the tourism sector, which was not directly affected by the basket of goods used to calculate the consumer price index. The real effective exchange rate based on the wholesale price index had shown a more substantial appreciation of about 7 percent over the past three years, because domestic prices as reflected in that index were not directly influenced by subsidies or price controls. Using an index based on unit labor costs, the appreciation would be close to 15 percent. However, that calculation involved a number of estimates regarding value added, employment, and productivity, and was not necessarily a precise indicator of Tunisia's competitiveness. The staff did not specifically advocate a strong discretionary change in the exchange rate, but emphasized that in order to reverse the erosion of competitiveness or to relax import restrictions, Tunisia would have to adopt a stricter monetary, fiscal, or incomes policy, which might have higher economic and social costs than a more flexible exchange rate policy.

The staff did not have a precise indication of the effect of the increase in the interest rate on deposits of workers' remittances, the staff representative continued. The authorities expected that the amount of financial savings transferred to Tunisia would increase as a result of an adjustment in the deposit rate. The Central Bank of Tunisia estimated that about one third of the financial savings of workers in Europe was deposited in Europe.

The tax reform had two components, the staff representative commented. First, the reform of the income tax was aimed at reducing widespread tax evasion and the disparities between the various categories of taxpayers. It would result in a lowering of the tax rate as well as a strengthening of tax administration in an effort to expand the tax base. Second, the gradual introduction of a value-added tax would partly replace the system of indirect taxes on transactions. While the implementation of the tax reform was necessary to reduce income disparities, it was not expected to increase government revenue significantly in the short term, partly because of the expected decline in oil revenue. The tax burden was already high, although not by comparison with other North African countries. The staff believed that remedial fiscal action should focus on expenditure.

The stability of the ratio between quasi-money and GNP over the past five years reflected a sharp change in the structure of savings, the staff representative from the African Department indicated. The share of household savings had increased substantially over the past two years, as wages had increased and savings had been transferred from the public enterprise sector to consumers.

Mr. Salehkhou remarked that the differences of opinion between the staff and the authorities should be regarded only as matters of emphasis and priorities. The broad objectives of the authorities' economic policy were the same as those of the staff, although the instruments used and the emphasis given to each of them might be different. The authorities had preferred to pursue a slower pace of adjustment as they were convinced that only a gradual correction of distortions and introduction of structural reforms would be successful, given the social and political realities in Tunisia.

On the question of interest rate policy, the staff report had not emphasized enough the crucial effect of interest rates on the diversification of the economy, Mr. Salehkhou considered. The interest rate had been used as an instrument to encourage the development and promotion of priority sectors, particularly the agricultural sector, which had benefited considerably from the low interest rates on agricultural investment. The improvement in the agricultural sector had, in turn, helped to contain the migration of the rural population to the urban areas.

Although the current account deficit of the balance of payments was projected to remain at about 8 percent of GNP through 1988, the financing of the deficit was expected to be sustainable, Mr. Salehkhou indicated. The additional borrowing required would result in only a small increase in Tunisia's low external debt service ratio. Finally, despite the deterioration of Tunisia's domestic and external financial position, there had been a commendable expansion of real growth since the mid-1970s, owing primarily to the authorities' development policies largely aimed at the expansion of the agricultural and manufacturing sectors. The success of those policies, however, was somewhat threatened by a number of exogenous factors, including protectionist practices in some of the country's major export markets. Furthermore, despite a relatively liberal payments system and a number of financial incentives, there had been a marked deceleration in foreign investment. He hoped that those adverse trends would be reversed, and that domestic adjustment would therefore be made easier.

The Acting Chairman made the following summing up:

Directors generally concurred with the views expressed in the staff appraisal. The rebound in Tunisia's economic activity in 1983, the decline in the inflation rate, and the prospects for a sizable increase in real GDP growth during 1984 were cited by Directors as positive developments. However, they expressed concern over the deterioration in a number of areas, particularly in the domestic financial situation. Unemployment was also a difficult problem that remained. While exogenous developments were partly to blame, policy weaknesses were also identified as being a major cause of the widening fiscal deficit, the large increase in wages, and the rapid credit and monetary expansion.

Directors stressed the need to strengthen adjustment measures in view of the expected deterioration in the current account. Significant adjustment was considered necessary for Tunisia to maintain a viable balance of payments position and to provide an environment conducive to economic growth and employment.

In the fiscal area, Directors commented on a number of recent favorable developments, in particular, the wage and salary restraint and upward adjustment in cereal prices. Nevertheless, additional steps would be needed to avoid a sharp increase in the fiscal deficit. While appreciating the political and social constraints faced by the Tunisian authorities, and also noting that the tax burden was relatively high, Directors nevertheless considered it necessary to strengthen tax administration and to apply restraint to the rapidly rising expenditure components. With respect to expenditures, the authorities' recognition that capital outlays had to be scaled back was welcomed, but Directors cited other areas--in particular, the Government's wage bill, extensive consumer subsidies, and transfers to public enterprises--where savings should be sought. Directors also stressed the importance of putting the public enterprises on a sound financial basis: they noted that greater price flexibility could be a means for accomplishing that objective, and a number of speakers suggested that there might be a need for some restructuring of the public enterprises.

Regarding monetary and credit policy, Directors believed that substantial moderation was called for in credit growth, and some Directors pointed to the positive role that could be played by a more active interest rate policy and a rise in interest rates in order to encourage savings. Directors also emphasized the need to restrain wage increases in the future to keep them in line with productivity trends.

Directors observed that capital outlays under the Sixth Development Plan has so far agreed broadly with the Plan's target allocations, which stressed the agricultural and industrial sectors and encouraged private sector development. It was also mentioned that the planned emphasis on more labor-intensive development was positive. Great importance was attached to agricultural prices that would be remunerative and encourage production.

In view of the importance of substantial growth in nonenergy exports for Tunisia's medium-term balance of payments viability, and in light of the recent erosion in Tunisia's competitiveness, a number of Directors stressed that the authorities should conduct an exchange rate policy in a flexible manner so as, at a minimum, to prevent a further real appreciation of the dinar. While it was desirable for Tunisia to remove import restrictions for internal efficiency and growth, concern was expressed about the extension of protectionist practices and constraints in some of Tunisia's major export markets.

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

The Executive Board then took the following decision:

Decision Concluding 1984 Article XIV Consultation

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Tunisia, in light of the 1984 Article IV consultation with Tunisia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. No significant changes have been made in Tunisia's system of exchange restrictions since the last consultation. The Fund encourages the authorities to ease restrictions on payments and transfers for current international transactions.

Decision No. 7784-(84/127), adopted
August 10, 1984

APPROVED: May 28, 1985

LEO VAN HOUTVEN
Secretary