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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/139

10:00 a.m., September 10, 1984

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
	H. G. Schneider
	X. Blandin
A. Donoso	M. Teijeiro
	M. K. Bush
	M. Lundsager, Temporary
	T. Alhaimus
	T. Yamashita
G. Grosche	B. Goos
J. E. Ismael	
R. K. Joyce	L. Leonard
A. Kafka	
G. Lovato	
	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
	M. Camara, Temporary
	J. L. Feito
	K. A. Hansen, Temporary
	T. A. Clark
Zhang Z.	

L. Van Houtven, Secretary
R. S. Laurent, Assistant

Also Present

F. Escobar, Director, Financial Policy, Central Bank of Chile. African Department: P. Beaugrand, R. O. Carstens, F. d'A. Collings, Y. Fassassi, M. G. Gilman, U. Wilson. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; E. H. Brau, P. A. Molajoni, T. H. Mayer. External Relations Department: H. P. Puentes. IMF Institute: M. D'Almeida, K. M. Dossa, Participants. Legal Department: Ph. Lachman, P. L. Francotte. Middle Eastern Department: S. H. Hitti. Research Department: E. A. Milne. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; P. D. Brenner, M. Caiola, H. M. Flickenschild, C. M. Loser, C. G. Muniz B., J. F. van Houten. Bureau of Statistics: P. Gschwindt de Gyor. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, L. K. Doe, H.-S. Lee, W. Moerke, G. E. L. Nguyen, D. I. S. Shaw, A. Steinberg, D. C. Templeman. Assistants to Executive Directors: J. R. N. Almeida, I. Angeloni, R. L. Bernardo, J. Bulloch, C. Flamant, N. U. Haque, L. Ionescu, S. Kolb, A. Koné, K. Murakami, G. W. K. Pickering, D. J. Robinson, C. A. Salinas, A. A. Scholten, M. A. Weitz.

1. CHILE - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the mid-year review under the stand-by arrangement for Chile (EBS/84/179, 8/20/84; and Sup. 1, 9/7/84).

Mr. Fernando Escobar, Director of Financial Policy of the Central Bank of Chile, was present for the discussion.

Mr. Donoso made the following statement:

The successful completion of this review is one of the prerequisites for completing the consultation under the stand-by program, which would allow Chile to keep moving within the agreed policies and targets.

As mentioned in the staff report circulated to Executive Directors, Chile has made great strides toward financial stability and has resumed economic growth, all this in compliance with the performance criteria included in the stand-by program.

This accomplishment has taken place within an unusually adverse international environment for Chile. Despite the world recovery, the country has seen a sharp deterioration in its terms of trade, which is dramatized by the low prices in the world market for Chile's main export, copper. One of the key assumptions in the financial program negotiated with the Fund and the international banking community was the copper price. For the third quarter, the program projected an average price of 80 U.S. cents per pound while in reality it has barely been above 60 cents. Even more damaging has been the dangerously high interest rate that Chile has had to pay on its external obligations. The reference rate in the original program was 9.5 percent. Each decline by 1 U.S. cent in the copper price means US$26 million less in foreign exchange receipts for Chile, while each percentage point of increase in the interest rate means approximately US$150 million a year of additional outflow. It should also be mentioned that unusually hard weather conditions this past July caused serious damage to an extensive area of the country, which has required an expensive emergency program.

So far the Chilean authorities have been successful in compensating for the exogenous adverse factors just mentioned. Even though the road ahead is a difficult one, the Chilean authorities would like to express to the Board what they reiterated to the staff: their will and determination to continue to adhere to the economic program agreed upon with the Fund, despite the pressures imposed on the balance of payments and the fiscal accounts by developments beyond their control. This, of course, will be a difficult task both economically and politically.

> There is considerable uncertainty about the future course of external events. For this reason, the Chilean authorities are adopting a cautious attitude, and they are planning to keep in close touch with the Fund staff in the months ahead. They already have discussed the convenience of a number of policy adjustments, of a monetary and fiscal nature. The Chilean authorities have also agreed to an additional review of policies for the last quarter of this year, which will require a staff mission to Santiago in October. The Chilean Government thinks that during this visit it is essential to initiate formal discussions on a new Fund-supported economic and financial program for the coming years. Negotiations with foreign banks should begin in the next few weeks, and a successful completion of an external financing program for 1985 and beyond will require the backup of a new arrangement with the Fund.
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> The Chilean authorities have repeatedly expressed their conviction that they will have to work closely with the Fund for many years to come. This calls for a reaffirmation of the open and straightforward relationship that Chile has maintained with the Fund in the past. In this spirit, the Chilean authorities would like to request from the Board a positive response to the staff's proposed decision.

Mr. Kafka noted that the two basic external assumptions underlying the program--stability of interest rates and copper prices--had both failed. Nevertheless, the authorities had made substantial progress in restoring output and bringing inflation down; as of June 30, 1984, all performance criteria had been met with a considerable margin. As a result, the present outlook was less uncertain than it had been during the Board's discussion in May of the staff report for the 1983 Article IV consultation with Chile (EBM/84/76, 5/14/84).

Fiscal performance had been better than programmed, Mr. Kafka continued. The slight excess on the current account deficit, which was a fraction of 1 percent of GDP more than expected, had been caused by an increase in imports in anticipation of higher import duties. In addition, the authorities had taken the right decision in July by imposing a 15 percent tariff surcharge on luxury goods. The surcharge, a precautionary measure that deserved commendation from the Fund, had provided extra government revenue at a time when external factors might impose additional pressure on the balance of payments. Although the staff considered that it would not be appropriate under present circumstances to activate the contingency plan that would have permitted an increase of up to 0.8 percent of GDP in the deficit of the nonfinancial public sector in the second half of 1984, he would nevertheless feel that if the balance of payments appeared to be improving, part of the plan could still be activated.

The staff had re-estimated the balance of payments projections for the medium term made the previous March, Mr. Kafka noted. Chile's balance on current account was expected to deteriorate further, principally because the growth of exports was expected to slow during the next few years. Changes in medium-term projections over such a short time suggested that the staff's six-year estimates were quite sensitive to day-to-day changes. While he could understand the need to revise estimates when totally unexpected factors arose, particularly exogenous ones beyond the authorities' control, it might be asking too much to expect semiannual reports. Perhaps the staff should limit itself to forecasting a range of possibilities.

He welcomed the authorities' perseverance in maintaining a policy of promoting positive real interest rates, which were particularly important given the low savings ratio, Mr. Kafka concluded. Current indications for the 1984 savings ratio were hardly different from those for 1980, a development on which he would appreciate staff comment. Finally, he did not object to the provision in the proposed decision contemplating a further review by the Board before Chile could make the final purchase, but too many reviews might cause the Fund to become excessively involved in the day-to-day operations of authorities in member countries.

Ms. Bush commented that since the inception of the stand-by arrangement, she had been impressed with the determined manner in which the Chilean authorities had confronted a difficult problem of economic adjustment, and in particular by their ability to put the economy back on the adjustment path in 1983 after encountering serious problems in the banking system. However, in May 1984 her chair had cautioned that given the priority assigned to the recovery of the economy from the deep decline in real growth in 1982 and 1983, there was a danger that a premature resurgence of domestic demand could undermine adjustment at a time when the rate of inflation remained too high, the current account deficit large, and the foreign debt burden among the world's most serious. In May, her chair had also raised some questions about the adequacy of exchange rate policy. In fact, the staff paper for the current review identified problem areas developing in the balance of payments, the budget, and monetary policy; the staff also pointed out that little progress had been made in dismantling the restrictive system. On the other hand, the information in the supplement to the staff paper helped to allay such fears, as did in particular the decision to conduct an additional review of policies before the Chilean authorities could make the final purchase under the stand-by arrangement.

The staff paper indicated that there had been continued strong growth for the first half of 1984, Ms. Bush went on. For instance, GDP was almost 7 percent higher than the same period a year ago, with industrial production nearly 11 percent higher. For the year as a whole, the forecast growth rate was expected to be about 4.5 percent instead of 4 percent. A positive factor was that some of the additional growth would take the form of a higher than expected investment rate, especially in the private sector. Unfortunately, the private savings ratio was expected to decline, so that the share of investment to be financed from foreign savings would rise, a worrisome development.

She hoped that the expected faster growth would not be accompanied by a resurgence of inflation or a worsening of the balance of payments position, Ms. Bush noted. In fact, although inflationary performance was better than expected, the balance of payments performance was worse. The staff estimated that Chile's current account deficit was likely to equal 7.5 percent of GDP, instead of the earlier estimate of 6 percent. Fortunately, the volume of copper exports had risen sufficiently to offset the price decline, but the faster pace of recovery had evidently led to faster than expected import growth, while noncopper exports did not appear to be doing especially well. In fact, such exports had followed a generally declining trend between 1980 and 1983, and the latest forecast showed a slight scaling down in the growth rate for 1984. Also somewhat disturbing was the buildup of short-term debt during the first half of 1984; the Fund's experience with debt problems during the past few years had made it clear that such a trend was one of the main symptoms of trouble ahead for a country, especially when the inflow had been encouraged by the monetary authorities.

On the fiscal side, Ms. Bush said, she was pleased that the staff and the Chilean authorities had agreed that it was not appropriate at present to implement the proviso in the stand-by arrangement for contingency spending. In fact, unless new fiscal measures were taken, there would probably be an increase in the public sector deficit in 1984 from some 4.5 percent of GDP to some 5.5 percent, without the use of that proviso. She was glad that the authorities had taken additional fiscal measures to bring the deficit down toward the original target, and also that they would notify the Fund of any future measures before the October mission. Nonetheless, the greater part of the new fiscal measures affected the revenue side, and some of them were transitory. Did the new travel tax constitute a new multiple currency practice?

Concerning monetary policy, Ms. Bush stated, the staff had highlighted several problem areas: the Central Bank was continuing to use subsidies, especially to entice capital inflows, and was also expanding its role in intermediation. Neither of those developments seemed to be in keeping with the basically free-market approach to economic policy taken by the authorities. In addition, according to the terms of the stand-by arrangement, subsidies were supposed to be reduced between March 1984 and March 1985. Consequently, she had been pleased to read that the authorities intended to raise deposit rates, resulting in a reduction of such subsidies. Perhaps the staff or Mr. Donoso could explain the size of the subsidies and the extent to which they would be reduced. In any event, it seemed clear that monetary policy for the remainder of 1984 would need to be tighter if Chile were to stay on the planned path of adjustment. She was reassured by the authorities' commitment to meeting the credit and international reserve targets contained in the program.

She remained concerned about the exchange rate, not just because of the real appreciation of the peso but also because of the recent worsening of the current account position and the prospects for dealing with the debt burden, Ms. Bush remarked. The rise in the spread between the official exchange rate and the parallel rate of about 25 percent--and the emergence of a multiple currency practice as a result--were further warning signs. Related to the question of the adequacy of the exchange rate was the continued upward creep in restrictive measures. For instance, the 15 percent surcharge on imports of luxury goods, introduced in July, might be justified on revenue grounds, but it also raised questions about growing de facto protectionism in Chile. The authorities also appeared to have made little progress so far in reducing foreign exchange restrictions and eliminating multiple currency practices.

In conclusion, there were some clouds on the horizon in Chile, but the authorities had taken steps to dissipate them, Ms. Bush noted. She took comfort from Chile's past performance and hoped that those measures would be strengthened further, if necessary.

Mr. Lovato said that the Chilean authorities' policies for the second year of their stand-by arrangement had been subject to the unsettling events of 1983, which had jolted the domestic consensus established the previous year. More recently, external conditions had worsened considerably, as world interest rates had climbed and copper prices had plummeted. The framework of the Chilean adjustment program implied a strain for an already severely dislocated productive system. Yet policymaking in Chile did not have ample room for maneuver in the medium term, being restrained by a large accumulated external debt and an exceedingly onerous debt service schedule for the next few years.

Like the staff, Mr. Lovato said, he had been disturbed by the large increase in short-term external borrowing recorded so far in 1984, which he found to be inconsistent with the policy understandings underlying the present program. As he recalled, the strategy for managing external debt announced by the authorities during the May review had had as its foundation the goal of reducing total net borrowing in a manner consistent with decreasing use of external finance and greater use of domestic resource utilization. Moreover, the amount of capital flows envisaged over the medium term in the balance of payments projections in Table 12 of EBS/84/179 implied both new loan disbursements and a rescheduling agreement to be reached with creditor banks. Could the staff or Mr. Donoso say what degree of confidence should be attached to that projection? In any event, given Chile's high debt servicing obligation for the next few years, a substantial amount of adjustment remained to be accomplished in terms of the domestic resources that would have to be transferred abroad to generate the needed foreign exchange.

Previously, Mr. Lovato continued, he had welcomed the flexible exchange rate policy followed since December 1983 and had thought that maintaining a stable value for the peso in real terms would give a stronger impetus to the trade sector and hence improve the near-term outlook for the current account. Had recent developments prompted the staff and the Chilean authorities to reassess their conduct of exchange rate policy? Furthermore, had the spread between the official and the parallel exchange rates for the peso remained as wide recently as it had been earlier in 1984?

The increasing protection afforded to domestic industries was a matter for concern, Mr. Lovato considered. In particular, import duties had proved to be a permanent feature of the Chilean trade system rather than a temporary one, and stood in apparent contrast to the undertakings agreed to by the authorities under the program. He therefore urged them to change direction.

On the monetary and fiscal fronts, the supplementary paper together with Mr. Donoso's statement had dispelled to some degree the impression of a paralyzing policy vacuum that he had gained from the staff report, Mr. Lovato went on. Indeed, the contingency fiscal measures adopted recently were expected to maintain the budgetary upturn within program objectives. On the monetary side, the country should adhere to the undertakings agreed with the Fund, if, as the staff stressed, those measures were transitory and could not be relied upon to address Chile's external imbalances. In conclusion, the staff was right to observe that corrective policies would need to be implemented for 1985 and beyond.

Mr. Feito shared the appraisal made by the staff and supported the proposed decision. The authorities were to be commended for their courage and determination in complying with the performance criteria of the program in the face of mounting difficulties. Even after having experienced negative rates of GDP growth per capita and still greater negative rates of per capita growth of imports and consumption in 1983, and notwithstanding an adverse international economic environment, the country had complied with the intermediate objectives of the program, indeed overperforming in some areas.

The poor private savings ratio in Chile over the past few years might have something to do with the severe decline in per capita income experienced by the country during those years, Mr. Feito said. In general, the savings ratio fell in the face of a deceleration in the growth of income, all the more so when interest rates were negative in real terms, as they had been in Chile recently. It should be recognized, however, that the savings ratio in Chile had been rather low, even at times of high growth in real GDP.

Chile's compliance with the program in such a difficult environment augured well for the final success of the program itself and also for whatever relationship the Fund might establish with Chile in the years ahead, Mr. Feito remarked. The sharp decline in the country's terms of trade, together with the rise in nominal interest rates internationally, would call for greater trade surpluses and consequently a larger fiscal adjustment than initially programmed to achieve the desired viable balance of payments structure. The larger than planned correction of the fiscal imbalance had contributed to the accommodation of negative external developments within the framework of the program.

He shared the authorities' view, expressed by Mr. Donoso, that they should try to continue to offset such negative effects so as to keep on the path of adjustment envisaged under the current stand-by arrangement, Mr. Feito concluded. Successful conclusion of the program might help to improve the state of confidence both at home and abroad. Therefore, the authorities might have to make the necessary efforts to continue to meet performance criteria for the remainder of the program. They might then be able to initiate a new program on the basis of the change in Chile's real and financial terms of trade and with the external resources available at such a time.

Mr. Clark commended the authorities for having kept the program under the stand-by arrangement on track and for meeting all the performance criteria for June in the face of continued external difficulties. It was encouraging that growth in the first half of 1984 had been higher than expected: employment had grown considerably, while inflation had continued to fall. However, because of weaker world copper prices and higher world interest rates, prospects for the second half of the year and beyond looked more difficult. He agreed with the staff that those developments, together with Chile's larger than expected current account deficit and the continuing difficulty of its medium-term prospects, made it inappropriate for the authorities to activate the official contingency reserve. Indeed, the staff analysis suggested that further fiscal restraint would be needed if the deficit target of 4.5 percent of GDP were to be met.

The measures outlined in EBS/84/179, Supplement 1 went most of the way toward meeting that objective, Mr. Clark continued, although a gap of 0.2 percent of GDP still remained. On the assumption that the gap would be eliminated by October, and given the additional monetary measures currently planned by the authorities, he could support the proposed decision.

He welcomed the fiscal outturn during the first half of 1984, with the current account surplus of the nonfinancial sector at 1.1 percent of GDP having been higher than expected, Mr. Clark said, a change that had partly reflected expenditures postponed to the second half of the year. It was noteworthy that the authorities had maintained effective restraint on public sector wages in spite of understandable pressures for increases following a sharp drop in real wages in 1983. How far was the authorities' restraint being reflected in wage settlements in the private sector?

Like the staff, he was concerned about certain aspects of monetary policy, Mr. Clark explained. In particular, he was concerned about the maintenance of relatively low domestic interest rates combined with subsidy schemes to attract short-term capital inflows. Besides having obvious dangers, the strategy was resulting in financial losses for the Central Bank. Would the staff provide its views on the implication of those operations on Chile's net reserve position? He had also been concerned by references in the staff report to the Central Bank's role in financial intermediation. Like the staff, he would strongly encourage the authorities to raise domestic interest rates and eliminate such schemes as soon as possible, and he had been glad to see that measures toward those ends were being proposed in EBS/84/179, Supplement 1.

Because of the widening gap between official and parallel exchange rates for the peso, he agreed with the staff's view on Chile's exchange rate policy, Mr. Clark noted. In addition, he attached some importance to the authorities' setting a specific timetable to eliminate the exchange restrictions and multiple currency practices as soon as possible. In fact, he would have preferred future drawings by Chile to have been contingent upon progress in that area. Could Mr. Donoso elaborate on where the authorities stood on those issues?

Developments in international copper prices would be crucial for Chile, both in the short term and in the medium term, Mr. Clark concluded. Although it was encouraging that the prospects of the United States imposing restrictions on copper imports had recently receded, he nonetheless wondered whether the staff's projections for the copper price in the future were not somewhat optimistic.

Mr. Joyce commented that Chile had achieved greater than expected growth in GDP and higher employment in the first half of 1984, despite adverse economic conditions and poor weather. In the circumstances, the authorities were to be particularly commended for having met all the performance criteria under the program at the end of June. Since the Executive Board had last discussed Chile in May, the authorities had shown evidence of implementing policy measures with prudence and perseverance. Despite improvements in the overall economy, the notable reduction in inflation, and growth in the private sector, the overall balance of payments position remained quite weak. Of course, the international environment had also been adverse: copper prices had fallen below the figure envisaged when the program had been designed, and international interest rates had risen further. Such external developments underscored the need for the authorities to take additional steps if they were to adhere to the original objectives in the program and maintain a sustainable balance of payments position.

On fiscal policy, the authorities were to be commended for their good performance in reducing the deficits of the nonfinancial public sector below the figure originally planned for the first half of 1984, Mr. Joyce remarked. However, he agreed with the staff that it would be inappropriate to activate the contingency spending provisions at present. He found it discouraging that the fiscal gap for 1984 had not yet been closed. The authorities would have to adopt further measures quickly if they were to sustain the momentum of adjustment.

In the monetary area as well, there was a need for a further tightening of policy if the program targets for the balance of payments were to be achieved, Mr. Joyce continued. He supported the staff view that domestic interest rates needed to be raised further and that the authorities must eliminate subsidies by the Central Bank. Although he welcomed the authorities' efforts to strengthen their financial system by recapitalizing domestic banks, he had the impression that the pace of adjustment in the monetary sphere was too slow.

Wage pressures in the public sector remained strong, Mr. Joyce observed, and the authorities had publicly rejected any further wage increases in 1984, a stance for which they were to be commended. Any deviation from the current tight wage policy could seriously undermine the adjustment effort. Although he appreciated Mr. Kafka's point that too many reviews might overburden either the Chilean authorities or the staff of the Fund, it did seem that, given the progress achieved under the Chilean program, a review in October would be vital. The authorities themselves had yet to decide how they were going to close the fiscal gap, and the economic situation in Chile was continuing to weaken. The authorities had set out a number of measures, some already introduced and others requiring approval, but even the additional measures would not in themselves close the gap entirely. If the authorities deferred taking action until the October review, there would probably not be enough time left to introduce the necessary further measures in 1984. Therefore, he urged them to have those measures in force before the review.

He agreed with Mr. Donoso that the review could be used as a basis for initiating discussions on a follow-on program with Chile, Mr. Joyce said. He felt fairly sure that such a program would be needed. In any event, it was essential that the current program should be concluded successfully; otherwise there would be no point in launching another Fund program. Thus, the immediate priority for the Chilean authorities must be to take the necessary measures to ensure that the program continued to succeed. Thereafter, they could begin to talk about what strategy should be pursued with a view toward achieving the medium-term objectives identified by the authorities and the staff.

Mr. Polak noted that Chile had once again been hit hard by unfavorable external developments, which had required a further strengthening of the adjustment effort. He welcomed the authorities' courage in facing up to the task. It was indeed disconcerting that the medium-term scenario envisaged a new recession for 1985 and 1986. It was likely that Chile would have to undertake new debt rescheduling, the scenario requiring more than one new fresh money package; the current account deficit was considerably larger than earlier in the year. Moreover, there were questions whether such a path of adjustment would be feasible. A recovery of the price of copper was uncertain, and he was unsure where the projected inflows of capital over the medium term were supposed to come from. Further adjustment thus seemed unavoidable.

Chile's exchange rate policy should be considered during the October review and in discussions for the program for 1985, Mr. Polak considered. On a more technical aspect, present exchange rate policy did not take into account either exchange rate developments in Chile vis-à-vis other Latin American countries or the third-market effects of such developments. He could see the practical difficulties of incorporating into any formula the accurate real effective exchange rate of a relatively low-inflation country against countries with high inflation. Nevertheless, competition between Chile and those countries was surely not negligible, and the authorities should make some effort to take it into account in designing Chile's exchange rate policy. That policy was particularly important because it represented a more expansionary reaction to renewed economic difficulties, in contrast to the fiscal and monetary measures upon which the authorities seemed to have relied predominantly so far.

One additional measure on which the authorities had relied was the special technique of inducing private short-term capital inflows, which had so far produced a reduction in external private assets rather than an increase in liabilities, Mr. Polak observed. The performance criteria for new external debt did not take account of private debts; and he was uncomfortable about the potential for a sudden increase in private external liabilities.

On monetary policy, Mr. Polak noted that the performance criteria must have lost their restrictiveness, as they were still based upon a projection of inflation of some 20 percent for 1984, even though actual inflation had been running at a considerably lower rate. To avoid excess liquidity and achieve the balance of payments target, the authorities might well need to overperform with reference to the monetary targets. He would be interested in hearing whether such overperformance would indeed be the result of the recent monetary action.

He had some misgivings that the required fiscal action had not yet been specified, Mr. Polak concluded. The remaining fiscal gap of 0.2 percent of GDP might seem small, but if it were to be corrected in the space of two months, it would amount to 4 percent of all government spending during that period. From that perspective, the authorities might find it quite difficult to tie together the loose ends remaining in the program.

Mr. Grosche expressed broad agreement with the staff appraisal and support for the proposed decision. He commended the Chilean authorities for having met all the performance criteria by comfortable margins. However, economic prospects in the years ahead were less favorable, largely because of external factors like high interest rates and weakened copper prices. The authorities would nonetheless have to make a number of policy adjustments and implement a number of additional measures, a line of reasoning with which they apparently agreed. Indeed, the supplement to the staff paper indicated that the additional measures recommended by the staff were being adopted in order to close the remaining fiscal gap. As the staff stressed, it was important for additional monetary measures to be implemented, in particular to deal with low real interest rates.

He joined others in supporting the staff's proposal for another Fund review of Chile's policies before the final purchase could be made, Mr. Grosche concluded. He hoped that the authorities would continue on that occasion to work closely with the Fund to cope with the difficult period ahead. He shared Mr. Joyce's views on the preconditions of the new program. In framing their adjustment strategy, the authorities should keep in mind that the unavoidable burden of adjustment measures, in order to be politically accepted by the people, had to be distributed among the various segments of the population in a reasonable manner.

Mr. Blandin expressed satisfaction that Chile continued to be in compliance with the performance criteria under the Fund program. The additional fiscal and monetary measures that the Chilean authorities had already taken, or were about to take, were also most welcome, given the current account deficit envisaged for 1984 and given the Chilean debt burden, one of the largest in the world per capita. At least some of those measures should be of a more permanent nature, and the Chilean authorities should take the opportunity, during the October review mission, to discuss them with the staff. They still had a long way to go to achieve their objectives for growth and the balance of payments, especially with interest payments representing at least 10 percent of GDP in 1984.

Like previous speakers, Mr. Blandin continued, he would like to stress the inadequacies of financial practices that entailed subsidizing short-term dollar deposits and of swap operations that were also subsidized. Those operations were costly; they might well increase the foreign exchange risk of the Central Bank, and he was also not sure whether they were in conformity with at least the spirit of the program. Moreover, recourse to short-term borrowing did not alleviate a difficult financial situation.

In addition, he found it unsatisfactory that certain protectionist measures had been continuously in force since 1983, in other words, since the authorities had begun to implement the stand-by arrangement with the Fund, Mr. Blandin remarked. He would appreciate having the views of the staff or Mr. Donoso on Chile's financial practices and protectionist measures.

Mr. Suraisry said that he was in general agreement with the staff analysis and conclusions and that he supported the proposed decision. Chile's economic and financial performance under the stand-by arrangement showed that the authorities were implementing the program successfully. The performance criteria for the first half of 1984 had been observed: output and inflation had been better than expected, while confidence in the economy was gradually being restored. Despite those favorable developments, the balance of payments remained under considerable pressure; the current account deficit had been higher than expected during the first half of the year. Furthermore, the prospects for the second half had not been encouraging, in view of the continued softness in copper prices and the rise in international interest rates.

The authorities had recognized the need to respond to such external developments, Mr. Suraisry noted, and had taken additional corrective measures to ensure that the program remained intact. Specifically, he welcomed the adoption of a package of fiscal measures designed to improve the performance of the public sector in 1984. Further measures would be identified in the near future to close the remaining fiscal gap. Nonetheless, considering the unfavorable developments in copper prices and international interest rates, he agreed with the staff that it would not be appropriate for the authorities to activate the investment contingency part of the program.

It was encouraging, in view of the need to keep public spending and inflation under control, that the authorities were resisting demands for further wage increases in the public sector during 1984, Mr. Suraisry said. Their continued resistance should provide the correct example for wage restraint in the private sector.

The increase in Chile's short-term external debt in the first part of 1984 represented a cause for serious concern, in view of the size of the increase and the heavy debt service burden borne by the country, Mr. Suraisry said. Current circumstances called for more cautious demand management policies. Adjustment efforts would have to be continued for a number of years if Chile were to attain a sustainable balance of payments position. A new arrangement with the Fund, in which the authorities had expressed interest, could prove helpful during their negotiations with commercial banks on a financing plan for 1985. Moreover, the October review of the present program would provide an opportunity to initiate discussions on a new program with the Fund.

Mr. Prowse expressed support for the decision, including the proposed October review. As Mr. Joyce had pointed out, in circumstances in which fiscal measures had been planned but not carried out, it was important for that review to take place. The Chilean authorities deserved commendation for having strictly adhered to the program, notwithstanding the extremely difficult external environment, the price of copper being barely above 60 cents a pound compared with the 80 cents assumed. Indeed, the staff had assumed that the price of copper would increase from 66 cents a pound in 1984 to 104 cents a pound in 1989 and at the same time had projected an increase of some 40 percent in the volume of copper exported from Chile. Those projections merely underlined the extreme sensitivity of the economy to developments in the copper market. Could the staff comment on the soundness of Chile's ongoing reliance on copper exports? Table 9 on page 30 of the staff paper indicated that there had been a relatively strong growth of exports from the copper sector compared with agriculture, fisheries, and the industrial sectors. Perhaps greater emphasis should be placed on the need for diversifying the Chilean economy. Such structural improvements would surely be matters of interest if Chile undertook a further Fund program.

As other Executive Directors had noted, the spread between the official market and the parallel market for pesos had been widening, Mr. Prowse remarked. The widening suggested a need to review the present exchange rate arrangements, which involved discrete adjustments intended to maintain the real effective exchange rate for the peso at the level pertaining in December 1983. In view of the performance of agricultural and manufacturing exports, did the rate continue to be appropriate, particularly in the light of the evidently increasing protectionism in the manufacturing sector? In addition, why did the staff believe that the present arrangements were to be preferred to a unified, floating exchange rate in Chile?

At the October review, it would be desirable to confirm whether the proposals had been implemented and additional measures taken as necessary, Mr. Prowse said. In the circumstances, the transitory nature of some of the measures, such as import surcharges, might be justifiable; this effect on the economy should be considered on an annualized basis rather than merely for their short-term impact. On the other hand, there might be limits to what would be acceptable to the community in some of the areas of proposed action, including that of taxation.

Monetary targets in Chile appeared to be appropriate, Mr. Prowse considered, but he shared the staff's concern about the use of swap operations, which could fairly be described as an alternative to an effective interest rate policy. As the staff had noted, the swap operations did involve substantial subsidies, foster disintermediation by the private banking system, and play an intermediary role to the Central Bank. None of those aspects was desirable. Moreover, the increase in short-term foreign borrowing seemed contrary to the program and contrary as well to Chile's serious external debt situation. Because even with rescheduling in 1985, the debt service ratio would be above 55 percent, the authorities should manage their external debt with the utmost caution. As short-term debt arising from swap operations was probably more expensive than longer-term borrowing, a ceiling on short-term debt might be a topic for consideration under the program.

Mr. Zhang said that he supported the proposed decision. According to the staff appraisal, economic growth in the first half of 1984 had been somewhat stronger than expected, but prospects for the second half were now encouraging. The staff was now projecting a 4.5 percent increase in GDP during 1984, in contrast with the 4 percent originally programmed, and he asked whether that growth rate could be achieved. As he recalled, the staff had pointed out during the Executive Board meeting in May that one of the basic objectives of the current stand-by arrangement was to lay the foundation for self-sustained economic recovery and growth in the medium term. Given the unfavorable prospects for Chile's exports and a further deterioration in the current account balance, the growth of GDP in 1984 would have to occur entirely through an increase in domestic investment. Had the staff suggested any new measures for stimulating investment? Would the raising of interest rates, which the staff advocated to encourage domestic savings and protect the balance of payments, not at the same time adversely affect investment?

The management of external debt continued to be one of the most worrisome problems facing the authorities, Mr. Zhang considered. In the staff's medium-term scenario, the ratio of debt service payments to exports was projected to increase until 1987; until that time, new net external borrowing would not be undertaken. The authorities would therefore have to seek an early understanding with their main creditors in order to reach agreement on an orderly refinancing of future debt service payments.

Despite the unfavorable external and domestic factors beyond their control, the Chilean authorities were determined to adhere to the program agreed with the Fund, Mr. Zhang said. Nonetheless, the remainder of the adjustment task would be difficult; it would require a continuing consensus among the various economic and social groups. Finally, like some other Executive Directors, he was concerned about the number of reviews required by the Fund's program with Chile.

Mr. Camara expressed agreement with points made by previous speakers. He asked the staff to elaborate on the prospects for copper prices.

The staff representative from the Western Hemisphere Department explained that the copper price had a large influence upon medium-term projections. In light of the comment that the staff's projections in the medium term for Chile's copper exports had changed substantially from May to the present, it should be pointed out that many others besides the staff had been surprised by developments in the copper sector during 1984. Certainly, technical changes--such as the growing use of optical fibers and reliance on the transmittal of information through microwave networks rather than through direct transmission lines--had affected the demand for copper, a trend that might be continuing over the medium term. In view of those developments it was difficult to specify the copper price over the medium term. The staff had projected an average copper price of about 65 cents for the second half of the year; so far, the average price had been 60 cents. Anyone looking at the declining trend of copper stocks in the market would expect a rebound in the price of copper, but none had so far occurred; perhaps the price might increase somewhat after the decision by the President of the United States not to restrict copper imports. For 1985, the staff expected some rebound in the copper price because of the drawdown of stocks to historically low levels.

In his statement, Mr. Donoso had said that during the October review the authorities would be initiating discussions on a medium-term program with the Fund staff, the staff representative remarked. He understood that the Chilean authorities were quite open minded about their exchange rate policy. If the projections required an exchange rate adjustment, the authorities would be able to go in that direction. At present the staff felt that the exchange rate policy carried out so far in 1984 would suffice for the remainder of the year. The staff would not advocate making a major exchange rate adjustment on an ad hoc basis at present and would prefer that the topic be discussed in a medium-term context.

The reason for the staff projection of an increase in the real copper price of about 4 percent each year at the same time as the volume of copper exports increased was that Chile was a low-cost producer, the staff representative explained. Probably the best investment that Chile could make, given the present exchange rate for the peso, was in the copper sector. Part of the projected increase in exports was expected to occur in the public sector, but much would also be attributable to direct investment by multinationals, for which the Chilean authorities had already given approval.

As Executive Directors had correctly pointed out, the increase in Chile's indebtedness had not occurred in gross short-term debt but rather represented a decline in the foreign asset position, partly of the banks, but, interestingly, also of nonbanks, the staff representative continued. Certainly it had not been expected that the net inflow of capital would take the form of a drop in the country's foreign assets. The staff would investigate the possibility of controlling the amount of foreign assets held by the private sector. A number of Executive Directors had pointed out that the net inflow was being encouraged by the subsidy element in the Central Bank's policy on foreign currency swaps. In addition to taking on the exchange rate risk for up to six months, the Central Bank also provided an interest return on such swaps at an annual rate slightly in excess of 5.6 percent. It had been the staff's understanding that that particular subsidy would decline as interest rates were pushed higher by the tightening of monetary management during the rest of 1984.

The savings ratio in Chile had been an issue for a number of years, the staff representative recalled. During 1980-81, when real interest rates in Chile had been about 40 percent, the savings ratio of the private sector had been dismal; in 1981-82, it had been about 1 percent of GDP and had moved up to 5 percent in 1983-84, a significant increase. Interest rates in Chile continued to be positive in real terms, but were less so in real terms than previously. With the authorities aiming to achieve the target for net international reserves by the end of the year, the staff expected that there would be a significant monetary tightening in the economy during the remaining months of 1984, which would lead to higher interest rates on deposits and loans. According to the latest information, a tendency toward higher interest rates was already apparent. The authorities had not raised the suggested interest rates on 30-day deposits, but rates on deposits held for over 90 days had been moving up and so, correspondingly, had lending rates.

The need to exercise tighter control over net domestic assets would depend greatly upon the behavior of base money, the staff representative noted. During 1984, inflation had been lower than expected, leading some observers to conclude that the ceiling on net domestic assets would be less restrictive than would be desirable. However, if the increase in base money turned out to be less than expected, the authorities would need to show a lower increase in net domestic assets than programmed in order to meet the target for net international reserves. He understood that the authorities intended to do exactly that in the second half of the year.

The evidence showed that private sector wages at the lower end of wage scales were remaining quite stable in nominal terms, the staff representative continued. Such a development was to be expected with a rate of unemployment of 16-17 percent. There was no indication that wages were being pushed up excessively through collective bargaining.

It had been suggested that the staff's recommendation to increase interest rates might affect investment decisions and therefore lead to slower growth in coming years, contrary to one of the basic objectives of the program of promoting self-sustaining growth, the staff representative from the Western Hemisphere Department concluded. One new element that had to be considered was that Chile's terms of trade had deteriorated and that the authorities had to protect the balance of payments in the short term. The way for them to get the economy back on the self-sustaining path would be to look at relative prices, which they might wish to do in terms of the medium-term scenario to be prepared by the staff during the next few months. In the immediate future, the higher interest rates that had developed recently might have a negative effect on investment decisions. Nonetheless, over the medium term, it would be better to look at policy adjustments affecting relative prices.

The Deputy Director of the Exchange and Trade Relations Department noted that the staff was still experimenting with calculating medium-term projections. It would not claim to have found the best techniques or the best methods of presenting such projections, but they were essential for making assessments, especially in relation to programs. The staff made full-scale calculations for program countries yearly which, from time to time, needed updating. In the future, the staff might consider presenting a range of values, rather than a single value for such projections.

Various opinions had been expressed by Executive Directors about the number of reviews under the arrangement, the Deputy Director recalled. The staff would align itself with the comments made by Mr. Joyce, among others. In cases like Chile, the staff had a great deal of evidence that close contact with the authorities of the member country was necessary as considerable external uncertainties existed that called for steady implementation of policies. In all cases of programs with the Fund, there was more or less continuous contact between the staff and national authorities, but experience showed that a review conducted by the Executive Board of the Fund was an effective instrument for program implementation.

Whether the 20 percent tax on travel abroad constituted a multiple currency practice had been the subject of a question by Ms. Bush, the Deputy Director said. As the tax had not yet entered into effect pending submission to the Executive Branch, the staff had not obtained a copy of the precise regulations and thus did not have enough information to draw a conclusion on the topic. It might turn out to be a multiple currency practice, in which event the staff would have to come back to the Board for a possible waiver.

A number of Executive Directors had commented on protection, the widening spread between the parallel and official exchange rates, the relationship between Chile's exchange rate and those of its competitors in Latin America and techniques of adjusting the exchange rate, the Deputy Director of the Exchange and Trade Relations Department concluded. All such questions had borne on the fundamental adequacy of the exchange rate for the peso. He was confident that the exchange rate would be an essential feature in any new program with Chile for 1985.

Mr. Prowse commented that he too looked forward to a thorough-going review of Chile's exchange rate arrangements if there were to be a follow-up program. However, he would have preferred it to take place following the October review. Could the staff explain why it believed that a unified floating rate for the peso would not be appropriate?

The staff representative from the Western Hemisphere Department replied that the question of unifying the exchange rate system would be a topic for discussion with the authorities in a medium-term context. Whether such unification could be achieved in one step, eliminating the parallel exchange market, or whether a floating-rate regime should be established to achieve unification would require discussions with the Chilean authorities to determine how great the uncertainties would be with respect to copper prices and interest rates in the coming months. In recent weeks, there had been no change in the spread between the parallel exchange rate and the official rate.

Mr. Donoso commented that there had always been a perception that the size of the exchange market in Chile and its domination by the copper industry implied, in practice, some kind of exchange rate management policy by the copper sector and that if the authorities were to press for a floating exchange rate system, they would have to ask the copper companies, or that part of the copper sector generating foreign exchange earnings, to define a path for the exchange rate. It was of course the Central Bank that tried to achieve some stability in the rate.

It was clear from the staff papers discussed that no slippages had occurred in the implementation of the Fund program, Mr. Donoso went on. All targets had been met. There had even been overperformance in some areas, notably with respect to the deficits of the public sector, which had been about half of the target of 3 percent of GDP. Furthermore, inflation was running at a lower rate than originally projected, and the balance of payments results were within established limits.

During 1984, Chile's terms of trade had seriously deteriorated, and interest rates had turned out to be far higher than assumed under the program, Mr. Donoso pointed out. Nevertheless, a recovery of economic activity under more stable financial conditions had stimulated private investment, leading to some increase in imports. As a result, the current account of the balance of payments would present a deficit higher than that projected originally under the program. The upturn in economic activity and the strengthening of private demand had been accompanied by access to foreign financing in excess of the amounts contemplated, so that the overall balance of payments ceilings had been observed. Nonetheless, the authorities wished to be sure that the evolution of the external accounts did not hide elements of instability, as might occur if additional external financing were short term and occurred in response to subsidies. Thus, as reported by the staff, a plan to bring domestic interest rates more into line with rates abroad had been devised, along with one to minimize the role of the Central Bank in stimulating inflows of private capital. Foreign developments had had negative effects on Chile's trade accounts and also on the fiscal accounts, as some public enterprises were among the principal exporters and also because of the existence of public debt.

The authorities had undertaken measures and would identify additional ones to ensure full compliance with the target for the public sector deficit, Mr. Donoso noted. They remained strongly committed to the program and expected to maintain their record of compliance, in spite of having to offset negative developments abroad with demand restraint at home in order to remain within the program.

Despite a worsening environment abroad, 1984 appeared to be a year in which the authorities would consolidate their achievements in financial stabilization and would promote sound recovery from the most depressed areas of activity existing in 1983, Mr. Donoso said. Even in the midst of a recovery, economic conditions in Chile remained extremely difficult: the private sector was weak because of high indebtedness; the financial system probably reflected the weakness of enterprises; unemployment remained high. Thus, prospects for a slowdown in economic activity during the rest of the year were worrisome. Nevertheless, the authorities considered it important to preserve what had been gained in stability and to enter into negotiations for financing for 1985, in the hope that there would be no doubt about the country's ability to adjust to demanding circumstances. Thus, they had taken a firm decision to face up to their current difficulties by taking the actions required to comply fully with the Fund's program.

The recent rejection of a proposal for protection against copper imports into the United States was of major importance to Chile, Mr. Donoso observed. He wished to express his recognition of the role played by the Fund in opposing protectionism and specifically in opposing restrictions on the free trade of copper. The economies of industrial countries were recovering faster than expected, benefiting developing countries in general. Nonetheless, high interest rates made indebted countries very vulnerable, and a return to normal financial conditions in the world would generate an environment that would facilitate the return of the Chilean economy to reasonable rates of growth. Owing to expected improvements in world economic conditions as well as the demonstrated will of the Chilean authorities to follow appropriate policies in difficult times, the prospects for the Chilean economy were attractive. In the shorter run, however, the delayed effects of the world recovery on Chile's terms of trade, high interest rates, and the weaknesses associated with the 15 percent decline in national GDP during the previous year had combined to create a delicate situation that would call for profound analysis in order to determine the delicate balance between adjustment and external financing that would make it possible for the country to continue to progress. For the Fund to minimize the importance of the need to further continuous economic growth in Chile, even if at only moderate rates, might make the task of pursuing orderly adjustment unrealistic.

The Chairman noted that the thoughtful and interesting views and suggestions put forward during the discussion, especially on the issue of the exchange rate, would be borne in mind by the staff during the October review, which would be crucial to the continuation of the Fund's collaboration with Chile. Equally vital was the recognition of the Chilean authorities' determination to adhere to the program and to take additional measures if necessary.

The Executive Board then took the following decision:

1. Chile has consulted with the Fund in accordance with paragraph 6 of the letter of March 12, 1984 (EBS/84/50) which modified the letter of December 13, 1982 attached to the stand-by arrangement for Chile (EBS/82/227, Sup. 2) and paragraph 3(b) of the Executive Board decision completing the consultation under the stand-by arrangement (EBS/84/50, Sup. 2).

2. Chile will not make purchases under this stand-by arrangement after November 14, 1984 that would raise the Fund's holdings of Chile's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12 1/2 percent of quota until a review of the policies that would ensure the successful implementation of the economic program has been completed.

Decision No. 7800-(84/139), adopted
September 10, 1984

2. TOGO - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the review under the stand-by arrangement for Togo (EBS/84/173, 8/13/84).

The staff representative from the African Department noted that according to the latest information, Togo had met the performance criteria for net domestic assets and net claims on Government in May; the figures in EBS/84/173 had been provisional. With regard to domestic payments arrears, Togo had made net cash payments totaling CFAF 7.3 billion by August 10, 1984, exceeding the performance criterion for end-July by CFAF 1 billion. The authorities would thus be in a position, following completion of the present review, to make a second purchase of SDR 4 million under the current stand-by arrangement.

Mr. Alfidja commented that following a satisfactory performance under a Fund-assisted program in 1983, the Togolese Government had launched a new program in early 1984 aimed at consolidating the gains achieved thus far. In particular, the program was designed to strengthen public finances and restore viability to productive sectors. Likewise, public enterprises were to be restructured and domestic arrears significantly reduced. Despite the advent of unforeseen adverse events, performance under the program had been satisfactory to date. Indeed, all the performance criteria set through end-May 1984 had been met.

On the basis of developments during the first half of the year, revised macroeconomic projections indicated a more rapid expansion of total output and a slowdown of inflation, thanks to a recovery of food production, Mr. Alfidja continued. As revised, the current account deficit was slightly larger than earlier projected, mainly because of a decrease in export volume and a large deterioration in the terms of trade. However, the outlook for Togo's overall balance of payments was projected to be brighter, a small surplus being expected instead of the large deficit foreseen at the beginning of the program.

Although monetary expansion was projected to remain unchanged, the overall fiscal deficit had been revised upward, Mr. Alfidja noted. The projected increase should not be construed as a relaxation of the adjustment effort. The Togolese authorities continued to adhere strictly to their policy of fiscal restraint, as shown by the maintenance of unpopular measures such as a ban on the recruitment and promotion of civil servants and a 5 percent additional income tax. Furthermore, the projected deficit, at 3.9 percent of GDP, while larger than the earlier forecast, still constituted an improvement over the 1983 outturn of 4.7 percent of GDP, which in turn had been lower than the outturn of nearly 7 percent recorded in 1982. Thus, the trend toward moderation had not been disturbed. Moreover, the larger fiscal deficit reflected more a shortfall in tax revenue than an increase in spending. Higher capital expenditures were essentially attributable to an emergency need to buy and install electric power facilities following large unforeseen cutbacks in supplies of electricity from Ghana. Therefore, it was essentially the increase in current outlays that ought to be a subject for concern. On the basis of revised estimates, current expenditure was forecast to rise by CFAF 1.5 billion more than earlier envisaged. On the other hand, as the staff had stated, tax revenue was forecast to be CFAF 6 billion lower than projected, largely owing to the effects of the regionwide economic contraction, the closure of the border between Nigeria and Benin, and the poor coffee harvest in Togo itself. Thus, had the revenue shortfall not occurred, the nondiscretionary increase in current outlays would have been more than accommodated by higher revenue, ceteris paribus.

Confronted with such a slowdown in revenue expansion, the Government had promptly taken additional measures involving larger budgetary contributions by profitable companies such as the phosphate marketing agency and the consumer goods trading company, Mr. Alfidja remarked. In all, those companies were to contribute an additional CFAF 6.3 billion, equivalent to 8 percent of revenue in 1983. It was worth noting that the two largest public enterprises--the phosphate and cash crop marketing companies--had paid off their debts to commercial banks. Furthermore, the Government had moved to privatize the former state-owned steel company. In the public hotels, cutbacks in personnel had been effected in order to reduce costs.

His authorities were aware of the still high debt service ratio of Togo, Mr. Alfidja went on. They acknowledged the cooperation of their creditors during the rescheduling of the country's commercial debt and were particularly appreciative of the debt cancellation undertaken by the Federal Republic of Germany.

The Togolese Government intended to improve the monitoring and control of employment--hence of the wage bill of the public sector--by developing a suitable computer data base, Mr. Alfidja remarked. However, while remaining committed to restraining expenditure growth, the authorities strongly felt that the impact of the austere fiscal policies during the past few years on productivity and government workers morale, as well as on the overall economy, was rapidly becoming unbearable. In particular, the simultaneous implementation of policies such as a ban on hiring, a freeze on wage increases and promotions, and the imposition of an additional income tax, along with large increases in prices of basic services during several consecutive years, were inimical to economic growth and inherently destabilizing. Therefore, his authorities had expressed the wish that the Executive Board and management show more flexibility and realism in providing guidance to the Fund staff in preparation for subsequent discussions and negotiations. In conclusion, the authorities had demonstrated determination to restore viability in the economy, and they had performed satisfactorily under the stand-by arrangement.

Mr. Blandin commented that the review of the stand-by arrangement with Togo presented further evidence, after the good performance achieved under the 1983 program, of the great courage of the Togolese authorities and testified to their strong commitment to the success of the present program.

In the 1984 budget, the authorities had already taken steps to offset the adverse consequences on revenue deriving from the closure of the border between Nigeria and Benin, a circumstance clearly beyond the authorities' control, Mr. Blandin noted. On the expenditure side, the authorities would maintain for the second year in a row their harsh stance on personnel expenditure. He had some difficulty in accepting some of the wording of the staff appraisal about the administrative weaknesses that had delayed the implementation of the tax reform, those weaknesses being at least in part the result of the Fund's program itself, which did not provide for all the means necessary for correct implementation of that tax reform. Although the revised program specifically provided for additional recruitment for that purpose, the decision had come a little late and had fallen short of what would have been needed to reap the fruit of the reform.

As to the supply side of the program, Mr. Blandin commented, the authorities' determination was impressive. The agreement reached with the World Bank on agricultural pricing policies boded well for an improved response by farmers. Furthermore, the prices of utilities were at a level that would cover costs. In addition, the authorities had taken some encouraging steps to privatize public enterprises. However, he wished to stress that the Fund was too impatient at times to obtain quick results in a sector where developments depended not only on the willingness of the Government to move in a certain direction but also on a number of other factors, including the strategy of potential private partners, that were largely beyond the Government's control. A good example of the difficulties facing African countries was presented by CIMAO (Cimenterie de l'Afrique de l'Ouest), a regional cement factory that the World Bank and the European Investment Bank had both considered to be worthy of financing but that had come to constitute a permanent drain on the already strained public finances of Togo, Ghana, and Ivory Coast. Such an example served to illustrate the folly of placing all the blame for the misallocation of resources on African Governments.

In conclusion, the policies in place in Togo appeared appropriate, Mr. Blandin observed. There was good cooperation between the authorities and the World Bank, and both the Fund and the Bank had resident representatives in Lomé. Nevertheless, the medium-term outlook demonstrated that it would take years before the financial situation came back to normal, because Togo's debt service would long remain out of line with the country's debt servicing capacity. Prolonged efforts would therefore continue to be required, together with sizable amounts of concessional aid from abroad. As the same problems affected a number of other African countries as well, and in view of the insufficiency of the most recent replenishment of IDA resources, there was clearly a need for the creation of a special fund for Africa.

Mr. Camara expressed broad agreement with the staff appraisal and support for the proposed decision. The Togolese authorities deserved commendation for their strict adherence to measures contained in the 1984 adjustment program. The efforts undertaken since 1983 to put the economy back on an even keel had proved fruitful. The series of corrective measures successfully implemented--particularly those affecting public enterprises, domestic arrears, and the external position--had prevented any further deterioration in the country's finances. As a result of those efforts, the authorities had brought public finances under much better control and, at the same time, had initiated a process of structural change to lay the basis for sustained economic growth and development.

It was unfortunate, however, to see those efforts undermined by a number of events entirely beyond the authorities' control. The Executive Board should keep those events in mind when assessing Togo's economy. After all, exogenous factors, including a severe regional drought and a deterioration in the terms of trade with other West African countries, had had adverse consequences on the recovery in Togo. Shortfalls in revenue and in export earnings meant that there might be a case for compensatory financing from the Fund, as the temporary nature of the shortfall was clearly demonstrated in the staff report. Could the staff elaborate on that question?

On the fiscal side, the current program called for a further reduction in the overall deficit from the 1983 provisional outturn of 3.4 percent of GDP to 2.9 percent through a combination of revenue-enhancing measures and continued expenditure restraint as well as a reduction in internal arrears, Mr. Camara said. The bulk of those efforts would be directed toward improving tax administration and the tax structure. Although recognizing the usefulness of expenditure cuts, he doubted whether any room was left in Togo for further restraint, a point on which he would also appreciate hearing the staff's opinion.

The authorities' intention to reduce government subsidies to public enterprises was welcome, Mr. Camara considered. He also welcomed the World Bank structural adjustment program, with the hope that problems experienced in the past--with a chain reaction leading from reduced output of a hydroelectric plant to the closure of major factories--could be corrected for good. Moreover, the privatization of a number of enterprises represented steps in the right direction.

As to pricing policies, the authorities had given enough incentives to producers of cocoa and coffee, Mr. Camara went on. If the weather returned to normal, production of those crops should increase. The authorities had also courageously taken measures to raise electricity and water rates, so that those enterprises would break even on their costs of production.

Despite the efforts of the authorities to redress the economy, considerable weaknesses still remained, mainly in the financial area, Mr. Camara concluded. In view of the authorities' willingness to improve the situation and their strict commitment to succeeding in their adjustment effort, Executive Directors should adopt a more flexible approach in reaching a conclusion on recent developments in Togo.

Mr. Grosche said that the Togolese economy was characterized by a further deterioration of the external accounts and a considerable worsening in the underlying fiscal position. Table 2 in EBS/84/173 showed that the prospective development of exports during 1984 was particularly unsatisfactory measured against earlier expectations and the original program. Nonetheless, the staff's analysis left no doubt that the deviations that had occurred were largely due to unexpected negative developments in the external sector beyond the authorities' control. Against that background, it was commendable that the authorities had already undertaken strong corrective measures to stabilize the fiscal position. It was also commendable that despite the adverse external environment, the staff was projecting a reduction of the fiscal deficit from the 1983 outturn.

The outlook for Togo's balance of payments in the short and medium term had been improved by the debt rescheduling granted by the country's official creditors in the Paris Club and also by the debt cancellation of the Federal Republic of Germany, Mr. Grosche observed. Given the special circumstances in which the country found itself during 1984, his authorities felt that, for the time being, the additional finance made available through such measures should not be taken into account by the Fund in formulating the credit ceilings for the current year. Thus, he could fully support the course suggested by the staff that the credit ceilings should not be adjusted downward by the amount of external resources received in excess of program projections. Furthermore, as all quantitative performance criteria stipulated in the stand-by arrangement had been met, he could go along with the proposed continuation of the arrangement.

The staff had become more optimistic in assessing the strength of the economic recovery in Togo, Mr. Grosche pointed out. However, such an improvement would depend greatly on further progress by the authorities in promoting structural reforms. Additional improvements in financial management appeared to be of particular importance, as did the implementation of tax reform without further delay. Moreover, continued privatization of public enterprises would make a further major contribution to structural adjustment. Finally, he had been greatly impressed by the Togolese authorities' determination in tackling difficult problems in their economy.

Mr. Salehkhou remarked that Togo's economic and financial performance under the stand-by arrangement with the Fund had been satisfactory, although a series of exogenous developments had caused deviations from the original targets. Better weather and a higher price for phosphates should help the country to achieve a higher than expected rate of growth in 1984 and a lower rate of inflation. The adverse factors had included the closure of the border between Nigeria and Benin, which had seriously upset regional commerce and Togolese Government revenue; the closure of the multinational cement and clinker plant; and the effects of the 1983 drought on the volume of Togo's exports of coffee in 1984, currently estimated to be less than one half of earlier projections. It should also be noted, however, that the remaining administrative weaknesses that had led to delays in the implementation of the tax reform had contributed to Togo's worse than expected performance in the fiscal area.

Since the adoption of the stand-by arrangement by the Board four months previously, the prospects of its successful implementation had improved, Mr. Salehkhou commented. On the one hand, the authorities had carried out additional measures to counter the effects of the adverse developments that had occurred. On the other hand, the external debt negotiations had had a favorable outcome, resulting in a larger than expected rescheduling and a significant reduction in pressures on Togo's balance of payments. He welcomed the flexibility of the Fund staff in adjusting the components of the program to the additional measures adopted by the authorities.

As current expenditure had already been substantially reduced, complementary measures would focus on the need to generate additional revenue, Mr. Salehkhou suggested. Moreover, notwithstanding the general freeze on wages and hiring, together with the imposition of a limit on personnel expenditure, the program allowed for modest new recruitment to ensure successful implementation of the tax reform.

The staff had not considered it appropriate to adjust credit ceilings downward to take into account additional external financing, although such a revision had been stipulated in the letter of intent, Mr. Salehkhou noted. As indicated by the staff, the additional inflow of financing had not resulted in any relaxation of fiscal austerity since the authorities had implemented even more measures to offset the shortfall in revenue.

As to the balance of payments, the expected deterioration in Togo's current account deficit in 1984 should be more than compensated by additional inflows of capital, as a small surplus was being projected for 1984, Mr. Salehkhou said. Moreover, exports, particularly of agricultural products, were expected to recover significantly during the year. Such a recovery should further strengthen Togo's trade balance and allow for a more appropriate level of imports. In view of the smaller amount of exports recorded in 1983 and 1984, could the staff comment on a possible drawing under the compensatory financing facility by Togo? Had there been any calculation of the size of the shortfall? Had Togo made any attempts to investigate recourse to the compensatory financing facility? In conclusion, he supported the proposed decision.

Mr. Clark commended the Togolese authorities for their commitment to the adjustment effort begun in 1983. It would be important for them to adhere to the revised program targets following the deterioration of public finances during the first half of 1984, especially in view of the uncertainties surrounding the external prospects of the economy.

Given the constraints on the policy implements used by the Togolese authorities by their membership in the West African Monetary Union, fiscal policy remained crucial to the success of the program, Mr. Clark said. He urged them to press ahead with full implementation of the banking reform, which was expected to improve the yield from the existing tax base. Such a reform had become more urgent following the shortfall in tax receipts in the first half of the year. He also hoped that the revised investment code would be brought into effect during 1984.

It was disappointing that the outturn in public expenditure for 1983 had resulted from the discovery of additional expenditure on personnel, Mr. Clark remarked. However, the authorities did intend to limit personal expenditure strictly during the remainder of the program. As for other current expenditure, he noted the authorities' concern but wondered whether there might be, nevertheless, areas in which savings might be made. For example, had the authorities considered accelerating their policy of phasing out agricultural subsidies?

He welcomed the speedup in the reduction of domestic arrears over the remainder of the program period in order to compensate for the slowness of the reduction during the 1983 program, Mr. Clark continued. However, taking the years 1983 and 1984 together, domestic arrears would still have been reduced by only three quarters of the amount originally foreseen. He would also be interested in comments by the staff on developments in the liquidity of the economy, particularly as payments to foreign enterprises had given rise to capital outflows.

The authorities were rightly giving priority to reducing the burden on public finances of loss-making public enterprises, in which endeavor the World Bank had an important role to play, Mr. Clark noted. Perhaps the staff could tell Executive Directors more about the state of negotiations between the authorities and the Bank on a second structural adjustment project, especially with regard to plans for the second year of the three-year rolling investment program. He hoped that the authorities' plans would be consistent with the necessary budgetary discipline. In that connection, could the staff or Mr. Alfidja say whether the authorities had taken a decision on the project for a phosphoric acid plant, about which several Executive Directors had expressed misgivings?

He was less sanguine than the staff about the outlook for Togo's current account, Mr. Clark concluded. If the projected recovery of exports in 1985 seemed to rely to a considerable extent upon sales of clinker by CIMAO, it was not altogether clear whether such a recovery would in fact occur. Granted, production would recover once the electric power supply again expanded, but he believed that CIMAO's selling price was well above the world price for clinker. He would appreciate any comments by the staff. He supported the proposed decision.

Ms. Lundsager said that it was disappointing to observe that according to revisions in 1983 data, several targets, including those for the budget deficit and the reduction in domestic arrears, had been missed by wide margins. However, the authorities appeared to be making a serious effort to turn the economy around: performance criteria were being met, and improvements were being made in public enterprises. The sale by the authorities of a steel mill to a private investor had been quite encouraging, and the plan to divest the truck company from government control was also welcome. Such steps to privatize enterprises previously under government management should promote a more active private sector, with consequent benefits to growth and efficiency for the economy as a whole. She looked forward to additional moves such as those in the future.

The authorities' cooperation with the World Bank was continuing, with better prospects for development, Ms. Lundsager continued. She was glad that Togo had reached agreement with the World Bank on the producer pricing policy for exports and encouraged them to continue their close cooperation.

Widening the productive base to include more agricultural products would diversify the economy and add to it the export base, Ms. Lundsager remarked. Although new exports did not simply materialize overnight, especially in a less developed economy, maintenance of an appropriate exchange rate over a sufficient period of time served as a price signal that could assist in generating exports of products previously thought to be uncompetitive. Had the staff anything to add on exchange rate developments in the West African Monetary Union?

In the fiscal sector, it was disappointing that budgetary expenditure and the deficit had both been revised upward, Ms. Lundsager considered. In particular, she had hoped that the existing numbers of government personnel would have been sufficient to implement the tax reform. However, since no wage increase would be granted in 1984, and as the shortfall in revenue had been beyond the authorities' control, she could reluctantly accept the upward revision. She supported the authorities' efforts to improve financial management and approved of the plan to reduce domestic arrears in 1984.

As to the external sector and the medium-term outlook, forgiveness of some external debts, combined with generous debt rescheduling, had improved Togo's current position and medium-term prospects as well, Ms. Lundsager considered. But, debt rescheduling merely postponed payments into the future, as shown on page 9 of EBS/84/173. Indeed, the medium-term balance of payments projections showed large unfinanced gaps for the next four years, with implications for debt rescheduling and other sources of external financing for Togo. The emphasis must be placed on development, with high priority being given to the external sector as well as to continued careful macroeconomic management. In conclusion, she supported the proposed decision.

Mr. Zhang also expressed support for the proposed decision.

The staff representative from the African Department pointed out that Togo had made no attempt so far to effect a drawing under the compensatory financing facility, although the staff intended to take up the question during the Annual Meeting. The principal point that remained to be resolved was whether there might be a recovery of phosphate exports from Togo in 1985, a development probably more important than the possible reopening of CIMAO and a resumption of clinker exports.

At the time of the staff mission, the authorities had said that the CIMAO had been closed temporarily owing to a lack of electricity originating in Ghana, the staff representative remarked. Since then, the closure had become semipermanent, and was the subject of considerable debate within the World Bank as to what to do about it. A study by outside consultants had indicated three options: first, to close the plant indefinitely; second, to keep it closed for two years, and third, to reopen it later in the present year, possibly in November. Those options would also be discussed during the Annual Meeting.

Several Executive Directors had asked whether restraints on fiscal expenditure had gone far enough, the staff representative recalled. The staff had indicated in several places in its paper that the restraints had indeed had the effect of holding down expenditures. In light of the high debt service carried by the budget, the authorities would probably have to continue to impose considerable restraints, particularly on personnel expenditures. Courageous steps had already been taken; new figures showed that between the end of 1983 and July 1984, the number of people employed by the public sector in Togo had decreased significantly.

Agricultural subsidies did not directly affect the budget, most such subsidies being given by state enterprises in the form of direct inputs, the staff representative explained. Indirectly, the public sector would improve its position if agricultural subsidies were restrained. The question of agricultural subsidies was under study in the context of broader structural reforms in the agricultural sector. The settlement of domestic arrears did involve an outflow of payments to the extent that those payments were made to branches of foreign companies that had supplied goods and services to the Government.

The proposed phosphoric acid plant project, if executed, would be a large investment in years to come, the staff representative noted. The plant was still in the planning stage, and it was included in the next World Bank structural adjustment project. Preparations for the latter were far advanced: the authorities already had in hand a first draft letter of development policies that would be discussed further by the World Bank and the authorities during the Annual Meeting.

It was impossible to be sure whether an exchange rate was precisely correct, the staff representative commented. The exchange rate for the CFA franc was pegged at 50 to the French franc, and had declined along with the latter currency in relation to the dollar, from about CFAF 200-220 a few years previously to CFAF 450 at present. Thus, the feeling of the staff was that the current exchange rate for the CFA franc was probably not greatly out of line, and that it provided sufficient incentives to develop new export industries in Togo.

Tax reform had been delayed by material shortages and not so much by shortages of personnel, the staff representative from the African Department explained. Agreement had been reached between the Fund and the authorities on some increase in expenditure on personnel, so that highly qualified experts could be hired to implement the tax reform as well as for the computerization of expenditure accounts.

Mr. Alfidja agreed with the staff representative from the African Department that there had been several reasons for the delay of the fiscal reform. First, the submission of the reform to the National Assembly had taken a little more time than expected. Second, there had been a need for preparing psychologically all the parties concerned with the reform. Third, there had been some problem with material and staffing. In any event, the important thing was that the authorities had begun to implement the reform.

Many countries had accepted recommendations committing them to undertake tax reform and increase the tax base, Mr. Alfidja noted. As indicated in the staff paper, unforeseen external circumstances sometimes led to those recommendations becoming outdated, a fact that Executive Directors should keep in mind. It made little sense for a country to increase taxes on exports when the closure of the border by a neighboring country made exporting impossible. The Fund should demonstrate flexibility and be willing to adjust schedules if circumstances changed.

He doubted whether developing countries like Togo--which were trying to promote the modernization of agriculture--could avoid subsidies in that sector, Mr. Alfidja said. Further, one of the public enterprises concerned with paying subsidies had no difficulty in meeting its financial obligations.

The Togolese authorities would like to follow a cautious investment policy, given what had happened to CIMAO and other gigantic undertakings of similar nature, Mr. Alfidja observed. The issue was being actively debated, and would probably not be resolved before the end of the stand-by arrangement.

The continuing depreciation of the CFA franc against the dollar for the past several years, Mr. Alfidja noted, did not necessarily mean that exports from the region were going to rise significantly.

The Executive Board then took the following decision:

1. Togo has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Togo (EBS/84/80, Sup. 3, May 8, 1984) and paragraph 37 of the letter dated March 28, 1984 in order to review financial policies and to reach understandings on performance criteria subject to which purchases may be made by Togo during the remaining period of the arrangement.

2. The letter dated June 20, 1984 from the Minister of Mining, Energy, Water Resources and Public Works, acting for the Minister of Economy and Finance, setting forth the policies and measures that the authorities will pursue shall be attached to the stand-by arrangement for Togo, and the letter from the Minister of Economy and Finance dated March 28, 1984 shall be read as supplemented and modified by the letter of June 20, 1984.

3. Accordingly, the minimum amounts of cumulative reduction of government domestic payments arrears stated in Table 1 of the letter dated March 28, 1984 shall be modified to read CFAF 8.0 billion at September 30, 1984 and CFAF 10.2 billion at December 31, 1984 in accordance with paragraph 10 of the letter dated June 20, 1984.

4. The Fund decides, pursuant to paragraph 4(b) of the stand-by arrangement for Togo, that the review contemplated in paragraph 37 of the letter dated March 28, 1984 is completed.

Decision No. 7801-(84/139), adopted
September 10, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/138 (9/7/84) and EBM/84/139 (9/10/84).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/48 through 84/50 are approved. (EBD/84/230, 8/31/84)

Adopted September 7, 1984

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to an Executive Director as set forth in EBAP/84/191 (9/6/84) is approved.

APPROVED: June 25, 1985

LEO VAN HOUTVEN
Secretary