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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/178

10:00 a.m., December 7, 1984

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	T. Ramtoolah, Temporary
C. H. Dallara	M. K. Bush
	D. C. Templeman, Temporary
J. de Groote	H. G. Schneider
	C. Flamant, Temporary
	T. Alhaimus
	M. B. Chatah, Temporary
	H. Kobayashi, Temporary
G. Grosche	B. Goos
J. E. Ismael	
	L. Leonard
	G. D. Hodgson, Temporary
	C. Robalino
	A. Vasudevan, Temporary
	A. Abdallah
F. L. Nebbia	B. Jensen
	J. E. Suraisry
	G. Ortiz
J. J. Polak	T. de Vries
	A. A. Scholten, Temporary
	A. V. Romuáldez
G. Salehkhou	
J. Tvedt	
	T. A. Clark
	J. Bulloch, Temporary
	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

H. Sommerville, Director-Coordinator of External Debt, Central Bank of Chile. G. Rutihinda, Principal Secretary to the Tanzanian Treasury; J. Kipokola, Head of the Monetary and Fiscal Affairs Division of the Tanzanian Treasury. African Department: A. D. Ouattara, Director; R. J. Bhatia, Deputy Director; A. I. Abdi, N. Abu-zobaa, A. Basu, M. W. Bell, I. A. H. Diogo, K. G. Dublin, P. J. Duran, C. N. Egwim, C. Enweze, A. S. Linde, E. K. Martey, D. E. Syvrud. European Department: T. H. Mayer. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; G. Begashaw, E. H. Brau. External Relations Department: H. P. Puentes. Fiscal Affairs Department: E. S. Kreis, C. Y. Mansfield, C. Schiller. IMF Institute: P. R. Rado. Legal Department: P. L. Francotte, Ph. Lachman, J. M. Ogoola. Middle Eastern Department: A. Ouanes. Research Department: A. R. Ismael, P. R. Menon, A. Salehizadeh. Western Hemisphere Department: E. Wiesner, Director; C. Atkinson, M. Caiola, J. Jaramillo-Vallejo, S. J. Stephens, J. F. van Houten. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. A. Ajayi, H. A. Arias, G. R. Castellanos, D. Hammann, S. M. Hassan, G. E. L. Nguyen, G. W. K. Pickering, M. A. Weitz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, I. Angeloni, N. Haque, Z. b. Ismail, S. Kolb, A. Koné, M. Lundsager, J. A. K. Munthali, K. Murakami, E. Olsen, D. J. Robinson, J. E. Rodríguez, C. A. Salinas, A. H. van Ee.

1. LIBERIA - STAND-BY ARRANGEMENT

The Executive Directors considered a request by Liberia for an 18-month stand-by arrangement in an amount equivalent to SDR 42.78 million, or 60 percent of quota (EBS/84/234, 11/19/84).

The staff representative from the African Department informed Executive Directors that the latest calculations for the information notice system indicated that as of October 1984 the real effective exchange rate for the Liberian dollar had appreciated by 10.4 percent since the Executive Board discussion in April 1984 (EBM/84/56, 4/6/84). The staff wished to draw the attention of the Executive Board to that development in lieu of issuing an information notice. As noted in the staff report, Liberia's real effective exchange rate had remained virtually unchanged between the third quarter of 1983 and the second quarter of 1984, but the sharp rise of the U.S. dollar in the past few months had resulted in a renewed rise in the real effective rate. The inflation rate had been very low--less than 2 percent over the past year--but there had been a substantial nominal appreciation of the exchange rate relative to Liberia's main trading partners. The recent appreciation brought the cumulative real effective appreciation since 1980 to about 40 percent. Liberia's long-standing policy of maintaining parity with the U.S. dollar and a relatively open economy had produced good results in terms of the low rate of inflation. The rise of the U.S. dollar, however, posed problems for Liberia's competitiveness that were being addressed by continuing efforts to compress costs and to raise productivity.

Information received that morning about the quantitative performance criteria for the end of November indicated that net domestic assets of the National Bank of Liberia were well below the June level, the staff representative continued. Net claims of the banking system on the Government were slightly above, and net claims of the National Bank on public corporations below, the June levels.

Liberia had accumulated some external arrears since June 1984, the staff representative stated, largely because of a shortfall in revenues. The staff had worked with the Liberian authorities to cover those arrears, and it fully expected all arrears to be paid by the end of December. The staff had expected that many of the arrears would be paid that week with the help of the first disbursement under the $45 million U.S. Grant Aid Program, but there had been a delay of a few days in that disbursement for technical reasons. Included in the arrears were amounts owed to two Paris Club participants. To allow the meeting on Liberia's rescheduling to take place as planned on December 17, 1984, the Secretary of the Paris Club would have to be able to confirm in advance that all arrears with participants had been settled.

Mr. Abdallah made the following statement:

The economy of Liberia has experienced difficult financial and economic conditions in recent years, characterized by declining output and high rates of inflation. This was due in large part to the adverse impact of the prolonged recession in the world economy which depressed the foreign markets for Liberia's principal export commodities. The situation was exacerbated by widening budgetary deficits. Consequently, the balance of payments weakened and external reserves were virtually depleted, resulting in the accumulation of payments arrears. The economy would have worsened were it not for the determined adjustment efforts of the Government, which were supported by four successive stand-by arrangements with the Fund.

The harsh external environment, coupled with deep-rooted structural problems, have prolonged the adjustment process despite the implementation of a number of bold policy decisions. Even though the authorities had been largely successful in meeting performance criteria under the various programs, the optimism that they and the staff shared for the medium-term scenario did not fully materialize. However, it is encouraging to note that recovery is under way, with real GDP expected to grow by about 4 percent in 1984/85.

The 1983/84 program was successful in that further declines in output were halted and the rate of consumer price increases fell well below the program's target. However, fiscal and balance of payments targets could not be attained despite the fulfillment of the quantitative ceilings. From the staff's summary of the performance under the 1983/84 program shown in Table 3 of EBS/84/234, it is clear that the authorities were able to implement all the measures that had been agreed upon, and had even taken additional action to ensure that the program remained on track. This was particularly noticeable in the area of government operations where the authorities had to take further measures to reduce expenditure because revenue fell short of the revised program target by $11 million.

The authorities are encouraged by the gains that have been made and are aware that much remains to be done. They have put in place a further adjustment program for which Fund assistance is being sought; and the objective continues to be that of reducing the financial imbalances in the economy and getting the economy growing again on a sustainable basis. The authorities have stressed that in order to achieve these objectives, financial assistance from the Fund, the World Bank, and other multilateral and bilateral institutions will be crucial.

The Liberian authorities recognize that the budget will form the centerpiece of the adjustment program, whose objective is to bring the overall deficit, on a commitment basis, from the equivalent of 5.9 percent of GDP in 1983/84 to 4.9 percent in 1984/85. The deficit is exptected to be financed from external sources on concessionary terms, including debt relief. The program makes no allowance for domestic bank borrowing. The authorities are also aware that the persistence of shortfalls in revenue mean that the burden of adjustment will have to be borne by a further reduction in expenditure. Thus, in another bold move, they have undertaken to cut the wage bill by 4 percent, amounting to $5 million, through a $10 reduction in the monthly wage for all public employees. This follows the first absolute reduction of public sector wages by an average of about 20 percent that came into effect in January 1983. Under the current program it is expected that additional savings will be achieved by the implementation of voluntary and mandatory retirements, normal attrition, and the laying off of redundant personnel.

The authorities are also ready to implement measures, agreed upon with the World Bank, designed to rationalize public enterprises with a view to reducing their need for budgetary support. This will include the sale of some of these enterprises to the private sector and the scaling down or closure of some of the operations. To this end, the Liberian Timber and Plywood Corporation is already in the process of being converted into a joint venture. The National Iron Ore Company, which had received substantial subsidies from the Government in the past, has been closed down and its future status will be reviewed in due course.

On the revenue side, the authorities initiated a detailed study of the level and composition of all imports as well as tax administration procedures that formed the basis for implementation of measures to increase revenue from import duties which had hitherto been declining. The Government also suspended all duty-free privileges that had been granted to state enterprises. Furthermore, an import surcharge of 5 percent has been imposed on all imports and is expected to yield additional revenue amounting to $4 million in 1984/85. The authorities also announced the imposition of a monthly payroll tax of $5 on employees in both the private and public sectors. It will also be noted from the staff paper that the authorities initiated important institutional changes in 1983/84 under which tax receipts and expenditures were to be handled through accounts at the commercial banks. To ensure zero domestic bank financing, disbursements by the Government from these new accounts are to be made only as balances permit. In the meantime, expenditure control procedures have been tightened through a monthly disbursement scheme to ensure adherence to this objective.

Financial targets in the monetary sector have been drawn to be consistent with the balance of payments objective of reducing the overall deficit from the equivalent of 6.1 percent of GDP in 1983/84 to 3.2 percent in 1984/85. The achievement of this objective will to a large extent depend upon the expected improvement in the financial position of the Government. Another key assumption of the program is related to the projected increase in exports of 8 percent, which is predicated upon a recovery in foreign demand for Liberian export commodities. The authorities are also hopeful that further rescheduling from both the Paris and London Clubs will be successfully concluded. They have been encouraged by the agreement of the London Club participants to refinance the principal obligations falling due in 1983/84 and 1984/85. Contacts with the Paris Club creditors have already been made with a view to reaching an early agreement. Although all external payments arrears were eliminated by June of this year, the external debt burden remains worrisome and poses a serious threat to the viability of future economic growth. The Liberian authorities have thus agreed to continue pursuing a cautious external borrowing policy in order to avoid aggravating the external debt situation.

It is clear from the foregoing that the Liberian authorities have drawn up a comprehensive set of measures in their continuing efforts to achieve sustainable economic growth. They deserve the full support of the Fund in these endeavors, and I therefore urge Directors to approve the proposed decision.

Mr. Suraisry commented that Liberia's 1983/84 program could be considered successful even though some of its targets had not been achieved. The growth rate, although modest, had been positive for the first time in four years; the inflation rate had been low; and the overall deficit of the Central Government had declined sharply. The balance of payments, however, showed mixed results; while the overall deficit had fallen, the current account deficit had remained high. It was encouraging that, to consolidate the gains and to eliminate the weaknesses that still existed, the authorities had agreed to enter into a stand-by arrangement with the Fund.

The precarious condition of government finances was the main weakness of the Liberian economy, Mr. Suraisry stated, and it was appropriate that the 1984/85 program placed considerable emphasis on dealing with that problem. Fiscal adjustment was therefore of particular importance, and he welcomed the program's objectives of further narrowing the overall fiscal deficit, eliminating domestic bank financing, and further reducing the wage bill, which had increased substantially between 1978/79 and 1981/82. The authorities would have to maintain a firm fiscal stance if they were to benefit from the recent pickup in private sector activity and the lower rate of inflation.

Strengthening the external sector was of equal importance, Mr. Suraisry continued. The current account and overall balance of payments deficits were both large, and the official debt service ratio was high. The program's objective of reducing those deficits through, inter alia, increased exports was therefore welcome. But the staff had reported that between the third quarter of 1980 and the second quarter of 1984 the Liberian dollar had appreciated by 48 percent in nominal terms; the staff had also reported that "with a view to maintaining the competitiveness of the export sector, in the absence of an independent exchange rate policy, Liberia has pursued since early 1983 sustained efforts to compress costs and raise productivity." He invited the staff to comment on the extent to which Liberia could continue to compress costs and raise productivity, and whether that approach could be considered an effective substitute for an independent exchange rate policy. The projected increase in exports appeared to be attainable, and Liberia could thus provide a lesson for other countries.

Finally, Mr. Suraisry noted that Liberia had been in arrears to the Saudi Fund for Development since mid-1983. He could support the proposed decision, provided that he received reassurance from the Chairman and the staff that Liberia would settle all its overdue obligations and other obligations coming due during 1985 to the Saudi Fund for Development.

Mr. Grosche said that the Liberian authorities' efforts--supported by substantial Fund assistance and helped by favorable external conditions--had ultimately had some satisfactory results. However, public finances remained difficult and the balance of payments was, despite some progress, still fragile. The amount of external indebtedness continued to impose a heavy burden on the economy, and, even more disquieting, the authorities did not seem to be fully convinced of the merits of a sustained commitment to a prudent course of economic policy. He was also concerned that Liberia had missed three of four end-June indicative criteria for the most recent program.

Liberia's medium-term prospects were favorable, and it enjoyed a comparative advantage for many agricultural products, Mr. Grosche remarked. Given the link of the country's currency to the U.S. dollar, however, that potential could be used only if the authorities maintained sound economic management. He invited the staff to comment on those prospects, given the overvaluation of the currency.

Budgetary performance, while markedly improved, had nevertheless fallen short of expectations as a result of both expenditure overruns and revenue shortfalls, Mr. Grosche continued. The authorities would have to broaden the revenue base to offset administrative difficulties. Could the staff comment on the scope of taxation of transnational enterprises? On the expenditure side, it was of utmost importance to further contain wages and to strengthen the performance of public enterprises; in that connection, the growing involvement of the World Bank was welcome. He wondered to what extent measures to reduce the wage bill had already been implemented.

With regard to the balance of payments, Mr. Grosche expressed his concern that the financing gap in 1983/84 had been almost exclusively filled by drawings on the Fund. Moreover, those drawings had greatly exceeded private as well as official net capital inflows. He hoped that the general improvement in economic conditions in Liberia would stimulate an increase in private capital inflows and in development aid, especially as the Fund's net contribution in future would become negative because substantial repurchases would fall due. The staff's projections for the balance of payments showed that Liberia would depend on debt relief and the availability of extraordinary finance for the next two years. It was obvious that the situation would not allow any slippages in the implementation of the policies prescribed by the program. Finally, he supported the proposed decision, with the expectation that the remaining financing gap would be covered by debt relief from the Paris Club.

Mr. Scholten stated that he could support the proposed decision. The 18-month arrangement provided for heavy front-loading: 40 percent of the purchases fell in the first three months of the arrangement. The proposed phasing indicated that in exceptional cases the Fund could show flexibility, the need for which had been so strongly stressed during the discussion on the relationship between performance criteria and phasing of purchases under Fund arrangements (EBM/84/177, 12/6/84). The stand-by arrangement in an amount equivalent to 60 percent of quota, supporting a two-year program, could be regarded as providing a fairly low annual rate of access to funds, with significant adjustment efforts early in the program. However, two factors highlighted the exceptional nature of the proposal. First, under the previous program, although it had generally been well implemented, there had been considerable slippages after the last drawing, with overshooting of the indicative targets for June 1984. He therefore wondered to what extent recent adjustment measures were correcting those slippages. Second, debt relief from the Paris Club was still pending, and he asked the staff whether the needed debt rescheduling might not have to be on exceptional terms.

Because of the front-loading under both the proposed arrangement and the World Bank's projected structural adjustment credit, a sizable financing gap was indicated for the second year of the program, Mr. Scholten commented. Could that gap be covered by further London Club and Paris Club reschedulings on present terms, or would it require further adjustment in the absence of other favorable developments? He did not want to prejudge the terms of possible debt relief, but the staff's indications would provide further insight.

The present case illustrated a promising meshing of Fund and Bank involvement, Mr. Scholten remarked. After a number of arrangements that had taken Liberia's drawings in the credit tranches to about 240 percent of quota, the Fund's holdings of Liberian dollars subject to repurchase were forecast to decline moderately under the present arrangement. That movement, simultaneous with the Bank's acceleration in lending, reflected the shift in emphasis to structural adjustment after a period in which improved demand management and important supply-side measures had laid the groundwork. That the World Bank foresaw a structural adjustment credit on IDA terms, and not a structural adjustment loan, was additional reason for welcoming the tilt toward Bank assistance to Liberia.

The key to success would lie in increasing fiscal revenues and reducing the public wage bill, Mr. Scholten stated. Much had been done: the wage bill, expressed as a percentage of fiscal revenues, had declined from 66 percent in 1981/82 to a planned 56 percent in the current year, mainly through severe and often courageous measures to reduce the nominal wage bill. Moreover, the medium-term scenario projected a further decline to 37 percent in 1987/88. Although the more favorable growth prospects that had developed would facilitate the task of increasing tax revenue, the emphasis on appropriate measures to reduce the wage bill was essential not only for the present year but for coming years as well. The medium-term fiscal scenario did not incorporate a further reduction in domestic arrears, and he wondered whether that implied that all domestic arrears had been settled.

He concurred with the provision in the program that allowed for short-term bridge financing, Mr. Scholten concluded. Liberia had, on several occasions over the past year, been in arrears to the Fund, and it apparently faced a similar situation with respect to the World Bank at present. It would be extremely unfortunate if the present program were interrupted because of a temporary recurrence of external arrears. He invited the staff to comment on how the information given in its opening statement might affect the start of the stand-by arrangement.

Mr. Flamant commented that the proposed stand-by arrangement for Liberia was the eighteenth since 1963 and the fifth consecutive arrangement since September 1980. Yet, judging from the staff's balance of payments projections, which were based on rather optimistic assumptions regarding exports, a sustainable balance of payments position--implying the absence of any financing gap--would not be achieved before 1988/89. Since the record of policy implementation under the previous programs seemed to have been good, and since Liberia was not a Sahelian country and was favorably endowed with natural resources, he wondered whether the programs had been adequately designed to address the problems facing the Liberian economy. The world recession had reduced the market for Liberian exports, but, after an initial deterioration in 1981/82, the terms of trade had improved in the two following years. Moreover, while the wage bill in the public sector had increased in 1980/81 to $138 million, it had fallen to $127 million in 1983/84. Nevertheless, during that time interest payments in the budget had almost tripled, from $24 million in 1980/81 to $68 million in 1983/84.

Those observations suggested that the main problem facing the Liberian economy might well be one of insufficient competitiveness, Mr. Flamant continued. The country had been prevented from increasing its share in the world market for its main export products and from taking full advantage of the recovery in world trade that had occurred in 1984, for example, by diversifying its exports through increasing the share of nontraditional exports, while investment in import-substituting activities had also been discouraged. The main reason for the loss in competitiveness was that the U.S. dollar was the legal tender in Liberia; the gradual appreciation of the dollar since 1980 had entailed a 40 percent appreciation in the real effective exchange rate.

The paper "Formulation of Exchange Rate Policies in Programs Supported by the Fund" (EBS/84/232, 11/16/84; and Cor. 1, 12/3/84), which had provided background information for the Board discussion on the review of conditionality at EBM/84/174 and EBM/84/175 (12/5/84), strongly advocated exchange rate action to offset previous real appreciation of the exchange rate and to restore competitiveness, Mr. Flamant remarked. But that paper also noted that in Liberia, changing the peg would involve a major institutional modification. He nevertheless wondered whether, owing to the evident disadvantages of the present situation, the staff had made a detailed cost-benefit analysis of a change in the peg.

Another feature of the present system was the high cost of financial intermediation, Mr. Flamant remarked. The interest rate on one-year deposits was 10 percent, whereas the average interest rate on commercial bank loans was 23 percent, which represented a large margin. Since inflation had been kept low as a result of the appreciation of the dollar, real lending rates were over 20 percent. It was therefore not surprising that credit to the private sector had remained in 1983/84 at half the June 1980 level; he wondered how private investment could take place at such rates.

The program for 1984/85 utilized fiscal and monetary policies to compensate for the absence of exchange rate action, Mr. Flamant continued. In the fiscal area, the wage bill would fall in absolute terms owing to a number of measures, which testified to the commitment of the Liberian authorities to the success of the adjustment effort, since such measures were never popular. Although the $10 monthly deduction from all public sector paychecks would bear more heavily on low wages, it could be argued that those wages had benefited the most from the 1980 wage increase. Moreover, he asked the staff whether the reduction in wages, to the extent that it was applied to the private sector, would be enough to offset the appreciation in the exchange rate and to restore competitiveness.

With regard to monetary policy, Mr. Flamant added, he had no problem with the absence of ceilings on the cumulative change in net domestic assets, in net credit to Government, and in net credit to public enterprises. He was, however, somewhat surprised by the lack of the usual ceiling on credit to the private sector, and he asked the staff for an explanation.

Apart from the necessary restructuring of the public enterprise sector, much remained to be done in the area of supply-side policies, Mr. Flamant considered, for example, to ensure that iron ore production would continue after the depletion of the reserves currently being exploited and to increase nontraditional exports. Liberia could develop exports of a number of agricultural products--notably food products--in addition to rubber.

Purchases under the present arrangement appeared heavily front-loaded, Mr. Flamant concluded, especially in light of Fund practice. The purchase schedule raised the question of uniformity of treatment when it was compared with that for other African countries. He therefore asked the staff whether the present arrangement signified a change in policy in the direction of increased flexibility that would, in the near future, benefit other countries.

Mr. Hodgson said that all performance criteria under Liberia's latest stand-by arrangement with the Fund had been met, but that success had to be tempered by the fact that the indicative targets set for the end of the arrangement had been generally exceeded. The recently completed arrangement had been Liberia's fourth with the Fund since 1980. It was particularly appropriate that the staff had provided an analysis of Liberia's adjustment efforts to date, which indicated clearly the progress achieved as well as the serious financial weaknesses that remained.

There had been a number of positive developments over the past two years, Mr. Hodgson continued. The pricing system had been reformed, the cost structure of producers had improved, growth--although modest--had become positive, and the rate of inflation had fallen to below 2 percent. Externally, the balance of payments deficit prior to debt relief had declined, arrears had been largely eliminated, and private capital had begun to return to Liberia in response to growing investor confidence. Liberia was at present in a relatively good position to take advantage of future growth in international markets. Nevertheless, he remained concerned about the precarious state of the country's financial position. International reserves had declined to almost zero and external debt service payments were rising sharply.

Even with further rescheduling by official and commercial creditors over the coming years, it would be difficult for Liberia to avoid new arrears unless continued adjustment efforts were made, Mr. Hodgson commented. The program under consideration would be a positive step toward that adjustment. In particular, he supported the authorities' intention to reduce further the current account deficit through continued export growth, and to achieve an overall balance of payments surplus by 1986/87. Although the financing gaps projected over the next few years were large, improved investor confidence in concert with adjustment efforts should allow Liberia to obtain the necessary resources. However, the appreciation of the Liberian dollar might limit the scope for balance of payments adjustment, and he encouraged the authorities to reassess their exchange rate policy.

The Fund's assistance during the period ahead should focus on adjustment rather than on new financing, Mr. Hodgson said. The sharp increase in debt servicing obligations projected for the next few years would be attributable largely to repurchases from the Fund. In addition, Liberia had already experienced serious difficulties in keeping abreast of its financial obligations to the Fund. It would be a bitter irony if the resources provided by the Fund to Liberia were to become part of the country's financial difficulties. Consequently, it was appropriate that the stand-by arrangement currently requested was for a smaller amount than previous arrangements.

The key element in the current program must be an improvement in the National Bank's financial position, Mr. Hodgson stated, which would depend heavily upon continued improvement in the fiscal balance. Higher than projected financial requirements of the public sector were one cause of the deterioration in the central bank's finances during the past summer. Emphasis under the program must therefore be placed on strengthening budget revenue and restraining expenditures, especially current expenditures, in order to limit recourse to central bank financing. The institutional changes that had been made in the banking system appeared to have been effective in helping to strengthen the financial system. In conclusion, he supported the stand-by arrangement.

Mr. Chatah noted that, because the stand-by arrangement under consideration was the fifth consecutive arrangement with Liberia since 1980, it was particularly important that in evaluating the proposed program, an adequate assessment be made of the extent of adjustment achieved thus far under the previous programs. The review of the performance of the Liberian economy during 1980-84 in the staff report showed that the improvement in the Liberian economy over the past four years had in many respects been quite modest. While the rate of inflation had been kept low, in two major areas of adjustment the outcome had been disappointing. The ratio of public expenditures to GDP, which was presumably a key policy variable in Liberia's adjustment strategy, had declined by only 3 percent. Similarly, the decline in the current account deficit from $107 million in 1980/81 to $87 million in 1983/84 was not impressive.

He nevertheless did not wish to minimize the difficulties, both domestic and external, that the Liberian authorities had had to face during that period, Mr. Chatah continued. Presumably, however, the successive arrangements should have taken into account such difficulties in formulating policies that would lead to full adjustment over the medium term. The present condition of the Liberian economy did not show evidence of that process of adjustment.

On a presentational point, Mr. Chatah observed that, in evaluating the improvement in the Liberian economy over the four successive Fund arrangements, the staff had compared figures for 1983/84 with those for 1980/81, the time of the first stand-by arrangement. It would have been more informative if 1979/80--the year prior to the first arrangement--had been taken as the base year for purposes of comparison.

The focus of the new program was again on the fiscal sector, Mr. Chatah remarked; a major objective was to reduce the overall budget deficit by 1 percent of GDP. He wondered whether that movement, while in the right direction, would be enough to produce financial stability over the medium term, particularly at such a late stage. Nevertheless, the program envisaged positive fiscal measures, in particular, the change in government banking procedures, which should be helpful in streamlining government operations; the efforts to reduce the public wage bill and government subsidies to enterprises; and the implementation of revenue-raising measures, including the planned examination of tax collection procedures that had in the past contributed to revenue shortfalls. The staff projected a 9.4 percent increase in total revenue in 1984/85, and he asked how much of that increase could be attributed to the projected rise in the demand for Liberia's exports and how much to revenue-raising measures. In passing, he noted that the staff had stated that "further cost cutting in the public sector is particularly difficult at the present time as the country is in the process of returning to civilian rule." While the assumption underlying the remark might be debatable, the staff should avoid giving perhaps an unintended impression that the Fund was making a judgment on the type of government that was more capable of undertaking fiscal adjustment.

With regard to the country's medium-term prospects, Mr. Chatah added, despite the projected improvement in the economy, Liberia would continue to face financing difficulties for some time. Improvement in the payments position seemed to depend critically on the optimistic projections concerning the demand for Liberia's exports and on the availability of further debt relief. Furthermore, any additional improvement in the balance of payments position would have to rely on fiscal and monetary, as well as productivity-enhancing, measures, as the present exchange policy of Liberia did not permit exchange rate action. Thus fiscal and monetary measures should be stronger than in other programs where exchange rate adjustment was normally included as a key policy instrument and where it often took the form of a prior action to signal the country's commitment to policy changes required by the program. The staff could have usefully discussed whether the present exchange system constituted an impediment to more efficient adjustment, particularly in view of the substantial appreciation of the U.S. dollar since 1980.

He recognized the positive aspects of the new adjustment program, Mr. Chatah concluded, and the potential significance of the increased involvement of the World Bank in the structural adjustment effort. Nevertheless, after evaluating the experience under the previous four arrangements, as well as the policies and objectives of the 1984/85 program, he wondered whether there was enough evidence to conclude, as the staff did, that the new program marked a significant turning point for the Liberian economy and its relations with the Fund.

Mr. Dallara said that Liberia had pursued several economic adjustment programs supported by Fund arrangements. Under the most recent stand-by arrangement, which had expired in September 1984, all the performance criteria through May had been met; economic growth had been positive; and inflation had fallen to under 2 percent. However, owing in part to the delayed implementation of the budgetary measures, the end-June indicative ceilings had been missed, as well as the current account and budget deficit targets. Those results gave cause for concern, particularly when considered in light of the staff comment that further cost cutting in the public sector would be particularly difficult at present and in the immediately foreseeable period.

The authorities had continued their efforts to reduce costs and increase productivity to offset the effects of the appreciation of the U.S. dollar on Liberia's exports, Mr. Dallara remarked. The present program set reasonable targets, although some--notably the fiscal and current account goals--were less ambitious than those in the previous program. However, the policy actions covered a wide spectrum of economic activity and would reduce the degree of disequilibrium that continued to exist in Liberia's external accounts, while continuing the process of structural reform that had been under way for some time.

The fiscal deficit was programmed to decline to 4.9 percent of GDP on a checks-issued basis, Mr. Dallara commented, which was still higher than the target under the previous program. However, he recognized the need to provide for maintenance of infrastructure; he was pleased that nominal wage expenditures would continue their downward trend, which would not be an easy feat. Although development expenditures were budgeted to increase, they remained lower than historical levels. He would appreciate information on the World Bank's views on Liberia's investment program for the first review of the program. The tighter administrative controls over government expenditures and the continued divestiture of several public corporations were commendable. The reduction in the fiscal deficit should result in no increase in banking system credit to the Government, which was an important aspect of the program. The reduced credit demand should generate a decline in lending rates, which were now over 20 percent in real terms, and should allow for needed credit demand by the private sector.

Liberia had followed a traditional, historically rooted exchange rate policy that appeared to have shifted the burden of adjustment to other sectors in the economy, Mr. Dallara continued. Nevertheless, exchange rate policy should not be overlooked as an instrument of adjustment, and, he therefore joined other Directors in asking for the staff's view on the continued propriety of Liberia's exchange rate policy. It was important that the Fund, particularly in dealing with countries that had demonstrated progress but that continued to have difficulties in restoring sustainable payments positions, continue to look into all possible instruments of adjustment.

Net private capital flows had made a large turnaround, from an outflow of $27 million in 1982/83 and $14 million in 1983/84 to a projected inflow of $20 million in 1984/85, owing to renewed business confidence, Mr. Dallara stated. However, developments in international bank lending remained unclear. Nevertheless, the commitment of the Government to avoid accumulating new external arrears could not help but contribute further to business confidence both internally and externally.

Natural rubber output showed great potential with regard to both short-term balance of payments projections and the medium-term scenario, Mr. Dallara commented, and Liberia should make every effort to take advantage of that sector. However, Liberia would face stiff competition for rubber exports, and impediments to production still existed. World Bank assessments of the industry and Fund research concerning the rubber market could be very useful. He invited the staff or Mr. Abdallah to comment on the Liberian authorities' specific plans for implementing the improvements suggested by World Bank experts. There might be room for foreign investment and management assistance. Since Liberia could not generate producer incentives through a price increase under current exchange rate policy, it had to rely on cost control to be competitive. He regretted that the export tax on rubber, applied to foreign concessions, had been reimposed during the current fiscal year; that tax could have detrimental effects on the revival of the rubber sector and should be reviewed.

The close collaboration between the Fund and the World Bank in the effort both to address Liberia's balance of payments problems and to provide the basis for a sustained revitalization of the economy was welcome, Mr. Dallara remarked. The negotiations currently under way between Liberia and the Bank on a structural adjustment credit were commendable, and that credit would have implications for the Fund's role in Liberia in the period ahead.

Liberia's economic situation was so precarious that no increase in gross official foreign assets would be possible during the program period, Mr. Dallara commented. In addition, the potential accumulation of arrears to foreign creditors remained an area of concern. Thus, the need for some front-loading under the program was necessary. However, given Liberia's long-standing use of Fund resources and its good, but in some respects less than expected, performance under the previous program, he questioned the justification of the phasing. Furthermore, while he supported the program, he did so with growing concerns related to Liberia's prolonged use of Fund resources. The medium-term outlook indicated that the Fund might be called upon for further financial support, which would only create new repurchase obligations in the future. Indeed, the program under consideration would impose significant repurchase obligations on Liberia during 1988-91. The Fund should aim for a period when Liberia would look to the Fund for economic analysis and policy advice rather than financial support. An approach should be found to deal with Liberia's problems that not only responded to the continuing external needs of the Liberian economy but also protected the temporary character of Fund resources. Although the Fund was moving in that direction, more should be done to promote that process. He would appreciate any additional information the staff could provide on recent developments relating to the current status of foreign bank lending. He was concerned that the Fund's financial presence would continue--although under the planned program without any net increase in Fund exposure--while outstanding international bank exposure would be reduced. While understandable, that situation should be considered by the Fund when dealing with Liberia and similar cases.

Miss Bulloch stated that she supported the proposed decision and looked forward to the staff's responses to the questions on the exchange rate, the status of implementation of the wage measures, the prospects for debt relief, and the implications for the proposed stand-by arrangement of the staff's announcement regarding external arrears. She joined Mr. Scholten and Mr. Dallara in stressing the importance of the meshing of Fund and Bank assistance in Liberia.

The staff representative from the African Department, commenting on the cost competitiveness of the Liberian economy and the impact of exchange rate policy remarked that the staff considered that issue important, especially with regard to medium-term prospects. However, the degree of appreciation of the Liberian dollar had probably been overstated in the figures in the staff report and in his earlier statement. The deflator used for the real effective exchange rate had been the consumer price index for Monrovia, which did not reflect effective cost-cutting measures in the export sector. For example, as a result of layoffs and other measures, the Liberian American Mining Company had been able to eliminate its losses and to rehabilitate an old mine with a new investment of about $11 million. Firestone Company had also been able to increase its producer prices and to reduce its operating costs. The timber industry, which in 1983 had almost pulled out of Liberia, had also significantly increased its operations; that industry was particularly cost-sensitive because Liberia competed with neighboring countries and its markets were all in Europe. Therefore, the key supply constraints in the export industries would not be resolved solely by increased prices; roads and other infrastructure had to be improved to increase the supply of rubber, and additional investment would be necessary to increase the output of iron one. In the absence of fiscal discipline, exchange rate change alone would not solve the problem. A number of studies in the past year outside and inside the Fund had concluded that Liberia would be better off with a flexible exchange rate, independent monetary management, and additional instruments to resolve its economic problems. But those studies also concluded that exchange rate action should not be taken in the context of a serious financial crisis.

The financial situation of the public sector in Liberia was precarious, the staff representative remarked, although adjustments in the iron ore sector and major exploration and investment in the petroleum sector had contributed to the growth of the private sector.

The most important adjustment measure in Liberia over the past few years was the reduction in domestic borrowing by the Government, the staff representative stated. Domestic financing of the Government had been $82 million in 1982/83 and $40 million in 1983/84, of which the Fund had provided $65 million and about $40 million, respectively. Under the present program, domestic financing and net Fund financing would be reduced to zero; the $40 million change, equivalent to 4 percent of GDP, indicated a significant degree of adjustment, which had taken place primarily through expenditure restraint, particularly in the wage bill. The $10 reduction in the monthly wage for all public employees implemented on October 1 was a regressive measure, but two years previously there had been a 25 percent cut for upper-income workers, and a 16 2/3 percent cut for lower-income workers, while salaries of minimum-income workers had been doubled. The wage bill had therefore been significantly reduced from the pre-1980 level in real terms, although the minimum-income level was still modestly above that amount.

One reason for the high cost of money in Liberia was the National Bank's 30 percent reserve requirement, the staff representative stated. In addition, the banks held excess reserves with the National Bank that earned only about 10 percent, leading them to charge high rates. Another factor was the legal system, which increased banking risks to the extent that many foreign corporations did not feel that they received equitable treatment in court; for example, foreclosure for consumer loans was not legal. The staff had pointed out to the authorities that the legal system was keeping interest rates high and dampening private investment.

With regard to the medium-term outlook for Liberia, the staff representative continued, a significant degree of additional adjustment on the part of the Liberian authorities would be necessary at the time of the first review in January. The Paris Club would have to provide further debt rescheduling, and he hoped that the London Club would also provide terms for Liberia comparable with those agreed for other countries. Under the proposed London Club agreement, Liberia would repay 5 percent of principal and receive no new money. Over the past few years the commercial banks had reduced their exposure in Liberia by $40 million, thereby contributing to the economy's problems. In addition, the World Bank had calculated that it would be taking money out of Liberia, in net terms, in a few more years if Liberia did not start negotiating a structural adjustment credit. The Fund staff had been working closely with the Bank staff in designing the program, taking into consideration the country's medium-term prospects and the phasing of Fund-Bank involvement. The Fund's future role in Liberia would include technical assistance and help in demand management, but with a gradual withdrawal of Fund resources. For that reason there had been a sharp reduction in Fund financial involvement, from 100 percent of quota in previous years to 40 percent, which, on an annual basis, indicated no net flows from the Fund in the current fiscal year.

The Liberian authorities had advised the staff that they had invited the Saudi Fund for Development to participate in a rescheduling on the same terms and conditions as the Paris Club, as provided under the Paris Club Agreement, the staff representative added. The Saudi Fund had responded that it could not participate in rescheduling exercises. When the Fund staff had recently raised the issue with the Liberian authorities, they had expressed concern about those particular arrears and had advised the staff that they were endeavoring to cover the arrears to all their creditors on an equitable basis. The staff would make every effort to ensure that Liberia did so; in fact, all external resources available to the authorities during the coming month were earmarked solely for that purpose.

The staff representative from the Exchange and Trade Relations Department, commenting on whether the phasing of purchases under the stand-by arrangement represented uniform treatment of member countries, said that, as discussed at EBM/84/177, the staff would justify any departure from the broad guidelines adopted by the Board. The guidelines would not be applied in a mechanical way, but with flexibility when appropriate. In the present case, the justification for the phasing was presented on page 28 of the staff report. The implementation of the fiscal program, which was the centerpiece of the stand-by arrangement, had been delayed; it had become necessary to provide for more purchases before the first program review than would otherwise be justified. Furthermore, the phasing had become skewed because the initial purchase under the arrangement would be needed to clear the arrears that would otherwise jeopardize the program. The same flexibility would be extended to other members if justified by similar circumstances.

Mr. Suraisry remarked that the Saudi Fund for Development did not usually participate in the rescheduling of loans because, first, the Saudi Fund did not receive annual budgetary allocations. Therefore, if one country did not repay its loan, the amount that the Saudi Fund could provide to other developing countries was reduced. Second, the Saudi Fund was unlike other institutions; it was both a monetary and development institution that granted loans in key currencies for development projects, without conditions--for instance, it did not require the recipients to import products from Saudi Arabia. He asked the staff to comment further on the authorities' statement that they would try to meet their arrears.

The staff representative from the Exchange and Trade Relations Department explained that the Paris Club had advised Liberia that rescheduling with non-Paris Club creditors should be on terms similar to those granted by the Paris Club and that more favorable treatment should not be extended to other official creditors. The Paris Club maintained that the Saudi Fund should be included among those other official creditors; that ruling created a problem that had arisen in other instances.

The staff representative from the African Department said that Liberia was in the process of rescheduling with the Paris Club and that a meeting was tentatively set for December 17, 1984. Liberia would ask for the same terms that it had obtained at the previous Paris Club rescheduling. The authorities were also in the process of rescheduling debt with the London Club; the terms and conditions had already been arranged and the agreement would be signed that month. The Liberian authorities had made efforts to reschedule debt with all the non-Paris Club members; in some cases they had been successful but in others there had been an unwillingness to reschedule. The staff had encouraged the authorities to make every effort, and had been assured that all arrears would be covered on an equitable basis.

Mr. Dallara commented that the staff had put forward a persuasive case for front-loading, related to the delays in the budgetary process. But as those delays stemmed primarily from endogenous developments, the justification would have been more convincing if it had been based more generally on the Fund's policies concerning arrears, on recent adjustment efforts, or on the prospective adjustment efforts under the program. The staff had briefly described the need for the phasing, but such a significant departure from the norm called for more elaboration of the elements cited by the staff. He was prepared to support the program, but remained somewhat unconvinced with regard to the phasing.

The staff representative from the African Department recalled that in June 1984 initial measures in the public sector with regard to the wage bill had been negotiated with the staff. At that time it had been anticipated that the program would be considered by the Board in September and that purchases under the stand-by arrangement would be phased evenly. The delay in the implementation of the wage bill measure until October 1, following some months' debate in the Interim National Assembly over the wage cut, had led to serious problems. At the end of June, as he had notified the Executive Board, the Liberian National Bank had had no external reserves, which had led to arrears to creditors, including the Fund. The staff had worked with the authorities on a day-by-day basis to ensure the elimination of those arrears. The Fund had received $12 million net in repurchases, although the staff had not planned that Liberia should move in one year from a net inflow of $40 million in Fund resources to a net outflow of $10 million; it had been agreed that the Fund should phase out its involvement in Liberia, with the degree and speed to be determined. The phasing of purchases under the present stand-by arrangement had been worked out as part of an effort to ensure that the authorities were in a position to meet their arrears and to maintain their financial stability. The case was not unique, it did not establish a precedent, and it was justified by the circumstances.

Mr. Suraisry said that the staff's explanation had increased his uncertainties about the repayment of the Saudi Fund loan. The fundamental distinction between the Saudi Fund and other development institutions remained. Loan repayments were not returned to the general budget but were used to provide assistance to other countries. For that reason, loans by the Saudi Fund had not been considered for rescheduling, although many loans by the Ministry of Finance had been rescheduled.

Mr. Chatah observed that development institutions were treated differently in rescheduling arrangements, and he asked the staff for clarification. With regard to the medium-term outlook, he wondered whether consideration had been given in the present case to providing alternative scenarios on the basis of assumptions with respect to key exports.

The staff representative from the Exchange and Trade Relations Department commented that institutions such as the World Bank were excluded from the Paris Club rescheduling arrangements, but national development funds, if under the control of the national government, were covered by the Paris Club. He understood that it was the Paris Club's contention that the Saudi Fund did not differ in that respect and could therefore participate in rescheduling.

The staff representative from the African Department explained that the staff had considered other scenarios for Liberia. The 1983 Article IV consultation report (EBS/84/54, 3/12/84; Sup. 1, 4/2/84; and Sup. 2, 4/3/84) had included scenarios with alternative adjustment measures. The scenario included in the report under discussion had been based on present policies, but in the context of the 1984 Article IV consultation reports, the staff would again present alternative scenarios, including those with and without any new policies considered necessary.

Mr. Abdallah said that the question of the exchange rate clearly would have to be addressed by the Liberian authorities, to determine whether it was an impediment to further export growth. At present, the U.S. dollar was circulating concurrently with the Liberian dollar, and both currencies were at par and interchangeable.

With regard to the front-loading of purchases under the arrangement, Mr. Abdallah pointed out that the program had been negotiated in June with a lag of six months before Board consideration. The front-loading was, therefore, in line with the original schedule and enabled Liberia to make the purchases that would have been drawn to date.

The Government was organizing rubber production on a smallholder basis, but not much activity had taken place so far, Mr. Abdallah remarked. The smallholder arrangement had been successful in other countries; in Kenya, for instance, smallholder tea production was more successful than large-scale production. He therefore saw no reason why smallholder production of rubber would not be successful, given that that was a simpler operation to manage. Coffee, tea, and sisal also lent themselves well to smallholder production.

He agreed with Directors that the scope for further cost cutting had reached its tolerable limits, Mr. Abdallah commented. It was not possible to continue cutting wages and squeezing costs; moreover, it was unlikely that redundant government labor would be fully absorbed by the private sector. In sum, the financial position of Liberia was precarious.

The staff representative from the African Department, noting the importance of the rubber industry in the medium-term scenario, said that a paper on the industry prepared by a Fund staff member was available.

The World Bank had also sent a mission to review the rubber sector and the Fund staff was looking forward to its report on specific measures that should be taken to improve output and exports.

The Executive Board then took the following decision:

1. The Government of Liberia has requested a stand-by arrangement for a period of 18 months from December 7, 1984 for an amount equivalent to SDR 42.78 million.

2. The Fund approves the stand-by arrangement set forth in EBS/84/234, Supplement 1.

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

Decision No. 7859-(84/178), adopted
December 7, 1984

2. CHILE - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for a review under the stand-by arrangement for Chile (EBS/84/238, 11/26/84).

Mr. Hernan Sommerville, Director-Coordinator of External Debt, Central Bank of Chile, was also present.

The staff representative from the Western Hemisphere Department said that the most recent information indicated that Chile had been in compliance with the stand-by arrangement on November 30, 1984. The quantitative performance criterion on net domestic assets of the Central Bank had been met with no margin to spare. The staff had reviewed the authorities' monetary plan for December and was satisfied that the plan, if fully carried out, was consistent with Chile's commitments under the stand-by program. Inflation in November had been 1.2 percent, compared with 8.2 percent in October. Cumulative inflation in the 11 months through November 1984 stood at 21.4 percent.

Mr. Nebbia made the following statement:

> The Executive Board is requested to approve Chile's performance under the stand-by program as of September 30, 1984 and to complete the review under the decision adopted by the Board on September 10. We would like to thank Executive Directors for their agreement to our request for a waiver of the circulation period, which was necessary to allow timely disbursement of the last tranche of Chile's money facility with the international banks.

During the present year, Chile has been in full compliance with the stand-by program, despite extremely adverse external developments. The price of copper averaged US$0.60 a pound in the third quarter, compared with US$0.80 estimated under the program. For the last quarter of this year, the price of copper is expected to average about US$0.62 compared with US$0.85 envisaged when the program entered into effect. The prices of other exports have also been much lower than expected. In addition, foreign interest rates have largely exceeded original estimates. Despite these adverse developments, the quantitative performance criteria established in the program remained unchanged, and the unforeseen financial needs had to be met by an increased short-term and medium-term net capital inflow.

During the first nine months of 1984 the current account deficit deteriorated significantly as a result of the adverse external developments already mentioned, and showed a larger than expected response of imports to GDP growth. Both factors moved the authorities to change their assessment of balance of payments prospects for 1985, leading to the decision to devalue the peso by 19 percent on September 17. This measure was accompanied by: first, an increase in import duties to a uniform level of 35 percent, thus yielding additional fiscal revenue in 1985 to meet the expected shortfall caused by the low price of copper; second, a strict monetary policy, as reflected by stepped up open market sales and real domestic interest rates higher than the corresponding foreign rates; and third, a wage policy for the public sector, effective January 1985, that will fully protect only the lowest end of the salary scale from the cost of living increase of 1984, leaving medium and higher brackets with a salary adjustment equivalent to only 60 percent of the cost of living increase. The private sector remains free to negotiate wages either collectively or on an individual basis, the only constraint being the observance of the minimum wage, which will be increased proportionately to the increase in the cost of living in 1984.

The economy seems to be responding as expected to those measures. Although the effects on the balance of payments will take time to materialize, a substantial reduction in registered imports has already taken place. The spread between the official and the parallel exchange rate declined to 4 percent in late November from 23 percent prior to the devaluation. Meanwhile, economic activity--as expected--seemed to be experiencing a significant slowdown, and inflation accelerated sharply in October. To avoid further inflationary pressures, the peso was depreciated in November by about one half the rate of inflation registered in October, in a transitory deviation from the standard policy of daily devaluations during any one month at a rate equivalent to the change in the consumer price index in the previous month, less an estimate of external inflation. The inflation rate dropped to 1.2 percent in November.

Looking ahead, it is clear that Chile will be able to overcome its present financial difficulties by stepping up profitable investment in export sectors. To achieve this, Chile will have to maintain a favorable social and political climate. Macroeconomic policy will have to preserve external balance, stimulate domestic financial stability, and keep key prices--such as interest rates, exchange rates, and real wages--within realistic margins. Of course, these efforts will require continued support from the Fund and the international financial community over the next few years.

Chile has already undergone a tremendous adjustment effort. Per capita consumption is estimated to have dropped in 1984 to a level 21 percent lower than three years ago. No further downward adjustment in per capita consumption seems feasible without causing widespread distress among the poor, thus undermining social and political stability. Therefore, the investment effort has to be financed through economic growth while domestic policies have to ensure that economic growth is directed toward investment and not toward consumption. A 4 percent rate of growth for 1985 seems, according to this viewpoint, absolutely necessary. To achieve the growth and investment objectives, additional support will be needed from our foreign creditors. To finance the required investment and thus improve Chile's future ability to service its debts, significant amounts of new money will be needed in the next two or three years. Foreign banks' exposure to Chile's risks is expected to start declining in absolute terms after 1987.

Chile and the Fund are currently discussing a new medium-term macroeconomic program. The Chilean authorities want to assure the Executive Board of their intention to continue pursuing orderly and sound domestic policies such as those successfully implemented under the current stand-by program and--with appropriate support from the international financial community--to keep the nation's tradition of fully honoring its commitments. The Chilean authorities are confident that the open and straightforward relationship that Chile has maintained with the Fund in the past will be preserved and enhanced. In this spirit, the Chilean economic authorities would like to request the support of the Executive Directors for the proposed decision, and to thank the Managing Director and the staff for their efforts to help the Chilean economy recover from its present difficulties.

Extending his remarks, Mr. Nebbia commented that, with regard to monetary policy for December, although it was true that the performance criterion on net domestic assets had been met with no margin, all the performance criteria had been met. His Chilean authorities remained fully committed to respecting the monetary ceilings established in the program.

Mr. Robalino stated that he supported the decision. The Chilean authorities should be commended for their determination and successful efforts in maintaining the current stand-by program on track and complying with all performance criteria, with margins, as of September 30. Fiscal performance had been better than programmed, and state enterprises in general had had adequate operational resources. Even though there had been an increase of 2.9 percent of GDP in the deficit of the current account of the balance of payments in the first nine months of 1984, it had been caused in part by an increase in imports in anticipation of an expected devaluation and an increase in import duties, as well as by a less favorable price for exports.

Inflation, although not totally controlled, had been manageable, Mr. Robalino commented. The staff pointed out that there had been a rapid shift in the monthly inflation rate from 2.9 percent in September 1984 to 8.2 percent in October, compared with an 11 percent increase in the first eight months of the year. That drastic change seemed to represent the automatic effect of the 19 percent currency devaluation in September that had brought about a once-and-for-all change in the price structure. If that were not so, he invited the staff to provide more information about the sustainability of price levels in Chile.

There was no doubt that the Chilean authorities had made determined efforts to keep their program on track, Mr. Robalino continued, notwithstanding lower prices for copper exports--$0.60 a pound instead of $0.80 as estimated under the program--and higher than estimated international interest rates. Those two factors had greatly hampered Chile's chances of resuming sustainable growth, with damaging effects on the Chilean economy.

The authorities had continued to follow an adequate monetary policy and to control credit expansion, consistent with the main objectives of the program, Mr. Robalino remarked, and he encouraged them to maintain that approach. The increase in import tariffs had reduced the benefits of the September devaluation, but the combined effect of the devaluation and the tariff increases had resulted in a real net increase in exports. However, the staff stated that "the export sector, consequently, continues to be penalized by the tariff increase." He invited the staff to comment on whether the export sector was being penalized in absolute terms and whether the current account of the balance of payments was thereby threatened.

The authorities had implemented a temporary shift in exchange rate policy, Mr. Robalino noted, but he hoped that they would soon return to the former basic exchange rate adjustment policy in order to avoid negative effects on the country's competitiveness in the long run. The Chilean authorities should continue to implement a sound economic policy in 1985 through additional stabilization and adjustment efforts in accordance with the advice of the Fund.

Mr. Dallara commented that during the course of the stand-by arrangement he had generally commended the Chilean authorities for the determined and prompt manner in which they had addressed their problems, both foreign and domestic. A willingness to adapt a program to changing circumstances had been a key element in successful adjustment programs. But there was also a danger that too much fine-tuning, as in the case of recent Chilean exchange rate and interest rate policies, might contribute to speculative forces.

More important, Mr. Dallara continued, an examination of the latest economic data suggested that there had been a general erosion of the adjustment program during the course of 1984. Admittedly, exogenous factors had played an important role. However, accelerated growth had clearly been a major cause of the worsened economic picture, at least in the early part of the year. A number of offsetting measures had been taken, but some of those measures had been introduced under considerable time constraints and might not be appropriate over the medium term.

There were several reasons for concern, Mr. Dallara commented. After negative growth of 14 percent in 1982 and 1 percent in 1983, positive real growth in 1984 was welcome. But the strength of the recovery had been underestimated, with the rate of growth--estimated at 4 percent--currently projected to reach 5.5 percent. Inflation had, accelerated correspondingly. The current account deficit, projected to be 6 percent of GDP in 1984, was currently estimated to be 9.2 percent of GDP, which was nearly equal to the high level of 9.6 percent reached in 1982, the year before the present stand-by arrangement began. The capital account surplus was also expected to be much larger than anticipated, mainly due to a liquidation of Chilean foreign assets.

The recovery of economic growth was a crucial objective of the current adjustment program, Mr. Dallara remarked, but it should be sustainable, both in terms of the savings and investment pattern and in relation to the balance of payments. On both counts there were reasons for concern. Latest estimates indicated a ratio of gross domestic investment to GDP of 13.5 percent, 1 percentage point higher than programmed, mainly due to the higher than expected level of investment by the private sector. That result in itself was good, but the composition of savings expected to finance the investment was disturbing. For example, the ratio of private savings to GDP would be only 3.7 percent instead of the programmed target of 5.7 percent, and foreign savings would amount to 9.2 percent of GDP instead of the expected 6 percent of GDP. The overall savings and investment ratios were low by international standards, and Chile's past history of high dependence on foreign savings added a cautionary note.

The staff report was cryptic concerning wages and prices, Mr. Dallara commented. He would appreciate a more general assessment of what had happened to real wages in 1984 and the prospects for 1985, given the cost of living adjustment already agreed for public sector employees.

The worsening in the balance of payments seemed to have been due in large part to a surge in imports earlier in 1984, Mr. Dallara noted, partly triggered by exchange rate and tariff increase expectations. He wondered whether there was evidence of a substantial buildup of imported stocks, which might have a one-time effect on the trade balance.

A number of elements of monetary policy were somewhat disturbing, Mr. Dallara remarked. While there had been a substantial drop in 1984 in the rate of credit expansion to the public sector in real terms, the expected rise still seemed high. He would be interested in more information on the problem of central bank subsidies; such subsidies were to be reduced between March 1984 and March 1985 under the program. He welcomed the authorities' intention to tighten up monetary policy for the rest of the year through reduced central bank credit, more open market sales, and rising interest rates.

The fiscal position was somewhat brighter, Mr. Dallara stated. The larger than expected operational surpluses of the public enterprises were particularly welcome, and he hoped that the target for the public sector deficit in 1984 would be reached. He invited the staff to comment on the greater resort to foreign financing of the deficit than originally contemplated--about three fourths of the total instead of one half. The sharp increase in customs duties, to a uniform 35 percent, gave cause for concern. Admittedly, the resulting increase in revenues could ensure that the public sector deficit ceilings were met; however, by increasing the cost of imported inputs, the increase in duties had led to the proposal for a new export drawback scheme.

His remarks might sound rather critical in view of Chile's strong determination to adjust, Mr. Dallara concluded. But it was necessary to survey the final results of policies and not only the policies themselves. A good start had been made on adjustment, but significant problems remained, and the threat of erosion of past progress was real.

Mr. Goos commented that since the previous review under Chile's stand-by arrangement, the authorities had taken impressive steps to keep the program on track in the wake of serious and unexpected problems encountered in the external sector. The authorities' continued strong commitment to the Fund arrangement was commendable and had led to remarkable results. All performance criteria had been met, the real growth of GDP would probably exceed the original program projections, and the expected results in the nonfinancial sector were virtually identical with the initial program targets.

Unfortunately, Mr. Goos continued, that positive picture had become considerably blurred in recent months. In addition to adverse external developments, there had been distinct shortcomings in domestic policies that could jeopardize the progress achieved thus far. He agreed with the staff's description of those shortcomings, and he subscribed to the staff's concerns and recommendations, in particular, its views on monetary policies, including domestic interest rates. The staff had also made a valid recommendation for a more cautious fiscal policy stance.

With regard to exchange rate policy, he sympathized with the authorities' concern about the recent sharp acceleration of inflation and their endeavor to moderate inflationary expectations, Mr. Goos said. Their attempt to achieve that moderation by slowing down the rate of depreciation of the peso brought to mind Iceland's earlier success with a policy of maintaining stable exchange rates, although recent discussions in the Board had shown that that policy had run into considerable problems. Furthermore, in view of the difficult situation in Chile's trade account, the country could not afford even a temporary erosion of its international competitiveness. He therefore supported the view that the country should return to a consistently flexible exchange rate policy. At any rate, the use of the exchange rate as a discretionary short-term policy instrument would probably do more harm than good, at least with respect to foreign capital inflows.

The anticipated shortfall in foreign direct investment, compared with the program target, might indicate the need for re-establishing the confidence of foreign investors in Chile's economic policy orientation, Mr. Goos stated. Instead of recourse to questionable exchange rate policies, the authorities' concern about inflationary expectations might be more efficiently met by reviewing the latest increase in import duties. Such a review--which preferably would result in an early reversal of the increase--would also be appropriate in view of its adverse repercussions on exports. He seriously doubted that the envisaged drawback scheme could effectively compensate for those repercussions. His doubts were reinforced by the experience of the existing drawback scheme, which the staff had described as "administratively complex." Finally, he supported the proposed decision.

Mr. Clark commended the Chilean authorities for their determination to keep the program on track in the face of a further decline in copper prices and the lagged effect of earlier rises in international interest rates. He shared many of the concerns cited by Mr. Dallara and therefore welcomed the authorities' September package of measures, although, like the staff, he did not believe that a tariff increase would prove to be the best way of raising revenue in the longer run, especially if a drawback scheme for exporters could not be implemented promptly. He was also concerned about the reintroduction of indicative interest rates for short-term deposits and the slippage in exchange rate policy in November, and he emphasized the importance of consistent policy implementation.

He was in general agreement with the staff appraisal, Mr. Clark continued. The staff had noted that the drawdown of foreign assets by the financial system, which he believed would finance over half of the expected worsening of the current account, was due to attempts by Chilean corporations to improve their debt/equity ratio. He wondered to what extent the drawdown also reflected the continued existence of the subsidized central bank swap scheme, even though the subsidies had been reduced. He invited the staff to comment on the extent of the Central Bank's losses in domestic currency terms on that scheme following the recent depreciation. Overall, the scheme appeared to encourage foreign currency inflows at considerable expense and risk for the Central Bank and allowed domestic interest rates to be held at lower than appropriate levels. The authorities should take steps to terminate the scheme as soon as possible.

While he welcomed the substantial devaluation in September, which among other things had sharply reduced the differential with the parallel market rate, his authorities remained concerned that unification of the two exchange rates did not seem to be in prospect, Mr. Clark commented. The unification had originally been scheduled for completion by December 1983 as a performance criterion. Following the problems in the financial sector, the Board had agreed to a waiver and had approved the associated multiple currency practice, which was intended to be a temporary measure until the end of 1984. He invited the staff or Mr. Nebbia to comment on the present timetable proposed by the authorities to unify the rate.

Finally, Mr. Clark said, he was concerned that for the third time in succession, papers on Chile had been circulated to the Board on very short notice. While he appreciated the need in the present instance, he hoped that efforts would be made to ensure that it was not necessary in the future. In conclusion, he supported the proposed decision.

Mr. Leonard commented that his Canadian authorities were also aware of the decline in copper prices and increase in interest rates abroad that had presented difficulties for Chile. In fact, the situation was more difficult than had been expected when the current program had been formulated earlier in 1984. Economic policy would need to be adapted to the unfavorable prospects if the gains made by Chile were not to be lost. The end-September performance criteria had been met with some margin to spare, and the authorities were to be commended for that achievement. To maintain progress, further restraint in economic management was needed, particularly in fiscal policy, which had been slower to respond to changes in circumstances than monetary policy.

The direction that adjustment was taking in a number of areas was cause for concern, Mr. Leonard commented; for example, the recent increases in trade barriers did not represent a positive development. If Chile were to obtain a new arrangement when the current stand-by arrangement ended in January 1985, attention should be focused on the correction of weaknesses in certain areas. First, the external current account deficit in 1984 was expected to be larger than projected. Although higher capital inflows would have an offsetting effect, a significant increase in external debt as a percent of GDP would further aggravate Chile's already heavy debt service burden. Furthermore, that increase in external liabilities was more than accounted for by the increase in public sector debt, as the level of private sector debt had fallen in absolute terms for the second consecutive year. Continuation of that trend would place increased strains concerns and recommendations, in particular, its views on monetary policies, including domestic interest rates. The staff had also made a valid recommendation for a more cautious fiscal policy stance.

With regard to exchange rate policy, he sympathized with the authorities' concern about the recent sharp acceleration of inflation and their endeavor to moderate inflationary expectations, Mr. Goos said. Their attempt to achieve that moderation by slowing down the rate of depreciation of the peso brought to mind Iceland's earlier success with a policy of maintaining stable exchange rates, although recent discussions in the Board had shown that that policy had run into considerable problems. Furthermore, in view of the difficult situation in Chile's trade account, the country could not afford even a temporary erosion of its international competitiveness. He therefore supported the view that the country should return to a consistently flexible exchange rate policy. At any rate, the use of the exchange rate as a discretionary short-term policy instrument would probably do more harm than good, at least with respect to foreign capital inflows.

The anticipated shortfall in foreign direct investment, compared with the program target, might indicate the need for re-establishing the confidence of foreign investors in Chile's economic policy orientation, Mr. Goos stated. Instead of recourse to questionable exchange rate policies, the authorities' concern about inflationary expectations might be more efficiently met by reviewing the latest increase in import duties. Such a review--which preferably would result in an early reversal of the increase--would also be appropriate in view of its adverse repercussions on exports. He seriously doubted that the envisaged drawback scheme could effectively compensate for those repercussions. His doubts were reinforced by the experience of the existing drawback scheme, which the staff had described as "administratively complex." Finally, he supported the proposed decision.

Mr. Clark commended the Chilean authorities for their determination to keep the program on track in the face of a further decline in copper prices and the lagged effect of earlier rises in international interest rates. He shared many of the concerns cited by Mr. Dallara and therefore welcomed the authorities' September package of measures, although, like the staff, he did not believe that a tariff increase would prove to be the best way of raising revenue in the longer run, especially if a drawback scheme for exporters could not be implemented promptly. He was also concerned about the reintroduction of indicative interest rates for short-term deposits and the slippage in exchange rate policy in November, and he emphasized the importance of consistent policy implementation.

He was in general agreement with the staff appraisal, Mr. Clark continued. The staff had noted that the drawdown of foreign assets by the financial system, which he believed would finance over half of the expected worsening of the current account, was due to attempts by Chilean corporations to improve their debt/equity ratio. He wondered to what extent the drawdown also reflected the continued existence of the subsidized central bank swap scheme, even though the subsidies had been reduced. He invited the staff to comment on the extent of the Central Bank's losses in domestic currency terms on that scheme following the recent depreciation. Overall, the scheme appeared to encourage foreign currency inflows at considerable expense and risk for the Central Bank and allowed domestic interest rates to be held at lower than appropriate levels. The authorities should take steps to terminate the scheme as soon as possible.

While he welcomed the substantial devaluation in September, which among other things had sharply reduced the differential with the parallel market rate, his authorities remained concerned that unification of the two exchange rates did not seem to be in prospect, Mr. Clark commented. The unification had originally been scheduled for completion by December 1983 as a performance criterion. Following the problems in the financial sector, the Board had agreed to a waiver and had approved the associated multiple currency practice, which was intended to be a temporary measure until the end of 1984. He invited the staff or Mr. Nebbia to comment on the present timetable proposed by the authorities to unify the rate.

Finally, Mr. Clark said, he was concerned that for the third time in succession, papers on Chile had been circulated to the Board on very short notice. While he appreciated the need in the present instance, he hoped that efforts would be made to ensure that it was not necessary in the future. In conclusion, he supported the proposed decision.

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Second, Mr. Leonard continued, in light of the deterioration in trading conditions and the increase in inflation in recent months, the tightening of monetary policy was welcome. It was regrettable that, although market forces had been permitted to play a greater role in determining interest rates, the authorities had reversed their initiative with respect to 30-day rates after only a short trial period. He hoped that there would not be a similar weakening of resolution with regard to interest rates on longer-term instruments, which continued to be determined by market forces and were now positive in real terms.

Third, a tightening of fiscal policy, similar to that of monetary policy, during the current quarter would have been desirable, Mr. Leonard commented. The authorities had merely retained the targets originally provided for in the program. Although the authorities considered that low private sector demand for credit should prevent any crowding out problems, there was a danger that pressures on financial resources could grow in future if greater adjustment in fiscal policy were not effected in 1985. The fiscal imbalance should be reduced, and he urged the authorities to constrain sharply the growth of expenditures and to implement previously envisaged revenue measures, such as a stamp tax on registered debt and higher road tolls.

Fourth, the large devaluation of the peso in September had been an important action to strengthen the external account against adverse trade developments experienced in 1984, Mr. Leonard remarked. The decision taken at that time to have daily adjustments in exchange rates on the basis of relative inflation developments was also a positive move. His authorities regretted that there had been a departure from that policy in November when the rate of devaluation had been slowed in order to contain inflationary pressures. They supported the staff in stressing that any short-term gains that might be achieved through that approach might not warrant the costs if it were to continue, and they welcomed the assurances that it was unlikely to be repeated.

Finally, his chair was concerned about the substantial increase in import duties--from an average of 21 percent to 35 percent, Mr. Leonard concluded. The Chilean authorities maintained that the increase had been implemented as a fiscal measure, but he questioned the necessity of a fiscal measure in that specific form, in view of the resulting trade distortions and the possible impact on other countries. He urged the authorities to rethink the desirability of that measure, and he welcomed the staff's plans to raise the issue in the context of discussions on a follow-up program.

Mr. Suraisry stated that he was in general agreement with the main points in the staff report and supported the proposed decision. Economic activity in the first half of 1984 had been satisfactory; however, it was disappointing to note that the situation had changed, mainly as a result of unfavorable factors beyond the authorities' control, such as the increase in international interest rates and the softening of copper prices. Because of that unfavorable turnaround, the authorities faced difficult economic conditions that called for adherence to the adjustment process to achieve the objectives of the program. He therefore welcomed the authorities' undertakings described by Mr. Nebbia.

The authorities had taken commendable measures to liberalize the exchange rate system, Mr. Suraisry remarked. While he appreciated the difficulties facing the authorities, he agreed with the staff that the policy should continue. Abandoning that policy stance could have short-term gains but could add to the uncertainties in the economy.

It was equally important that the authorities should continue their appropriate stance on fiscal and monetary policies, Mr. Suraisry continued. It was encouraging that the nonfinancial public sector deficit for the year as a whole was expected to remain within the program. But a number of revenue measures had not been implemented, and capital spending by public enterprises and the Government was expected to be below programmed levels for the whole year. On monetary policy, he agreed with the authorities and the staff that credit policy should be tightened in the remaining period of the program. He therefore welcomed the monetary plan that the authorities had presented, which was consistent with that objective.

Mr. Ortiz said that Chile had made great strides toward financial stability while managing to resume economic growth in 1984 after aggregate income had declined by a cumulative 15 percent in 1982 and 1983. Unfortunately, efforts to attain simultaneously growth as well as price and financial stability had been undermined to some extent by the continuing deterioration in Chile's terms of trade as a result of a very weak copper market. The difference between projected and actual export receipts during the third quarter of 1984 would probably exceed $100 million. At the same time, imports were higher than expected, due partly to the strong pickup of economic activity earlier in the year and possibly to speculative imports in anticipation of the modifications in tariffs and exchange rates. Interest payments on Chile's high external debt, on the other hand, continued to put pressure on the current account of the balance of payments, further complicating the external situation.

Notwithstanding the adverse developments in the external sector, the financial authorities had exercised prudent management of the budget, as reflected in a better than programmed fiscal performance in the first nine months of the year, Mr. Ortiz noted. The result was a substantially smaller deficit of the nonfinancial public sector as a percent of GDP than originally contemplated. He was concerned that fiscal equilibrium was being achieved at the cost of lowering capital formation--a phenomenon that seemed pervasive in all adjusting countries, especially in Latin America. He therefore sympathized with Mr. Nebbia's statement that achieving positive economic growth in 1985 was essential.

He remained puzzled by Mr. Dallara's intervention, Mr. Ortiz commented. While acknowledging that higher economic growth was a welcome development, Mr. Dallara seemed concerned that the economy was picking up too fast, leading to external disequilibrium. He himself had the impression that not enough importance had been attached to the effects of lower copper prices, which seemed to be the basic cause of external disequilibrium. The fiscal accounts clearly showed that the fiscal deficit was not being utilized to fuel economic activity; he invited the staff to comment.

Inflation had been kept under control during the first part of 1984, but following annual price increases of 13 percent, the September devaluation, and an increase in import duties, prices had risen rapidly in September and especially in October, Mr. Ortiz remarked. Although an acceleration of inflation following a devaluation was to be expected, the magnitude in the present case was surprising. After a relatively modest devaluation--less than 20 percent--the average rate of price increase in September and October, on an annual basis, had been almost ten times the rate of change in the first seven months of the year. He invited the staff to comment on those developments.

The Chilean authorities were firmly committed to an adjustment policy and had reacted promptly when adverse developments had taken place, Mr. Ortiz observed. In particular, as the external disequilibrium had become larger than expected, the authorities had taken commercial policy measures to discourage import growth. Those steps were likely to offset to some extent the benefits of the devaluation in promoting nontraditional exports, and the authorities were studying possible future reductions in tariffs. However, alarmed by the drastic price effects of the monetary and commercial measures, the authorities had suspended in November the exchange rate policy of devaluing the Chilean peso daily in line with the previous month's domestic inflation corrected for external inflation. It was encouraging that inflation had dropped drastically in November, and he was confident that the authorities would continue to follow a flexible exchange rate policy in the future.

His chair strongly supported the fiscal and monetary stance of the Government and endorsed the proposed decision, Mr. Ortiz stated. Given the great welfare loss suffered by Chile's population in recent years, and the economy's vulnerability to external shocks, he hoped that external conditions would improve sufficiently in the near future to allow continued adjustment efforts. The recent tendency of interest rates to decline was welcome, although the expected relief might not be sufficient to compensate for the damaging effects of the terms of trade. The authorities were aware of the need to intensify their efforts for export diversification in the light of both those developments and the bleak prospects for the copper market.

The staff representative from the Western Hemisphere Department explained that the acceleration of the rate of inflation to 10 percent in September and October, compared with a rate of 11 percent for the previous eight months, had been associated with the devaluation of the peso, which had taken place about mid-September, and the increase in the tariff level from about 21 percent on average to a uniform rate of 35 percent. Those two measures had increased the cost of imports by about 36 percent. The impact on prices had been sudden, perhaps because Chile ran a very open, market-oriented economy. That quick pass-through, along with the tightening of monetary policy, had resulted in a much-reduced rate of inflation by November, averaging about 1.2 percent for food, housing, and clothing.

As to the effect of the tariff increase on the export sector, the staff representative remarked, based on an input/output calculation for 1976, the authorities had estimated that an average 35 percent duty would reduce exports by 7-10 percent. An earlier suggestion had been to give all exporters a drawback in the range of 7-10 percent. At present, the drawback scheme was on hold as no decision had been made on whether to continue the 35 percent tariff over the longer term. Three alternatives were being considered within the Government: prompt reduction of the tariff level to a uniform, significantly lower, level; maintenance of the tariff for fiscal reasons; and establishment of a set of differentiated tariff rates. An important element of opinion in the Government favored lower rates because of doubts regarding the feasibility of a drawback scheme; two limited schemes existed, but they were complex and had not worked as well as intended.

With regard to the exchange rate, the staff representative continued, after the depreciation the rate of crawl had been reduced in November to half the rate of inflation in October for short-term considerations. He informed Directors that at 12 noon that day the Central Bank of Chile had announced a ministep devaluation of the peso of 3.6 percent to compensate for the real appreciation of the peso during November when the crawl of the exchange rate had been temporarily slowed to approximately half the rate of inflation in October. From December onward, the rate of crawl would again be determined by the rate of inflation in the previous month.

The wage rate was fixed by the Government for general government employees only and was negotiated collectively with labor in a number of public enterprises, the staff representative said. In January 1984 there had been a general government wage increase of 15 percent, while inflation in 1983 had been on the order of 23 percent, without any wage increase in the public sector. In 1984, with inflation to date at about 21 percent, there had been no further wage increases except for small bonuses of about $3-4, which had been given in the last three or four months of the year. Wage increases had been announced for January 1985 that would compensate for inflation in 1984 fully at the lower wage levels but only partially at the higher levels. On average, wages would increase by about 80 percent of the rate of inflation in 1984, but no further wage increases were planned for the remainder of 1985.

The larger current account deficit was mainly due to the higher import level, the staff representative commented. There had been some speculation in anticipation of a tariff increase and a devaluation, resulting in a buildup of stocks amounting to about $250 million of the import level in 1984. In calculating the 1985 import level, the staff was taking into account a buildup of stocks of about the same magnitude. The increase in the current account deficit beyond the expected level had been financed mainly by a drawdown of assets abroad by the banking system and the private sector and partly by an increase in short-term borrowing by the state copper company (CODELCO), which also explained the larger than expected foreign financing of the public sector deficit. CODELCO had financed a greater than expected share of its exports abroad and in effect had reduced its domestic financing requirements. Therefore, there had been a shift toward total foreign financing of the nonfinancial public sector and away from domestic financing. At present, CODELCO had less than 180 days' financing of its yearly exports; therefore, about five months of its exports were being financed, which was not considered excessive.

The staff believed that the subsidy on swaps must have brought in capital, whether it reduced assets abroad or not, the staff representative said. Central bank officials believed that the reduction of assets abroad by the corporate private sector had not been influenced by the swap mechanism. Nevertheless, that particular subsidy was costly to the Central Bank and should be decreased over time; the subsidy had reached 8 percent in 1984, and had been reduced in various stages to 5.6 percent and most recently to 4.6 percent. As a result of swap operations after the devaluation the Central Bank had suffered a sharp loss. Those swaps, the majority of which were for 30-60 days, had become due or had been rolled over in the period after devaluation, mainly in October. The large credit expansion of the Central Bank was due to the change in the exchange rate on those swap contracts, and it had been anticipated and included in the program. Therefore, the staff was confident that the monetary program for November and December would be less expansionary because of that once-and-for-all effect.

Mr. Templeman commented that he saw no inconsistency in the comments made by Mr. Dallara earlier concerning the growth rate and the current account deficit. He welcomed the recovery from a negative 14 percent growth rate in 1982 and a negative 1 percent rate in 1983, but growth in 1984 would be about 5.5 percent compared with 4 percent projected under the program. Moreover, because of lower copper prices and higher interest rates abroad, the balance of payments was expected to show a current account deficit of $1.8 billion rather than $1.2 billion. The deficit was also greatly affected by the growth of imports associated with a higher rate of growth. At 9.2 percent of GDP, the deficit ratio was practically the same as before the program began. Chile had one of the highest per capita debt ratios in the world and there were limits to what could be financed, not only for 1984 but for 1985 as well. While he hoped to see some recovery of real growth, it had to be kept within realistic financial limits. The goal of the Fund's program was a sustainable balance of payments position over the medium term, and the latest developments gave cause for concern.

The Chairman said that he concurred with Mr. Templeman's comments. Chile's debt situation and unsustainable current account deficit of about 9 percent of GDP indicated clearly that there were constraints due to external factors affecting the domestic growth rate.

The staff representative from the Western Hemisphere Department said that there were two elements involved in the unification of the exchange rate: one was the subsidy given to those with foreign debt, which was handled through the exchange system; the staff believed that the subsidy should be included in the fiscal system. The second element was the existence of a parallel market where it was legal to buy and sell exchange. The spread between the official and parallel markets had been reduced from about 25 percent before the devaluation to about 4 percent currently. The authorities expected the spread to narrow as appropriate policies were followed, although a timetable had not been determined.

The Deputy Director of the Exchange and Trade Relations Department added that Chile's multiple currency practices had been approved through the end of 1984. These practices would be an important issue for discussion during negotiations for a further arrangement. The staff would urge the implementation of policies to eliminate the multiple exchange rates within the period of the arrangement.

Mr. Nebbia thanked Executive Directors for their comments, which he would convey to his authorities for their consideration in implementing steps to consolidate progress in Chile and in dealing with the remaining problems in the context of their overall adjustment efforts. The deviation from the standard exchange rate policy in November had been temporary and had been made to avoid further inflationary pressures. He confirmed that the authorities had that day devalued the peso by a percentage equivalent to the rate of inflation in November plus the margin in October to restore the competitiveness of exports and to return to the standard exchange rate policy.

There had been no slippages during the implementation of the Fund program, Mr. Nebbia commented. All performance criteria for end-September had been observed, even with some margins, which in turn had led to full achievement of the targets. Those results were due to the full commitment of the Chilean authorities to the program and to the flexibility with which new measures had been implemented when necessary. Consequently, in spite of unfavorable external developments, it was clear that the country would be able to exhibit for the whole year a real GDP growth of more than 5 percent compared with 1983, an overall fiscal deficit that was compatible with the net borrowing requirements established in the program, an increase in international reserves, and a rate of inflation that would be only slightly higher than the 20 percent originally envisaged.

In spite of those signs of recovery, economic conditions in Chile remained difficult, Mr. Nebbia remarked. The authorities had to preserve current achievement and to move toward a more sustainable balance of payments position while continuing to pursue orderly and sound domestic policies. However, those efforts on the part of Chile would need to be supplemented by cooperation from foreign creditors, as well as from the Fund, in order to achieve a reasonable rate of growth that would allow increased investment and reduced unemployment. Chile had already undertaken a tremendous adjustment effort with the support of the Fund, and a new medium-term program was currently being discussed. A positive conclusion to that discussion would be imperative for Chile's recovery from its current difficulties.

The Executive Board then took the following decision:

1. Chile has consulted with the Fund in accordance with paragraph 2 of Executive Board Decision No. 7800-(84/139) of September 10, 1984 (EBS/84/179, 8/20/84; and Supplement 1, 9/7/84), which completed a review under the stand-by arrangement for Chile (EBS/82/227, Supplement 2, 1/11/83).

2. The Fund finds that no further understandings are necessary and that Chile may proceed to make purchases under the stand-by arrangement.

Decision No. 7860-(84/178), adopted
December 7, 1984

3. TANZANIA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Tanzania (SM/84/249, 11/6/84; and Sup. 1, 11/20/84), together with a proposed decision concluding the 1984 Article XIV consultation. They also had before them a report on recent economic developments in Tanzania (SM/84/256, 11/20/84).

Mr. G. Rutihinda, Principal Secretary to the Tanzanian Treasury, and Mr. J. Kipokola, Head of the Monetary and Fiscal Affairs Division of the Tanzanian Treasury, were also present.

Mr. Abdallah made the following statement:

The recent Article IV consultation with Tanzania took place against the background of continuing economic difficulties--in many ways similar to those facing a number of non-oil African countries. Real GDP experienced a cumulative decline of about 5 percent over the last three years, reflecting the drop in output of food and export crops due in part to the recurring drought and the unfavorable external environment. The manufacturing sector also suffered a decline. The main problem was the shortage of foreign exchange which forced Tanzania to cut back imports of not only consumer goods but also capital goods and raw materials. Nevertheless, since the sharp drop in real GDP in 1981 there has been improvement in each of the succeeding two years, and in fact there was 1.5 percent real growth in 1983. A further positive growth rate is projected for 1984.

The critical financial position of the Government reflects developments taking place in the real sector. However, the budget deficit has improved somewhat since 1981/82, declining from the equivalent of 16.5 percent of GDP to 12.3 percent of GDP in 1983/84. This is the outcome of "both steady increases in revenue and relatively smaller increases in expenditures as a result of tight expenditure policies" (see the report on recent economic developments, page 17). Between 1979/80 and 1983/84 revenue increased from the equivalent of 20 percent of GDP to 24.5 percent of GDP, owing to new revenue measures taken in each fiscal year and the increased effort to collect tax arrears and improve tax administration. On the expenditure side, there was an absolute decline in 1982/83, while there was a rise of 9 percent in 1983/84. In real terms this represented a decline in the two fiscal years, despite the sharp rise in interest payments. The authorities were able to achieve a slowdown in the rate of growth of expenditure primarily by holding down personnel costs, reducing defense and development expenditure, and containing growth in transfer payments to public corporations. In the words of the report on recent economic developments, "...developments reflected a more cautious management of all major outlay components."

The current account deficit narrowed from $615.2 million in 1982 to $388.5 million in 1983, though this improvement is more apparent than real. Exports declined sharply, along with a reduction in net inflows of official capital, so that the brunt of the adjustment was borne by imports, which declined by about 27 percent. With gross reserves at a very low level, Tanzania accumulated additional external payment arrears in 1983. The balance of payments position is expected to remain weak in 1984, although export receipts are likely to be higher than in the previous year. The overall deficit is projected to rise from near zero in 1983 to $193 million in 1984, reflecting a deterioration in both the current and capital accounts.

The policy measures announced at the beginning of the 1984/85 fiscal year are a continuation of adjustment efforts aimed at stabilizing and restructuring Tanzania's economy, which were initiated in 1982/83 with the adoption of the structural adjustment program. The emphasis of the program is on rehabilitation of the productive sectors, continuation of budgetary restraint, and institutional reform.

The staff had occasion to review the program with the authorities during the Article IV consultation and has expressed its views in the report that is before the Board. The fact that there are differences of opinion between the staff and the authorities with regard to the degree of emphasis on specific areas is not unusual. This should be expected when economic policy has to strike a balance between short-term stabilization goals, the longer-term objective of structural change, and the imperative of maintaining domestic stability. I must at this juncture emphasize that political stability, which Tanzania has been able to maintain in the face of severe economic hardship, is something that should not be lost sight of. One should also not overlook the fact that the policies now being implemented represent a substantial and important step in the right direction. In addition, it is worth stressing that the authorities are open to suggestions and are prepared to be flexible, as has been noted by the Fund staff during current discussions. The authorities are totally aware that real progress over the medium term will depend on the continuation of prudent policies, which should help the economy become less susceptible to exogenous forces.

One of the salient aspects of the 1984/85 budget program is the emphasis being placed on raising the level of output in the economy. Thus, as was the case in the previous fiscal year, steps are being taken to improve agricultural extension services and the transportation network, as well as to rehabilitate a number of projects in the agricultural sector. Special priority is also being given to increasing the amount of foreign exchange allocated to agriculture in order to facilitate the importation of much needed inputs, equipment, and spare parts. Meanwhile, the producer price for maize, the staple food, has been further increased effective September 1984 by more than 40 percent in addition to the 82 percent increase of a year before. This reflects the determination of the Government to move toward self-sufficiency in food production. Also, producer prices for export crops have been increased by between 46 percent and 55 percent. The intention is to ultimately raise real producer prices by about 30-35 percent in the medium term. With regard to the industrial sector, the major goal is to increase capacity utilization and improve financial management. Enterprises that have the potential of becoming profitable and contributing to the export effort also will receive priority in the allocation of foreign exchange to enable them to import necessary inputs. The export receipts retention scheme has been introduced and extended to help exporters of both traditional and nontraditional products.

Fiscal policy remains cautious. Additional steps have been taken to increase revenue, while efforts are being made to restrain expenditure. The composition of the budget reveals two important points which define the orientation of fiscal policy. First, subsidies on fertilizers, pesticides, and other agricultural inputs, as well as those to public corporations involved in purchasing and marketing crops--an amount that has been substantial over the years--have been eliminated. Second, recurrent expenditure is projected to rise by only 9 percent in 1984/85 compared with an increase of 16 percent in 1983/84. In addition, the Government intends to initiate steps to reduce administrative costs, starting with the reduction in the number of government ministries, and will in future require local government to finance a large share of its expenditure. A further strengthening of budgetary control has been put into effect.

As part of the overall strategy to improve the financial position of the public sector, steps are being taken to make public corporations more efficient. Most of the recommendations made by the Presidential Commission on Cost Reduction in Public Enterprises have been accepted. A good number of public enterprises have been closed down and the major crop authorities have been scaled down to function only as export marketing boards. Also as an immediate step, the Government has re-established cooperative unions which will take over some of the operations that had been undertaken by the crop authorities, including the National Milling Corporation. In addition, the decision was taken to liberalize prices with a view to making the newly restructured boards viable entities. The restructuring efforts are expected to continue beyond the current fiscal year and well into the next two years.

Since 1982, the growth in money stock has fallen substantially below the rate of price increases. In 1983, prices rose by 27 percent, while the growth in money was 13 percent. The authorities, however, have been concerned about the high dependence of the Government on domestic bank financing. In 1984/85, domestic credit is projected to expand by 19 percent compared with 21 percent in 1983/84.

Interest rates are negative in real terms, given the prevailing rate of inflation, and the authorities recognize that there may be a case for raising them. Nevertheless, there is some doubt that an increase would have a significant impact on resource allocation and the level of savings. One might note from Table XIV of Appendix II to the report on recent economic developments that the category "other residents," which is mainly comprised of households, has been responsible for much of the increase in savings, despite prevailing negative rates of interest.

On June 14, 1984, the shilling was further devalued by 36 percent. The authorities intend to be flexible in the management of the exchange rate, given the need to provide adequate price incentives to farmers. However, they have stressed that exchange rate adjustments alone will not increase production unless they are supported by other supply-oriented measures, including particularly inflows of external resources to revive output and greater availability of incentive goods to farmers.

Tanzania's debt service burden rose to 26 percent in 1983. According to Fund staff estimates, the situation is expected to worsen in 1984 with debt service reaching 75 percent of exports of goods and nonfactor services. The problem, it is pointed out, has been exacerbated by reliance on suppliers' credit for oil imports.

To conclude, the Tanzanian authorities are taking seriously the need to reverse the deterioration in their economy. They have already taken tough measures to this effect, so far without additional external support. They hope that the new policy orientation will appeal to donor countries, as well as serve as a basis for developing a program which can be supported by the Fund.

Mr. Ramtoolah commented that the performance of the Tanzanian economy since the previous Article IV consultation had been generally unsatisfactory. Real GDP had continued to decline, while inflation was running at more than 25 percent despite an official policy of price control. On the other hand, the fiscal deficit, although still at an unsustainable level, had been contained in 1983/84 to 12.3 percent of GDP, reflecting steady increases in revenue and relatively smaller increases in expenditure, the latter on account of tighter expenditure policies. Despite a decline in exports, the current account deficit had declined in 1983, but only at the cost of major cutbacks in imports with potentially adverse effects on growth in the long run.

In contrast with that poor performance, the 1984/85 budget marked a significant turning point for the Tanzanian economy, Mr. Ramtoolah remarked. Major policy decisions had been announced with the adoption of the 1984/85 budget, including increased foreign exchange allocations to the agricultural sector to cover its minimum needs of inputs, equipment, and spare parts; the elimination of all existing subsidies on inputs; and increases in agricultural producer prices, of 46-55 percent, for various crops. Other policy measures concerned the elimination of the deficit of the parastatals, the reduction of budgetary subsidies for local government, and a 36 percent devaluation--in local currency terms--of the Tanzanian shilling. Although it was questionable whether those measures would be sufficient to deal with the magnitude of the imbalances facing the Tanzanian economy, they should be seen, first, in the light of past policies in Tanzania, and second, as a step toward a comprehensive adjustment effort. In that context, he agreed with the staff that the measures represented "a significant policy reorientation."

The authorities had adopted a flexible attitude toward various sensitive issues, Mr. Ramtoolah continued, a positive step that provided a convenient starting point for a new outlook. He noted from Mr. Abdallah's statement that the authorities intended to be flexible in the management of the exchange rate; in addition, the producer price of maize--the most important food crop and the main staple food and thus a sensitive item--had been increased effective July 1, 1984 by about 80 percent. More generally, the authorities had indicated that they wished to see agricultural producer prices increased ultimately by 30-35 percent in real terms. Such flexibility on the part of the authorities called for a response by the international community. Tanzania was a country of great potential; with appropriate financing to back a comprehensive adjustment effort, the country could be on its way to self-sustained growth in a few years' time.

Mr. Goos commented that the staff papers conveyed the disappointing message that economic developments in Tanzania had not improved since the previous Article IV consultation with the country. Apparently, the adjustment measures adopted by the authorities had not been strong enough to achieve a turnaround in the economic crisis, which to a large extent seemed to be a crisis of supply. It was particularly worrisome that external payments arrears exceeded the past year's export earnings and that the debt service ratio projected for 1984 was clearly unsustainable.

Against that background, the authorities seemed prepared to introduce significant modifications in their overall policy stance, Mr. Goos continued. He welcomed that position and noted that the authorities had already adopted some corrective measures. However, both the measures adopted to date and those envisaged for the future fell short of what appeared to be required in light of the number of problems confronting the country. The extent and complexity of those problems were clearly reflected in the exceptional length of the staff appraisal, with which his authorities were in full agreement.

Several of the measures announced in the context of the recent budget, including the abolition of certain subsidies, increases in agricultural prices, and reform of the parastatal sector, were important steps in the right direction, Mr. Goos commented. It was also encouraging that the long-standing priority given to industrial development had given way to a revival of agricultural production, as reflected in higher budgetary outlays for agriculture and adjustments in agricultural producer prices. However, he shared the staff's view that the pace of adjustment of agricultural producer prices should be considerably accelerated and complemented by a faster liberalization of prices in all sectors. He welcomed the authorities' willingness to accept the idea of remunerative prices, which included profits and thus provided incentives for production.

He strongly supported the staff's suggestions regarding appropriate exchange rate policies, Mr. Goos said. The extremely high real appreciation of the country's exchange rate, which even after the past depreciation amounted to about 60 percent compared with the rate in 1979, had had devastating effects on domestic food production and had placed a heavy burden on the country's trade balance. Therefore, decisive action on the exchange rate seemed one of the most important preconditions for a turnaround in the overall economy. Although the authorities had adopted a more flexible attitude, they remained skeptical about possible exchange rate effects on production. Perhaps their attention could be drawn to the considerable improvement of the domestic supply situation in Ghana, which had been helped to a large extent by a resolute depreciation of its currency.

He agreed with the staff's views on the liberalization of import controls, the foreign exchange retention scheme, and the need to reduce the public sector deficit, Mr. Goos remarked. A sizable reduction of the budget deficit could be expected in the medium term only through improved supply conditions as a result of various policy reforms as well as through the more efficient operation of public enterprises. However, the recent wage increase in the public sector of 30 percent was too high in view of the difficult budgetary situation. He recognized that public employers were under increasing pressure to grant such wage increases as a result of declining real incomes and the adjustment of the politically sensitive price of maize--an adjustment that deserved the highest respect. With regard to the financing of the public sector deficit, he recommended greater recourse to nonbank credit sources in the interest of a more stability-oriented domestic credit policy. Such a policy would also be greatly facilitated if interest rates were raised to positive levels.

Mr. de Groote commented that the Tanzanian economy, which had been deteriorating over the past several years, was still plagued by both internal and external imbalances and was still without a stabilization program. He was particularly concerned that although the Tanzanian authorities had recently attempted to reorient their policies, they had thus far failed to reach an agreement with Fund management. The failure of the authorities to accept the need for a fundamental adjustment had inflicted serious income losses on the population. The present case was a typical example of how an incorrect assessment of a country's situation by its authorities could compound the difficulties imposed on that country by outside factors--difficulties that could have been remedied by a Fund-supported adjustment program. He was especially concerned because the country boasted a prestigious, ambitious leadership--as reflected by Tanzania's high literacy rate--and ideal conditions for effective reform if appropriate measures of sufficient intensity were taken.

The basic issue, Mr. de Groote continued, was that the measures taken recently were so gradual that they could have little impact on the structural weaknesses of the economy. As in many other African countries, Tanzania's problems were largely structural. The reorientation of the economy and the correction of the imbalances would take a long time and would require fundamental action. The gravity of the situation, which included a negative economic growth rate, galloping inflation, and a difficult balance of payments position, underlined the need for the authorities to redouble their efforts to create conditions that would permit a revival of economic growth and external adjustment. A durable improvement in the current account would require a more substantial depreciation of the shilling than the 36 percent adjustment in local currency terms enacted in June. Positive recent developments were the authorizations for enterprises to keep a fraction of their export proceeds and for companies with financial resources to use them for imports at free market prices.

Imbalances in the agricultural sector, which accounted for over one third of GDP and employed 80 percent of the population, had created several problems, Mr. de Groote remarked. Budget cuts, unrealistic pricing policies, and a lack of necessary inputs and adequate financial incentives had substantially depressed that sector's real growth rate. By affecting the growth of exports, the pressure on the balance of payments had been increased. A more flexible pricing policy and exchange rate policy, and an acceleration of the rate of reform of the agricultural sector, might help to eliminate the imbalances although that sector was also subject to important factors beyond the authorities' control, such as adverse weather, the lack of physical infrastructure--particularly irrigation facilities--and insufficient inputs. He welcomed the suppression of the crop authorities and their replacement by cooperative unions that were managed by the farmers and that operated on the basis of more realistic prices. He also welcomed the setting up of interministerial study groups to formulate appropriate reform proposals. Such study groups would ensure progress if they helped the authorities to better appreciate the need to reduce administrative intervention and to give appropriate price incentives to agricultural producers. The World Bank's assessment in Attachment III to the staff report made useful suggestions that could be incorporated into the Fund's judgment of the situation as reflected in the Chairman's summing up. That reference would be the first explicit one to the Fund's collaboration with the Bank in the establishment of a joint diagnosis.

Tanzania's total fiscal deficit would increase to about 16 percent of GDP in 1984/85, which was exceptionally high, Mr. de Groote remarked. Total tax revenues, about 24 percent of GDP according to "Quantitative Characteristics of the Tax Systems of Developing Countries" (DM/83/79, 11/28/83), were higher than the average of 17 percent for all developing countries and much higher than the average in Africa. It was interesting to note that the Tanzanian representatives had suggested that a sustainable medium-term reduction in the budget deficit could only result from an expansion of the domestic economy, which would increase the tax base. In the light of the relatively inelastic revenue system and the high tax/GDP ratio, he invited the staff or Mr. Abdallah to elaborate on the possibility of increasing tax revenues in the medium term in order to reduce the budget deficit. He was convinced that Tanzania's deficit was generally due to the excessive level of total expenditures, which had been about 35 percent of GDP for the past five years. He therefore agreed with the World Bank's opinion that preparation of a medium-term public expenditure program was urgently called for.

With respect to monetary policy, Mr. de Groote continued, although the announced trend toward liberalization of the economy had been accompanied by some expansion in private financing activities, the share of the private sector in total domestic credit expansion had been only about 3 percent. It was difficult under those circumstances to understand the extent of credit policy liberalization as well as the staff's recommendation on the direction that interest rate policy should take, given the existing institutional framework of the economy. At present, real deposit and lending rates were substantially negative. He wondered whether the staff considered it necessary to raise the real rates to make them positive in order to improve the allocation of resources and to increase savings, or whether it would be better to pursue the same goal by closing the gap between inflation and interest rates, even if that meant retaining negative interest rates. Almost 97 percent of total credit was allocated by the Central Government and the public sector. A rise in lending rates would increase indebtedness and thus the total public sector deficit. Higher interest rates required further strengthening of fiscal policy, which was already extremely ambitious. There might thus be limits to the interest rate increases that could be recommended; those increases could only be tolerated if structural changes were introduced into the financial mechanisms to ensure that the share of public indebtedness in total indebtedness was brought down to manageable proportions.

The National Bank of Commerce had carried the full exchange risk resulting from the accumulation of external commercial arrears and had experienced substantial losses owing to devaluations arising from recent adjustments, Mr. de Groote noted. As those losses must be covered by governmental resources, there was a danger that pressure could be placed on monetary aggregates in coming years. The proposed study of that issue must produce suggestions for reforms that would cut the automatic mechanism linking government imports to arrears, and arrears to government financing, thus leading to a vicious circle. The recently adopted policy measures would lead to further and more decisive actions by the Tanzanian authorities and that the coordination of divergent views would permit an understanding to be reached between Tanzania and the Fund in the coming months.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/177 (12/6/84) and EBM/84/178 (12/7/84).

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/262 (12/5/84) is approved.

APPROVED: September 9, 1985

LEO VAN HOUTVEN
Secretary