NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/76

10:00 a.m., May 27, 1983

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	H. G. Schneider
B. de Maulde	
	C. A. Salinas, Temporary
R. D. Erb	J. C. Williams, Temporary
	T. Alhaimus
	I. R. Panday, Temporary
	H. Suzuki, Temporary
R. K. Joyce	
A. Kafka	
	G. Grosche
G. Lovato	C. P. Caranicas
	A. S. Jayawardena
	S. El-Khouri, Temporary
J. J. Polak	
A. R. G. Prowse	K. G. Morrell
	O. Kabbaj
F. Sangare	
M. A. Senior	
	A. Lindå
	C. Taylor
	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present

African Department: J. B. Zulu, Director; O. B. Makalou, Deputy Director; R. J. Bhatia, Deputy Director; P. A. Acquah, E. L. Bornemann, S. E. Cronquist, A. B. Diao, M. G. Fiator, M. Sidibé, E. van der Mensbrugghe. Asian Department: T. J. Rommel. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; S. Kanesa-Thasan, A. B. Petersen. Fiscal Affairs Department: G. A. Mackenzie. Legal Department: J. G. Evans, Jr., Deputy General Counsel; H. Elizalde, A. O. Liuksila. Treasurer's Department: I. A. H. Diogo. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; H. Bierman, M. E. Bonangelino, M. Caiola, C. Cha, R. A. Elson, M. T. Hernandez, E. V. Zayas. Advisors to Executive Directors: C. J. Batliwalla, S. E. Conrado, S. M. Hassan, P. Kohnert, P.-C. Maganga-Moussavou, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, H. Arias, L. Barbone, R. Bernardo, T. A. Connors, C. Flamant, M. Hull, M. J. Kooymans, V. K. S. Nair, J. G. Pedersen, G. W. K. Pickering, E. Portas, J. Schuijer, Shao Z.

1. GABON - 1982 ARTICLE IV CONSULTATION AND REVIEW OF EXTENDED ARRANGEMENT

The Executive Directors considered the staff report for the 1982 Article IV consultation and a review of the extended arrangement with Gabon (EBS/83/42, 2/24/83; Cor. 1, 3/15/83; and Sup. 1, 5/25/83). They also had before them a report on recent economic developments in Gabon (SM/83/41, 3/2/83; and Cor. 1, 3/15/83).

Mr. Alfidja made the following statement:

In furtherance of the adjustment effort supported by a one-year stand-by program during 1978-79 aimed at reducing large internal and external financial imbalances that had emerged after the 1973-74 oil boom, the Gabonese authorities initiated a Fund-assisted structural adjustment program in 1980. The policies under this three-year program (1980-82) were aimed at providing a foundation for a noninflationary growth, expanding the productive base, and reducing the external debt while reinforcing the foreign reserve position. The extended arrangement was requested for precautionary purposes and has been successfully completed.

The macroeconomic targets during 1980-82, as revised for the last two years, include an annual average increase in the real GDP adjusted for changes in the terms of trade by 3.7 percent (1.9 percent for the unadjusted GDP), and in consumer prices by 10.7 percent, an overall budget surplus averaging 8.5 percent of GDP, an external public debt representing 29.2 percent of GDP, current account and overall balance of payments surpluses averaging the equivalent of 9.9 percent of GDP and 1.4 percent, respectively, and a domestic credit expansion of 8.2 percent.

As a result of the unexpected rise in the oil price from $31.30 per barrel in 1980 to $37.30 per barrel in 1982, and of the depreciation of the CFA franc, the foreign exchange earning position of the country improved considerably, as evidenced by the increase beyond target of the current account and overall balance of payments surpluses by the equivalent of 2 percent of GDP and 1.6 percent (on average during 1980-82), respectively. The large inflow of oil revenue has also contributed to the growth in government revenue, while the devaluation of the CFA franc and the unexpected high increase in interest rates in major foreign financial markets have exerted unfavorable pressure on expenditure. However, despite the adverse developments, significant progress was recorded in the fiscal sector, the overall budget surplus exceeded the target, large repayments of the external debt occurred as planned, and an accumulation of cash reserves has taken place during the program period. Reflecting

in part the aforementioned factors, real aggregate demand advanced less rapidly than programmed, whereas domestic credit expanded at an average annual rate of only 2.7 percent, well below the target of 8.2 percent. The implementation of the program was successful not only in financial terms, for progress has been also achieved on the structural front.

In the agricultural sector, coffee and cocoa plantations are being rehabilitated, while the cultivation of other crops--palm, rubber, rice, fruits--is being expanded. The construction of water supply and electricity facilities as well as of access roads is under way in rural areas in order to retain youth and expand the productive base and the distribution network. Durable gains have also been achieved in the public sector through the introduction of new hiring procedures, of public contract awarding regulations, and of improved supervision and monitoring of the financial operations of the major public enterprises. More progress remains to be made in areas such as economic diversification. My authorities share the staff's view that bottlenecks have slowed the implementation of policies aimed at diversifying the economic base of the country and intend to take measures aimed at removing these obstacles. However, given the structural nature of the problems associated with the diversification of the economy--hence, the time and amount of human, financial, and other resources needed, it would be unrealistic to expect favorable results swiftly. The diversification effort under way should be seen as the start of a long process.

In reference to the observance of the performance criteria, my authorities do not share the staff's view as expressed on pages 2 and 20 of EBS/83/42 whereby a loan to be used to finance the construction of the Trans-Gabon railways is to be included in the ceiling on external loan commitments in the maturity range of one to ten years. It is my authorities' opinion that the staff's treatment of the loan is the result of a misunderstanding, as the Government acting in good faith could not have possibly contracted a loan of SDR 335 million while knowing that the ceiling on such loans was SDR 75 million. The Gabonese Government's view rests principally on the fact that the average maturity period of the loan exceeds ten years and hence is beyond the maturity range for performance criteria. Moreover, the interest rate applicable to this loan is very favorable, and failure to take advantage of the offer would result in borrowing at considerably more onerous financial terms. Furthermore, the drawing of the loan will will occur only upon expiration of the extended arrangement. I would like to add that ceilings on external debt are set in order to ensure that the country's debt profile and debt service obligations will not jeopardize its internal and external financial balances. It is my authorities' view that obligations associated with the loan in question will not threaten these balances. To the contrary,

the debt burden would worsen in the future should Gabon forgo this concessional loan for a more onerous borrowing upon the expiry of the extended arrangement. Hence, on the basis of these considerations, I would like to reiterate my authorities' strong view that the amount of the loan in question be excluded from the ceiling on new external borrowings.

Finally, I would like to stress the determination of the Gabonese Government in its pursuit of the economic redressment under way--in particular in the field of public finance. In light of the recent fall in oil prices and the perspective of lower foreign earnings and revenue shortfall, and in a move consistent with the position reported by the staff on page 19, the Gabonese Government has recently taken measures aimed at promptly adapting expenditure policies to revenue developments. My authorities remain confident that in so doing, undue strain on the financial stability of the country will be avoided. The measures taken include the scaling down of capital outlays, the reduction of housing allowance, consumer subsidies, education allowances, the number of temporary workers, the number of official travels abroad (as well as the size of the delegations), the closing of some embassies, and the more vigorous enforcement of retirement laws. The Government has also instructed spending units to adhere strictly to budgetary ceilings and not to undertake unauthorized expenditure. Finally, no recourse to foreign borrowing in order to make up for shortfalls, if any, in oil revenues will be undertaken in 1983.

In summary, I would like to stress the strong determination of the Gabonese Government--as stated at the highest level--to safeguard the achievements that occurred under Fund-assisted programs and to make the pursuit of a disciplined economic and financial policy the central thrust of Government operations. It is in support of this effort that my authorities would like a Fund mission to visit Libreville soon in order to hold discussion on the future course of action and cooperation between the Fund and Gabon.

I would like to thank the staff for the thorough way in which the Article IV consultation and the review of the extended arrangement were conducted, and for the thoughtful suggestions put forward.

Mr. Sangare commented that it was clear from the staff report that the performance of the Gabonese economy under the three-year program for which an extended arrangement had been approved by the Executive Board in June 1980 had been satisfactory. The financial goals of the program had been attained, as almost all the performance criteria had been met. For example, the budget had consistently remained in surplus, reflecting mainly substantial oil revenues. Furthermore, the current account, as well as the overall balance of payments, had been in surplus in the past

three years, making it possible for the Gabonese authorities to build up external reserves to the equivalent of about four months' imports. He noted that the authorities had also been able to reduce substantially the country's external debt and to improve its profile. That commendable success story had made it unnecessary for Gabon to draw under the extended arrangement.

Despite those successes, Mr. Sangare continued, there had been slippages in implementing structural adjustment measures, so that growth in real output had been less than anticipated. While the overall growth of the non-oil sector, 2.7 percent in 1982, might have been lower than envisaged under the program, it had, nevertheless, been significant in light of prevailing international economic circumstances, when many developing countries had been experiencing declining output. However, it would be interesting to know the source of the impetus to overall economic growth, particularly since investment in agriculture, for example, had fallen short of what had been planned. The authorities should continue with their efforts to diversify into agriculture to provide for broader-based future economic growth.

In that connection, Mr. Sangare noted, it was worrisome that the share of agriculture in total investment had declined during the program period to 7 percent from a planned 10 percent. The decline was attributed to inadequate project preparation and weakness in implementation. As in other developing countries, problems in the agricultural sector included inadequate physical and economic infrastructure and, in Gabon, those problems had contributed to an exodus of youthful, more productive people from the countryside to the cities. In their future development plans, the authorities should consider an increase in infrastructural investment outlays to expand the absorptive capacity of the agricultural sector.

In the industrial sector, Mr. Sangare went on, the authorities realized that industries were operating below capacity, mainly as a result of the small size and segmentation of the domestic market. He noted that the authorities were encouraging private participation by providing fiscal incentives as well as by establishing the necessary infrastructure. As in agriculture, the authorities' overall objectives could be pursued if public sector investment in 1983 concentrated on improving physical and economic infrastructure to lay the foundation for increased private sector participation. Given the bottlenecks cited in the staff reports, such an allocation of capital outlays by the Government would be appropriate. In that connection, he invited the staff to comment on the Trans-Gabon Railway project. The thinness of the domestic market should not be a major obstacle to industrial production. What was important was the broadening of the market through export promotion, an effort in which the private sector might prove to be more efficient. Gabon could be greatly assisted in those endeavors if barriers to trade were dismantled, particularly in industrial countries.

Commenting on the program for 1983, Mr. Sangare endorsed the policy objectives of the authorities to accelerate growth, especially in the non-oil sector, while consolidating the gains made in diversifying the economic base within the framework of the Interim Plan. If public sector investment, which had been increased substantially, were directed at expanding absorptive capacity and at further diversification, such fiscal expansion would be warranted, given the position in the fiscal and external accounts. He had been encouraged by the track record set during the program period, when the authorities had demonstrated substantial financial discipline that had contributed significantly to the attainment of their overall financial goals. Fiscal expansion in 1983 would not unduly disrupt the gains made in the fiscal and external accounts, particularly if directed at improving the basic infrastructure in rural areas to prevent migration of able-bodied people to the cities. He supported the proposed decision.

Mr. Prowse stated that he agreed with the staff appraisal, although there had been a number of serious slippages in policy implementation, particularly with regard to civil service recruitment and systematic wage drift. Furthermore, the growth objective, the primary objective of the program, had not been achieved, largely as a result of the external situation. On the other hand, all the performance criteria had been observed, and the program had been successful in attaining its financial goals: the targets for the external current account, the overall balance of payments, and for the budget had all been achieved or surpassed.

The reduction in external indebtedness was particularly commendable, Mr. Prowse remarked. The staff stated that the debt servicing burden had increased, but the increase was in absolute terms as the result of factors beyond the authorities' control, such as exchange rate movements and increases in interest rates. The debt service ratios, such as debt service in relation to exports, or debt in relation to GDP, had declined. The declines reflected in part the higher than expected earnings from oil, which had resulted in the share of petroleum in exports rising from 71.5 percent in 1979 to 81.6 percent in 1982, and in government revenues rising from 54.6 percent in 1979 to 66.6 percent in 1982. Thus, petroleum was a more important factor in the economy than it had been several years earlier, a result that underlined the most serious issue to arise from the review of the program, i.e., the failure to achieve the diversification in investment and in production that had been an important program objective. The possibility of a decline in oil reserves and the uncertain prospects for oil prices emphasized the need to pursue structural diversification further. While the extended arrangement had been successful financially, it had failed to lay the groundwork for sustained diversified development. In that regard, continued collaboration with the World Bank should be encouraged.

The need to diversify and to direct investment into more productive activities was easy to advocate, Mr. Prowse commented, but difficult to put into practice. The existing excess capacity in the industrial and manufacturing sectors created a dilemma, since, in a sense, the necessary

productive capacity already existed. It should also be recognized that diversification of investment did not remove the need to keep the 1983 budget and future budget levels in line with the levels achieved during the period of the extended arrangement. The staff projection of an increase in the budget deficit from about 4 percent of non-oil GDP in 1982 to more than 9 percent in 1983 should give the authorities cause for concern.

Gabon's currency, the CFA franc, was pegged to the French franc, Mr. Prowse noted. As a result, there had been a rather steady depreciation in the nominal exchange rate in the two years to the second quarter of 1982, amounting to a real effective depreciation of about 5 percent. However, it appeared from Chart 4 in EBS/83/42 that the real effective rate of the CFA franc was about 20 percent higher than in 1975. He invited the staff to comment on the appropriateness of the real effective rate, an issue that might usefully have been discussed in more detail in the paper. Perhaps the level of the exchange rate had played a role in the creation of excess capacity in the manufacturing, and more generally, in the failure to diversify the economy.

Mr. Alhaimus said that he could endorse the broad thrust of the staff appraisal. Two aspects of Gabon's experience with Fund-supported adjustment policies were particularly relevant to future reviews of such programs. First, Gabon had closely adhered to the financial policies of the program, policies considered necessary to restore financial viability, both domestic and external. However, less than satisfactory performance with regard to growth, and in the non-oil sector, raised basic questions concerning the relationship between the design of the program, including the performance criteria, and the objectives of the program, in particular the developments envisaged in the real sector of the economy. Not infrequently, a country's compliance with the provisions of a program in terms of policy changes and performance criteria could result in no progress in the real sector even over the medium term. It might be said that the financial targets in such situations had been realized at the expense of growth.

At the time of the previous Article IV consultation with Gabon (EBM/82/70, 5/24/82), Mr. Alhaimus recalled, a number of Directors had pointed out that the economy's difficulties were not related to its management in the short term, but to structural and long-term development. As in other programs, growth had not been integral to the program in the same way that agreed credit ceilings and fiscal targets had been. However, while there had been no lapses in resource mobilization and while the growth of savings and investment had been achieved in line with the targets, the adjustment effort had left much to be desired in terms of progress toward addressing the structural problem, including diversification and economic growth, although some progress had been achieved in certain areas, as Mr. Alfidja had indicated in his statement.

A second noteworthy aspect of Gabon's experience, Mr. Alhaimus considered, was that an oil exporting country was as vulnerable as other developing countries to occurrences in the international economy. Some of the unexpected occurrences in Gabon's economy during the program period could be attributed to unduly optimistic assumptions about the effects of the world recession on the economy.

Commenting on the degree of effectiveness of exchange rate adjustment, Mr. Alhaimus wondered to what extent the depreciation of the CFA franc that had taken place during the program period corresponded to differential rates of inflation in Gabon and in its trading partners. He invited the staff to provide additional information on the relationship between the CFA franc depreciation and the decline in non-oil exports during the program period.

Mr. Kabbaj said that he agreed with the thrust of the staff appraisal and that he supported the proposed decision. In particular, he concurred with the staff analysis of the prospects for the Gabonese economy and with the recommendations for continued caution and budgetary discipline in 1983. The 1980-82 extended arrangement with Gabon, which had been adopted as a precautionary measure and had not involved actual drawings, had been a clear indication of the authorities' serious attitude and their resolve to cope with the structural weaknesses of the economy and eliminate the important imbalances that had developed after years of expansionary policies.

It was encouraging that performance under the extended arrangement had been largely successful, Mr. Kabbaj continued, particularly with regard to financial policies. The program had resulted in a substantial strengthening of both the balance of payments current account surplus and the budget surplus. While it had enabled Gabon to reduce substantially the ratio of outstanding external debt to GDP from 49.2 percent in 1979 to 25.3 percent in 1982, and of external debt service to GDP from 23 percent to 13.1 percent over the same period, it had also resulted in a significant buildup of gross foreign reserves, almost depleted at the beginning of the program, to the equivalent of about five months' imports. Such a performance was all the more remarkable as it had been achieved in an adverse environment, characterized by unsettled conditions in foreign exchange and financial markets, high rates of inflation and recession in industrial countries, high international interest rates, and consistent deterioration of the terms of trade for non-oil exports.

However, developments in the real economy of Gabon had been less satisfactory, Mr. Kabbaj observed, with the rate of real growth being beneath the modest figure targeted in the program, and with the failure to implement the projected diversification of the economy. While a considerable improvement had been achieved with respect to structural and institutional reforms, a more significant effort continued to be required to implement the major reforms envisaged, particularly with regard to taxes, the investment code, and customs duties. The diversification of the economy through investment in the non-oil sector was

crucial, since real oil export earnings and volumes were projected to decline substantially in the medium term. In that regard, the authorities' intention to use public sector investment as the prime instrument for such diversification, and to shift resources in favor of directly productive non-oil sectors, was broadly appropriate.

Commenting on Gabon's prospects and policies, Mr. Kabbaj remarked that, following the considerable strengthening of the fiscal situation, the balance of payments, and the international reserves position, it was legitimate for the authorities to aim at a strong resumption of growth and at an acceleration of diversification of the economy. In that connection, the tax measures and other incentives introduced to channel more private investment to the non-oil productive sectors was appropriate and they should not result in a large loss of budget revenues. However, the generally expansionary financial policies initially envisaged for 1983 could have failed to consolidate the gains of the 1980-82 extended arrangement. He agreed with the staff that continuation of budgetary discipline in 1983 and maintenance of existing financial conditions was certainly more advisable, and that it could pave the way for a successful implementation of the next development plan. In that regard, he welcomed the information in EBS/83/42, Supplement 1, that the Gabonese authorities were in the process of revising the 1983 budget, largely in line with the staff recommendations, and that they had announced a number of reductions in expenditure on public investment, civil service recruitment, and scholarship awards. Such moderation was particularly welcome since the fight against inflation had not been fully won under the extended arrangement, and since the prospects for oil revenues remained uncertain in light of the continued weakness of the oil market.

Mr. Williams said that he agreed broadly with the staff appraisal and that he supported the proposed decision. He commended the Gabonese authorities for their generally successful performance under the extended arrangement. However, he was concerned that fiscal policies had been relaxed substantially in 1983. Total expenditures were expected to increase by 30 percent above the estimated 1982 level, and the overall fiscal surplus was expected to be cut in half. It was questionable whether the economy had the absorptive capacity in the short term to handle such a large increase in spending. The recently announced decisions with regard to expenditure reduction measures were, therefore, welcome. On the revenue side, the move to reduce certain business taxes as an inducement to private sector investment was also a positive step.

Commenting on the external sector, Mr. Williams noted that only a modest current account surplus was projected for 1983, following large surpluses during the three years of the program. In light of the recent oil price declines, and the staff's concerns about recent public expenditure trends that would adversely affect Gabon's external position, more detailed discussion of Gabon's medium-term prospects would have been useful. The progress made during the program period in reducing the external debt service burden and building up reserves to more adequate levels was commendable. However, the SDR 446 million in new external debt with a maturity of one to ten years could well result in a significant deterioration in Gabon's external debt position.

Under the arrangement, performance had fallen short of expectations with regard to growth and the diversification of investment in the non-oil sector, Mr. Williams commented. As other Directors had noted, there was a continuing need to move away from the heavy dependence on oil for export revenues and overall economic growth. He understood that a new five-year plan was being developed for 1984-89. He hoped that greater priority would be given to investment in the non-oil productive sectors during that period.

Mr. de Maulde remarked that, on balance, the Gabonese economy had performed well under the 1980-82 extended arrangement. It had succeeded in avoiding, albeit narrowly, the major difficulties experienced by some other large oil exporters as oil prices had fallen. The balance of payments position had remained stronger than expected throughout the program period, while inflation had been kept under control largely as a result of the maintenance of an adequate degree of monetary restraint and financial discipline.

On the real side of the economy, Mr. de Maulde continued, the growth performance of the non-oil sector had been mixed. The rates of growth of 1.6 percent in 1981 and 2.7 percent in 1982 had not been particularly impressive. The situation appeared to reflect the outcome of two different factors. On the one hand, there had been large investment expenditures on infrastructure projects such as roads, bridges, and railways, which had usually been well selected and implemented but which, by their nature, did not contribute much to the acceleration of growth over the short term. On the other hand, there had been shortcomings in a number of areas of the directly productive sectors, in which cost overruns and technical difficulties had prevented projects from generating the expected rates of economic or financial return.

A number of conclusions could be drawn from the situation, Mr. de Maulde considered. First, economic growth and diversification could well be more complex and time consuming than originally expected. The development path selected by the authorities did not lead to quick payoffs. For example, large projects such as the Trans-Gabon Railway would continue to absorb a large amount of resources for some years, although its long-term contribution to the development of the economy was not in doubt. Second, the maintenance of an adequate macroeconomic framework was indispensable to the smooth continuation of the development process. The staff pointed out a number of areas in which potential weaknesses could develop. It indicated that the authorities were increasingly aware of those weaknesses, and the most recent information provided encouraging signs of their willingness to address the problems more effectively, especially with regard to public finances. Third, the extended arrangement seemed to have served Gabon well; no drawings had been made, because there had been no need to make them, and the program framework had helped to keep the economy on track.

Commenting on the exchange system, Mr. de Maulde remarked that the Gabonese authorities seemed satisfied with their monetary arrangements with other countries in the region, and those countries welcomed Gabon's cooperation. Finally, Gabon was a rich country, well endowed with natural resources, especially minerals and forests. Its Government and people were seriously dealing with the task of achieving balanced development; it was encouraging that the authorities had already approached the Fund to negotiate a new arrangement to maintain a sound financial basis for their development effort.

Mr. El-Khouri noted that Gabon had been highly successful in attaining the financial targets set out under the extended arrangement. All the quantitative performance criteria had been consistently observed during the arrangement, except for one ceiling on external borrowing. However, Mr. Alfidja had pointed out that the authorities believed that that ceiling had, in fact, been observed. The balance of payments targets had been surpassed, and the reserve position had improved significantly.

In the area of structural adjustment, Mr. El-Khouri continued, important corrective measures had already been implemented during the program period. They included the introduction of new procedures for controlling expenditures on civil service recruitment, the award of public contracts, and budget subsidies to public enterprises. He welcomed the recent information that the authorities had introduced additional expenditure control measures in line with the staff recommendations.

Difficulties were being encountered in the implementation of the public sector investment program, Mr. El-Khouri observed. Specifically, expenditures on the non-oil productive sectors seemed to be lagging behind what was necessary to achieve the sectoral targets of the investment program. He welcomed the steps taken by the authorities to seek technical assistance from the World Bank in the area of project operation and implementation, and to strengthen the Planning Ministry.

Commenting on the 1983 budget, Mr. El-Khouri noted that the authorities were in the process of revising the budget expenditures downward in light of the recent decline in oil prices. The statement on page 2 of EBS/83/42, Supplement 1, that certain capital expenditures for 1984 and 1985 would be reduced was intriguing. He invited the staff to provide further information, if possible, on the categories of capital spending that would be reduced, and on any planned reductions in capital spending in 1983.

The authorities had performed quite well under the extended arrangement, Mr. El-Khouri stated, especially on the financial side. Improvements would still need to be made on the structural side, especially in the public sector investment program. Now that the "precautionary" extended arrangement had expired, it would be interesting to know how the Gabonese authorities viewed their experience under the arrangement, and whether they agreed that it had been a useful approach.

Mr. Taylor said that he shared many of the comments and concerns expressed by other Directors. He stressed the usefulness of the comprehensive, but concise and readable, review of the program and its implementation provided in Appendix II of EBS/83/42. It could provide a model to be adopted by other area departments when reporting on progress under extended arrangements.

The staff representative from the African Department remarked that Gabon's exchange system was virtually free of restrictions; for that reason, the staff had not discussed it in detail in EBS/83/42. As for the exchange rate, the real effective depreciation of the CFA franc had been a modest 5 percent during the program period. It might be argued that, given Gabon's high wage cost structure and the need to make the non-oil sector competitive, a further depreciation could have been helpful. However, in light of the structure of Gabon's non-oil exports--primarily uranium, manganese, and timber--the exchange rate had not been the most important factor. The main constraint on exports had been the lack of external demand in industrial countries during the recession, which had hit the forestry sector particularly severely.

Commenting on the Trans-Gabon Railway project, the staff representative noted that the World Bank had judged that the rate of return on the project, at least in relation to the alternative development of a road network, had been quite low; the Bank had considered that it was for the authorities to judge whether to proceed with the railway rather than with other means of opening the interior of the country to trade. While the railway would, in the long term, increase access to timber sources and mineral deposits in the interior, the staff believed that the recurrent cost of the project could be substantial and could constitute a drain on the budget in the medium term.

In the staff's view, the ceiling on external borrowing was applicable to the suppliers' credits equivalent to SDR 335 million granted in connection with the railway construction, the staff representative from the African Department added, because the three loans involved had been signed separately and carried maturities that fell within the established ceilings. However, it had been recognized that, given the financial requirements of the railway, the terms of the loans, and the potential impact on Gabon's external debt service position, the authorities' decision could be justified on economic grounds.

Mr. Prowse commented that the staff representative had acknowledged that there could be a case for a lowering of the real effective exchange rate, but that the case was not necessarily strong, because Gabon could do little to influence the external price of its products, which were influenced primarily by world demand conditions. It was an important point, one relevant to other countries. However, the effects of too high an exchange rate on domestic profitability also had to be taken into account, especially if they prevented the necessary diversification and growth of the non-oil sectors in countries such as Gabon.

Mr. Alfidja observed that, while a number of factors had to be taken into account in assessing the appropriateness of the exchange rate, his Gabonese authorities found the existing arrangements with the franc zone satisfactory. The arrangements contained provisions to compensate for fluctuations in the exchange rate of a country such as Gabon that had accumulated reserves in recent years. He did not believe that the exchange rate had played a major role in adding to the underutilization of industrial capacity in Gabon. As Mr. Sangare had pointed out, the thinness of the domestic market was a significant obstacle to full capacity utilization; for that reason, Gabon was making an active effort to promote regional cooperation among its neighbors. While the benefits from such an endeavor would undoubtedly take time to mature, the effort constituted a step in the right direction.

He agreed with those Directors who had suggested that Gabon should place its development plans in a medium-term framework, Mr. Alfidja continued. He could assure Directors that the Gabonese authorities intended to do so in cooperation with the Fund and the World Bank. Indeed, a Fund staff mission would shortly be assisting the authorities in preparing a multiyear plan in cooperation with the World Bank. The further development of the Trans-Gabon Railway would be a part of that plan. It was a necessary project for the country, because weather and environmental conditions made road maintenance extremely difficult. The authorities did not expect that the cost overruns that had been incurred in the first phase of the railway construction would arise again in the later stages.

As one Director had pointed out, Mr. Alfidja recalled, diversification was easier to suggest than to achieve. It was a lengthy process, but the important point was that the authorities were fully aware of the necessity to diversify their economy. He would convey all the comments of Directors to his Gabonese authorities, who would take them fully into account in developing their policies. Finally, he reiterated the Gabonese authorities' viewpoint that the recent conclusion of a loan agreement to finance the Trans-Gabon Railway resulted from a misunderstanding between Gabon and the Fund.

The Acting Chairman observed that quantitative performance criteria should, of course, be designed in such a way that, as far as possible, questions of ambiguity did not arise. He then made the following summing up:

> Directors generally agreed with the views expressed in the staff appraisal in the report for the 1982 Article IV consultation and review of the extended arrangement with Gabon. They noted that, in financial terms, the program under the extended arangement had been successful. The targets for the external current account, for the overall balance of payments, and for budgetary surpluses had all been exceeded. In addition, the external public debt had been substantially reduced, and the debt service picture had improved. Thus, Gabon ended the three-year arrangement in a strong financial position. In that regard, Directors

commended the authorities for the prudence that they had shown, especially in fiscal policy, external borrowing, and reserves management during the period.

Directors observed that the growth performance and the record of economic diversification had been somewhat disappointing, leaving the economy of Gabon vulnerable to adverse external economic developments. Directors noted that private investment had tended to concentrate on oil sector exploration, and that it had otherwise remained cautious overall in light of the continued underutilization of plant capacity in industry and the small size of the domestic market. It was hoped that greater diversification and structural change would take place in future.

Directors expressed concern regarding the lower than planned investments in the directly productive sectors, the latter being partly due to difficulties in identifying and implementing viable projects. In that connection, Directors welcomed steps taken by the Gabonese authorities to avail themselves of technical assistance from the World Bank to strengthen the Planning Ministry and its capability for project evaluation and selection.

Directors noted the progress made in addressing some basic administrative problems, such as recruitment into the civil service, award of public contracts, expenditure control, and improvements in the accounting system of major public enterprises. They urged the authorities vigorously to pursue their efforts in those areas.

Directors agreed that the objectives for 1983 should be to consolidate the progress made so far, and they expressed concern that the 1983 original budget represented a relaxation of fiscal policy, which could put pressure on the domestic price level and on the balance of payments position; it could also lead to financial difficulties in the medium term, in view of the prevailing uncertainties regarding oil revenues. Directors therefore welcomed the authorities' decision to scale down the original budget appropriations to take into account the recent declines in oil prices. They also welcomed the new measures adopted to restrain the growth of current expenditures.

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

The Executive Directors then took the following decision:

1. The Fund takes this decision in concluding the 1982 Article XIV consultation with Gabon, in light of the 1982 Article IV consultation with Gabon conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

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

Decision No. 7408-(83/76), adopted
May 27, 1983

2. EL SALVADOR - CONSULTATION UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the consultation under the stand-by arrangement for El Salvador (EBS/83/84, 4/25/83).

The staff representative from the Western Hemisphere Department made the following statement:

The staff has just been informed that the tax package referred to in paragraph 6 of the Government's memorandum of economic policy, attached to EBS/83/84, was approved by the Legislative Assembly on May 19, 1983, but in somewhat different form than originally contemplated. The sales tax rate was increased from 2 percent to 5 percent, with the exception of inputs for the industrial sector, instead of from 2 percent to 4 percent as earlier proposed. Other changes in indirect taxes, however, have been delayed. The tax action just taken is legally in effect only for the balance of this year, but the authorities have indicated their intention either to replace this measure with a more fundamental tax reform or to extend the increase in the sales tax rate next year. The net effect of the tax package just approved is still expected to yield revenues on the order of ₡ 200 million, or 2 percent of GDP, at an annual rate, as mentioned in the Government's policy memorandum. However, because of the delay in the introduction of the tax package and notwithstanding the higher sales tax rate that has been established, there will be a shortfall of about ₡ 80 million with respect to the revenue estimates for 1983 presented in EBS/83/84. The authorities are nevertheless committed to compensate for this shortfall by cuts in current expenditure and administrative improvements in revenue.

The staff also wishes to point out that as of May 20, the deviation with respect to the target for payments arrears set for December 1982 has been eliminated. As of last week, payments arrears amounted to $44 million, which is below the applicable target set through the end of May in the program.

Mr. Senior made the following statement:

I would like to express the appreciation of the Salvadoran authorities for the excellent work done by the recent Fund mission in relation to the present consultation under the stand-by

arrangement. Indeed, as Directors know, the Fund has maintained continuous consultations with the Salvadoran authorities since before the beginning of the stand-by arrangement, and this has been reinforced by the presence of a resident representative since last year. The authorities highly value the Fund's advice and have been implementing economic policy consistent with the program and supplementary counsel from the Fund. The authorities are in broad agreement with the staff appraisal regarding developments in the Salvadoran economy during the last few months and its prospects for the near future. I would only like to make a few brief comments to complement the staff paper.

As might be remembered, the current stand-by arrangement with El Salvador was approved last July for one year (EBM/82/99, 7/16/82). However, given well-known uncertainties regarding the social and political environment in El Salvador in particular, and in the Central American region in general, the program's performance criteria were quantified for an initial period of only six months. Performance criteria for the last six months of the program period were left for a review, in which understandings with the Fund were to be reached by not later than December 31, 1982. As indicated by the staff, while understandings were reached by that date regarding the limits on net domestic assets of the Central Reserve Bank, on net credit from the banking system to the nonfinancial public sector, and on the target for the overall balance of payments and reduction of arrears, the letter of intent concerning the new understandings could not be transmitted earlier because of delays in the submission of new tax measures to the Legislative Assembly. As will be mentioned by the staff representative in more detail, these new tax measures were approved on May 19 last, by the Assembly.

The general internal political and social situation of El Salvador in the past few years is well known and need not be dwelt upon at any length. The same can be said for the external economic environment, and its effects on domestic economic activity. As I indicated in my statement of last July, suffice it to say that between 1980 and 1981 real GDP fell by over 20 percent, export volume decreased by more than 30 percent, and export value declined even more. Thus, it was quite clear that in such circumstances a realistic program with the Fund could not be geared to anything but a kind of holding operation in which the fundamental objective would be that of arresting any further economic deterioration while seeking to correct some fundamental distortions in order not to impair irreversibly the country's possibilities for recovery as conditions became more normal.

The program for 1982 was indeed framed in this context, with its main objectives being those of containing the decline in aggregate production and the beginning of a replenishment of the international reserve position of the Central Reserve

Bank of El Salvador. In this regard, targets were set for the overall balance of payments, inclusive of arrears, and limits were set, as is usual in Fund programs, for the net domestic assets of the Central Reserve Bank and for the net credit of the banking system to the nonfinancial public sector. To date, El Salvador's performance under the stand-by arrangement has been satisfactory, despite a deterioration of economic conditions. As of the end of 1982, El Salvador had complied with all but one of the applicable performance criteria, a more than satisfactory outcome under the circumstances. The one quantitative performance criterion that was not observed--that of reducing external payments arrears by $21 million by the end of 1982--was mainly due to the Central Reserve Bank's repaying more short-term foreign liabilities than expected; the authorities have just recently indicated that as of May 19, 1983 the Central Bank has further reduced arrears by approving and allocating foreign exchange in an amount of slightly less than $41.6 million to that purpose. Thus, the deviation in relation to the December 1982 limit has been eliminated, and the authorities have indicated that they will continue to allocate more foreign exchange to reduce arrears even further.

This satisfactory performance under the stand-by arrangement, however, has not been corresponded by developments in economic activity, further underscoring the authorities' noteworthy achievement. Indeed, during 1982 real GDP declined by more than 5 percent, with all sectors of the economy contributing to the decline. Real GDP is about 25 percent below that of 1978. Thus, the authorities intend to pursue basically the same economic strategy as last year, with the objective of arresting a further deterioration of economic activity, while deepening corrective measures initiated last year. The main targets of the program are to reduce the overall deficit of the nonfinancial public sector from about 7 percent of GDP in 1982, to about 6 percent in 1983; increase public sector savings by the equivalent of 1 percentage point of GDP, with a corresponding reduction in the domestic financing of the overall deficit; reduce external payments arrears to no more than $35 million by July 1983; and attain a small overall balance of payments surplus. The main elements of the program are detailed in the staff document, and there is no need to repeat them. I should mention once again, however, that on May 19, 1983 the Salvadoran Assembly approved an increase in the sales tax rate from 2 percent to 5 percent. The authorities consider that, with this increase and the other program measures to streamline public expenditure, El Salvador will be able to meet the revenue and deficit projections agreed with the staff.

In the summing up of last year's Article IV consultation with El Salvador, which was discussed at the same time as the request for use of Fund resources, the Acting Chairman expressed

Directors' preoccupations basically in three areas: (a) the critical importance of restoring confidence and of timely receipt of foreign assistance from other sources, (b) the need for a more flexible interest rate policy and an exchange rate policy that would allow greater competitiveness, and (c) the need to move from the present approach of a short-term holding operation to measures placed in the framework of a medium-term adjustment strategy.

The first of these preoccupations clearly is shared by the authorities, but its solution depends more on exogenous factors that are well beyond the authorities' control. The second preoccupation, however, is more endogenous and shows the authorities' determination. In regard to the interest rate, given the expected inflation rate in El Salvador for 1983 and movements in interest rates abroad, current domestic interest rates are positive in real terms and competitive with international rates. In this respect, however, I should mention that the value of interest rate policy at present is more of an allocative nature than that of serving as an incentive to stop capital flight or to repatriate capital, or even to foster savings. Given the present uncertainties, it is difficult to believe that interest rates would play such a role. In any case, as I mentioned before, interest rates are at adequate levels and need not be adjusted at the moment. The authorities have further stated that they will continue to manage the interest rate policy flexibly.

With regard to exchange rate policy, the authorities intend to continue a gradual movement toward deepening the parallel market, so as to reflect supply and demand forces. In this regard, transactions will continue to be shifted from the official to the parallel market. As mentioned by the staff, in February 1983 the Government transferred to the parallel exchange market imports of goods and services of the order of $35 million, as well as export receipts estimated at $20 million to $30 million. It would be hard to argue that in the current circumstances of El Salvador a more drastic approach to exchange rate policy would be adequate. The gradual approach of the authorities is both pragmatic and flexible, serving as a corrective measure in the right direction to stop further distortions in the Salvadoran economy.

Finally, in regard to moving to a medium-term adjustment strategy, I can only say that while it is clear that such a movement would be desirable, in current circumstances it might not be feasible. Conditions in El Salvador continue to point to the need for a holding operation, as evidenced by the further significant deterioration in real GDP growth, while introducing gradual corrective measures that would tend to make easier the adjustment under more normal circumstances. The construction

of a medium-term strategy, which has to be based on at least some kind of overall medium-term projections, would be tenuous at best. Thus, it is much more realistic to work on short-term corrections. I am sure that the authorities will continue to avail themselves of the Fund's advice and resources in the future, when the medium-term strategy could more realistically be established.

Mr. Kafka said that he fully supported the proposed decision; he commended the Salvadoran authorities for their successful performance under the stand-by arrangement. It had been achieved with great courage and decisiveness under clearly difficult conditions that had unavoidably brought about a fall in real GNP and in exports. The continuation of the program in 1983, in line with the understandings reflected in the letter and technical memorandum of April 27, 1983, constituted the most appropriate policy under El Salvador's present circumstances. He was particularly impressed by the fiscal, monetary, and exchange rate policies followed by the authorities. He endorsed the policies under which interest rates had, for the most part, become positive in real terms, and he agreed with the staff that the remaining real negative interest rates should also be raised to positive levels as soon as possible. It was also important that, as soon as possible, multilateral and national agencies and institutions should step up their assistance to El Salvador.

Mr. Grosche observed that, in the previous 12 months, El Salvador had met all but one of the performance criteria. As in a number of other cases recently discussed by the Board, the observance of the quantitative ceilings and targets did not necessarily mean that the economy was performing well. That observation was particularly true in El Salvador: the economy faced extremely difficult circumstances, real GDP had declined in 1982 for the fourth consecutive year, and no growth in real output was foreseen for 1983. He agreed with the thrust of the staff's appraisal and supported the proposed decision.

The recent adoption of the tax package by the Legislative Assembly was welcome, Mr. Grosche continued, although it had been introduced in a somewhat different form than originally planned. Because of the delay in the introduction of the package, there would be a revenue shortfall that would have to be met by cuts in current expenditure, as planned. In that regard, the intended administrative improvements in revenue collection were also welcome. In the absence of such measures, it had been difficult to believe that an increase in revenues of about 25 percent projected earlier would have been likely, given the political uncertainties and the stagnant economy. As for monetary policy, it was encouraging that a number of interest rates were positive in real terms, although further adjustment in deposit rates for savings would be desirable.

The Financial Times had reported on May 5, 1983 that the El Salvador Chamber of Commerce and Industry had questioned the official GDP statistics, Mr. Grosche noted. The article mentioned a decline of 20 percent

in real terms for GDP in 1980 and 1981, instead of the 9 percent mentioned in EBS/83/84. For 1983, a decline in real terms was predicted, compared to the zero growth projected in the program. The different estimates illustrated the difficulties in obtaining reliable data in a country with an internal armed conflict. He invited the staff to provide further information, if possible. If the data mentioned in the Financial Times were a more accurate reflection of the development of El Salvador's economy, what were the implications for the stand-by program?

Mr. Joyce commented that the economic situation in El Salvador continued to be uncertain, although there were some indications that real GDP would not decline in 1983 as it had done over the previous three years. The major economic problems that the country faced derived in part from the internal armed conflict and from the instability in the region as a whole, which affected private sector confidence and the authorities' ability to pursue adjustment programs and implement development policies. During the Executive Board's discussion of El Salvador in July 1982 (EBM/82/99, 7/16/82), the stand-by program had been described as a "holding operation," since El Salvador's economic situation implied that traditional expectations with regard to the Fund's adjustment programs would inevitably have to be modified. The realistic and cautious approach taken by the Fund on that occasion had been justified, as shown by El Salvador's peformance to date under the stand-by arrangement. Developments had been generally satisfactory, and progress had been made, particularly in the government sector, with regard to both fiscal and monetary policies, especially interest rates and exchange rate policies.

The Legislative Assembly had recently passed tax legislation, Mr. Joyce noted, a package that would go a considerable way toward meeting the original objectives of the program, even though it was smaller than originally expected. However, the authorities intended to compensate for the resulting shortfall by additional cuts in current expenditures and by administrative improvements in revenue collection. Mr. Senior's statement that the authorities intended to continue the gradual movement toward deepening the parallel market and to shift foreign exchange transactions from the official market to the parallel market was welcome. Although there was a considerable way to go in that movement, it was understandable that, in the circumstances, the authorities might find it difficult to move as fast as economic theory might justify.

The future of the Salvadoran economy and El Salvador's relations with the Fund over the medium term were matters for concern, Mr. Joyce considered. He sympathized with Mr. Senior's remark that it was difficult, and possibly not very useful, to attempt to devise a mediumterm adjustment strategy for El Salvador at the present time. Perhaps the "holding operation" would have to be continued. However, continued Fund support for El Salvador would be necessary, and it was not too early to consider the form that such support might take. He invited the staff or Mr. Senior to provide further information on the authorities' intentions in that regard.

Mr. Taylor remarked that the economic policies adopted by the Salvadoran authorities in 1982 had been generally successful, despite the difficult political and military situation in the country and the depressed world economy. Continuation of those policies was appropriate; he supported the proposed decision.

Given the unsettled circumstances, Mr. Taylor continued, macroeconomic policy should aim to achieve the maximum feasible degree of financial and monetary stability. Continued fiscal restraint would be essential, and he welcomed the authorities' intention to reduce the public sector deficit from 7 percent of GDP in 1982 to 6 percent in 1983. He also welcomed the recent decision by the Legislative Assembly to raise the sales tax to 5 percent. He agreed with Mr. Grosche that the aim to increase domestic revenue by 25 percent in nominal terms when inflation was about 11 per cent seemed fairly ambitious, particularly since revenue in 1982 had increased as the result of several nonrecurring items, such as the proceeds from a special surcharge on gasoline sales and the collection of overdue accounts by the public sector. To achieve the objective, the underlying increase in revenue would have to be much higher than 14 percent in real terms.

On the expenditure side, Mr. Taylor added, the authorities should monitor government expenditure closely and proceed only with those public investment projects for which foreign financing on appropriate terms was assured. While the authorities' commitment to match revenue shortfalls with corresponding cuts in expenditure was welcome, it would not be easy to fulfill. Since most capital expenditure would be financed externally, the authorities would be able to make cuts only in current expenditure. Because the control of current expenditure would be critical, it was unfortunate that there appeared to be little information about the behavior of wages in the economy. The staff stated that an increase in consumption expenditure by the Government had more than offset a decrease in capital transfers to the rest of the public sector. To what extent had that development been the result of an increase in public sector wages? Did the lack of information on wages arise from the difficult security situation, or was it the result of more fundamental defects in the statistical system?

Skepticism had been expressed by Mr. Senior with regard to the influence of interest rates, Mr. Taylor noted. Nevertheless, the maintenance of positive real interest rates would help to mobilize the domestic savings available in the economy and to discourage the heavy capital outflows that had drained a good deal of the economy's capital resources. He agreed with the staff that the authorities should increase savings deposit rates to make them positive in real terms. If a further program should be arranged with El Salvador, interest rates should be one of the principal areas for attention; given the potential for large capital movements, monetary policy would have to be framed with great care in any subsequent program and would have to be subject to close monitoring and review.

Commenting on the external position, Mr. Taylor endorsed the staff view that the shifting of transactions from the official to the parallel exchange market should be accelerated in the remainder of the program period. He joined other Directors in welcoming the measures taken by the authorities in that area, and he agreed that continued flexibility in exchange rate policy would be needed to support monetary and fiscal policy. The staff referred to a "timely reunification of the exchange markets and orderly elimination of exchange restrictions." If a subsequent stand-by arrangement were agreed upon, it would provide an appropriate opportunity to set a more definite timetable for meeting those objectives.

Given the obvious uncertainties and difficulties, Mr. Taylor stated, a follow-on program might best take the form of a one-year stand-by arrangement. An extended arrangement would not be appropriate without a considerable measure of structural reform, and structural reform would be difficult in the present circumstances. However, a stand-by arrangement should not ignore supply-side measures entirely. His chair had frequently argued that a series of stand-by arrangements involving consultation with the World Bank could be used to promote structural adjustment; El Salvador was an appropriate example. The uncertainties prevailing in the region should not be a reason for ignoring structural adjustments, but for emphasizing the importance of the mid-term review to ensure that the program remained relevant to the economy's needs.

Mr. Erb commented that El Salvador continued to face a difficult economic and financial situation as a result of noneconomic factors domestically and a weak international economy. He commended the authorities for the progress that they had been able to make up to the end of 1982 and for the recent steps to meet the performance criteria and effect a number of policy changes. The only performance criterion that had not been met was the target on the reduction in external payments arrears; he agreed with the staff that that target was important in the broader context of the program's balance of payments objectives and that the failure to meet it illustrated the danger of accumulating large stocks of volatile short-term liabilities. For that reason, he welcomed the authorities' intention to reduce those liabilities significantly during the remainder of the program period.

When the stand-by arrangement had previously been discussed by the Board (EBM/82/99, 7/16/82), Mr. Erb recalled, his chair had approved the program designed to halt further deterioration of the economy and to restore economic conditions conducive to the renewal of growth and private investment once noneconomic factors permitted. Consequently, the program should be evaluated on the basis of whether the authorities' policies would contribute to achieving those goals.

Commenting on fiscal policies, Mr. Erb noted that adjustment was to be carried out through a package of tax measures. He welcomed the recent approval of those measures by the Legislative Assembly. The fiscal imbalance should be corrected primarily through changes in the Government's fiscal structure in order to reduce reliance on extraordinary levels of

budget support. Therefore, he encouraged the authorities to continue to examine the need for a more fundamental approach to tax reform. It appeared that the revenues generated by the tax measures would be only about 60 per cent of those assumed in the program. He invited the staff to provide further information on the strategy to be adopted by the authorities to cover the shortfall.

There was to be continued restraint on net credit to the nonfinancial public sector by the banking system, Mr. Erb observed. That policy and the decision to restrain growth and credit to the private sector to the rate of nominal growth of GDP were appropriate. The larger than expected decline in inflation and the increases in interest rates in 1982 had resulted in positive interest rates in real terms by the end of 1982. He welcomed the authorities' commitment to keep lending and term deposit rates positive in real terms in 1983. Given the recent acceleration in inflation to 13 percent on an annual basis between November 1982 and January 1983, the authorities should follow developments closely and should be prepared to make additional adjustments as necessary.

With regard to the external sector, Mr. Erb remarked, greater emphasis should be placed upon the expansion and increased efficiency of the parallel exchange market. He stressed the need to move more rapidly to a unification of the official and parallel markets at an appropriate equilibrium rate for the colón, probably the parallel market rate. It was essential that the authorities should continue to transfer significant categories of transactions to the parallel market in preparation for the unification of the rate. The intensification of exchange restrictions in November 1982 was a matter for concern, although he recognized that until recently there had been some disagreement whether the measures in question were covered by the performance criterion on exchange restrictions. He believed that they were covered by that criterion; they should be removed for that reason and because they compromised the efficiency of the parallel market, a crucial element in the program.

Two general policy questions deserved attention, Mr. Erb considered. First, the staff had been correct to wait until the authorities had taken the necessary revenue measures and eliminated the arrears before bringing the program to the Board for review. However, it was questionable whether it was desirable in those circumstances to permit the early disbursement recommended, despite the fact that such an approach was consistent with past practice. Second, given that the program was considered a "holding operation" and that it was extremely difficult to assess the medium-term prospects for the economy, programs such as the one with El Salvador might better be treated as first credit tranche programs with a limited commitment of Fund resources, particularly if they covered a period of less than a year. Not only was the point relevant to wider policy discussions such as enlarged access, but it should also be considered in the context of the medium-term outlook for El Salvador's economy, as Mr. Joyce had indicated. Furthermore, El Salvador was not the only country to which such considerations applied.

Mr. Prowse stated that he supported the proposed decision. The remaining drawings were relatively small, and, more important, the authorities had performed quite well. They had met all the Fund's criteria except the external debt requirement. Although that deviation had since been rectified, it was worth noting that it had occurred because the Central Reserve Bank had been forced to repay some short-term debt. That consideration should be borne in mind in judging the seriousness of the deviation.

Government expenditure was to be maintained in real terms, Mr. Prowse continued, as a result of an increase in interest payments on bonded debt associated with agrarian reform and the nationalization of the banks. He invited the staff to provide, if possible, further information on the kinds of investment being undertaken by the Government with regard to agrarian reform. The definition of government expenditure did not include expenditure to nationalize the banks or to capitalize some of the semi-official institutions, but only the interest payable on the nonnegotiable long-term bonds being used to finance those measures. It was possible that the exclusion of direct expenditure by the Government distorted the budget picture. The staff urged the need for close monitoring of expenditure but did not suggest that expenditure should be reduced, so that there appeared to be an implicit endorsement of the subsidies prevalent in the economy. He invited the staff to comment further on the question of subsidies, a point that did not appear to have been treated in detail in the paper.

While interest rates were generally positive, Mr. Prowse noted, they were subject to ceilings. He inquired whether the Government was considering removing the existing interest rate controls and whether it was examining proposals to finance the budget deficit by issuing marketable government securities rather than financing it entirely from external resources.

Commenting on the exchange system, Mr. Prowse observed that the differential between the official and parallel exchange rates was about 50 percent. In that regard, the staff's recommendation that there was further room for progress and that unification should be accelerated in the program period was modest, since the program period was almost over. If there was to be a further program, the question of exchange rate arrangements would have to be a major policy area for consideration. The objective should be elimination of the dual arrangements. Other areas of importance were the effects of price and wage controls, the level of subsidies, and the removal of controls on interest rates.

Mr. Lovato remarked that he agreed broadly with the staff appraisal. However, the program with El Salvador represented another case in which, despite compliance with all, or almost all, the performance criteria, the outcome had been far from the original projections for output, trade flows, and other macroeconomic variables. The reasons for the unsatisfactory performance were partly outside the control of the authorities, given the state of internal disturbance. However, a realistic Fund program ought to be capable of taking into account the effect of events clearly perceptible at the time of negotiation.

El Salvador's precarious external situation clearly hinged on the continuance of large flows of external aid on concessional terms, Mr. Lovato continued. Therefore, it could not be considered self-sustainable. It seemed probable that the authorities might wish to seek further Fund assistance in those circumstances to formulate and to implement an economic program. If that should be the case, in view of the criteria concerning the use of Fund resources recently set out in the course of the Executive Board discussion of enlarged access and in view of the state of extreme uncertainty in the country, the staff and management should negotiate a realistic program compatible with a timetable that would allow the Executive Board to make secure judgments on the probable course of economic developments.

Mr. Salinas said that he also agreed broadly with the staff appraisal; he supported the proposed decision. El Salvador's performance to date under the stand-by arrangement had generally been satisfactory, despite a continuation of weak underlying economic conditions in the country and the disruptive effects of armed conflict. At the end of 1982, El Salvador had met all the applicable quantitative performance criteria established in the first half of the stand-by period, with the exception of the target for external debt arrears. He noted that the deviation with regard to the December 1982 limit had been eliminated and that the authorities intended to continue to allocate foreign exchange to reduce arrears further. The authorities had already taken a number of measures in line with the main objectives of the stabilization program, particularly in the area of restraining domestic demand, adjusting exchange rates, and increasing domestic interest rates. He welcomed those efforts and the authorities' commitment to further measures that could assure a successful response to economic conditions in the medium and long term.

Commenting on fiscal policy, Mr. Salinas observed that during 1982 the overall public sector deficit had accounted for about 7 percent of GDP compared with 8 percent in 1981, and that a deficit of 6 percent was expected in 1983, on the assumption that real GDP would remain unchanged. The fiscal adjustment would result primarily from an improvement in central government performance, which had not occurred in 1982, as a result of an increase in revenues arising from new tax measures and from the maintenance of unchanged expenditures in real terms. Given El Salvador's overall circumstances, constraining expenditure in line with the nominal growth of GDP would require major efforts by the authorities with regard to resource allocation, particularly in public investment, as well as in the management of the associated foreign borrowing that would be needed to finance such investment.

In the monetary area, Mr. Salinas noted, the aim of the program was to reduce further the overall rate of bank credit expansion. In that regard, the authorities ought to be commended for the interest rate policy already adopted, which had led to positive interest rates in real terms, and they should be encouraged to maintain that policy and to undertake further adjustments, particularly with regard to those rates for savings deposits that remained negative. He welcomed the authorities'

decision to shift an increasing number of transactions from the official to the parallel exchange market, representing an alleviation of demand pressures and permitting the attainment of the targets for the reduction in external payments arrears. He agreed with the staff that there was room for further progress in that area and that the authorities should maintain flexibility in their management of the exchange system as they moved toward a permanent unification of the exchange markets, a development that might also provide the opportunity for an orderly elimination of present exchange restrictions. Finally, he hoped that the authorities would succeed in their efforts to convert the short-term foreign reserve liabilities of the Central Reserve Bank into medium-term and long-term liabilities in order to avoid the problems that they had faced in 1982.

The staff representative from the Western Hemisphere Department remarked that, with regard to the quality of the statistics, he was unaware of the article in the Financial Times referred to by Mr. Grosche. The staff had generally relied on the information provided by the authorities, which was, of course, subject to a margin of error, because of the circumstances in the country and the base used. The staff believed that the data were broadly accurate; for example, the data for the agricultural sector showed fairly good prospects with respect to traditional export crops, and the foreign trade indicators showed similar trends. However, the possibility existed that the quality of the data varied from year to year. For 1983, the latest estimate by the authorities suggested that a deceleration in the rate of decline of output was quite feasible. The estimate of no growth in aggregate output had been reconfirmed, on the basis of a better performance for traditional export crops than had been expected at the end of 1982.

With regard to wage trends, the staff representative added, the problem was a lack of source material rather than failure to collect data because of the general situation in the country. The information available suggested that wage trends had been relatively moderate and in line with the guidelines established by the authorities. Those guidelines provided for private sector wages to increase by 10 percent a year if justified by the financial position of individual enterprises. In the public sector, the wage freeze in effect since 1981 had meant that the increase in consumption expenditures in 1982 had been less the result of wage pressures than of the burden of interest rate payments on the bonded indebtedness of the Government.

The delay in the implementation of a number of tax measures would affect the fiscal outcome in 1983, the staff representative continued. It was possible that the revenue yield from those measures would be less than originally expected, but it was worth noting that the Government's strategy was to rely on indirect taxation and on tax measures affecting sectors of the economy in a better position to pay and to rely less on direct taxation. Although measures would need to be taken during 1983 to compensate for the anticipated shortfall, the rate of increase in government expenditures to date had been low. The authorities had been going slow on expenditure plans so as to offset delays in the implementation of the tax package, and they had indicated that they would continue

to do so. On the revenue side, a number of measures had been taken to improve tax collection, such as an improved register of both individual and corporate taxpayers, with the help of assistance from the Inter-American Development Bank; those measures were expected to offset part of the shortfall foreseen for 1983.

In presenting the budget accounts, the staff representative observed, the staff had made a number of adjustments to the data with respect to large transactions that had taken place in recent years. The nationalization of the banks and the agrarian reform measures had been large, once-and-for-all transactions; since they were nonrecurring transactions, it had been felt appropriate to exclude them for analytical purposes. The main way in which subsidies affected the budget was through transfers by the Government to the Price Stabilization Authority; those transfers had been reduced significantly in 1982 as a result of measures taken to increase a number of controlled prices, and, at present, subsidies amounted to about ₡ 20 million.

With regard to interest rate ceilings, the staff representative commented, the authorities wished to continue to use rate ceilings as a guide for interest rate movements in the economy. However, they had reconfirmed their statement given in 1982 at the time of the initial phase of the arrangement that they would review the ceilings on a continuing basis and adjust them as necessary. To date, there had not been any effort to issue government securities in the local market, other than indirectly through bond issues related to the payment of arrears in 1982. At that time, the Government had engaged in mediumterm debt arrangements with foreign suppliers and had used the proceeds for budget operations. However, that activity had virtually ceased in 1983.

The staff welcomed Directors' comments on relations between El Salvador and the Fund in any possible future arrangement, the staff representative from the Western Hemisphere Department stated. Directors had stressed the need to take further action to raise interest rates throughout the economy to positive levels in real terms, to accelerate transfers from the official to the parallel exchange market, and to define more concretely the movement to exchange rate unification, as well as the need to place any future program in a medium-term context. The staff agreed with the importance of those issues and had informally mentioned them to the authorities, although the formal process of negotiation of a future arrangement had not yet begun. Finally, the proposed decision should be amended in paragraph 2 to read "the Acting Minister of Finance" instead of "the Minister of Finance."

Mr. Senior commented that the economic situation in El Salvador continued to be difficult and to require substantial amounts of external financial support. In present circumstances, El Salvador could not be expected to face its problems in "traditional ways." The only realistic goal for the authorities was to prevent any further deterioration in domestic economic activity in order not to diminish the possibility of economic recovery under normal circumstances. With the assistance of

the Fund, the authorities had been implementing such an economic policy, for which substantial external financial support was crucial; the authorities hoped that such support would also be timely.

The Fund's approach to the particular circumstances of El Salvador, reflected in the stabilization program, was both pragmatic and realistic, Mr. Senior considered. Appropriate instruments had been designed to deal with the situation, and the Salvadoran authorities had shown a remarkable commitment to deploying them. While the overriding objective of arresting economic deterioration had not been fully accomplished, the authorities had complied with the program's performance criteria. External payments arrears had been reduced substantially, and there was no longer a deviation from the agreed targets. At the same time, the new tax package and other measures were expected to gather sufficient revenue to comply fully with the performance criteria for 1983. The authorities remained committed to further adjustment, if necessary.

A number of Directors had commented on interest rate policy, Mr. Senior noted. Almost all interest rates in El Salvador were positive in real terms and competitive by international standards. In general, while a realistic interest rate structure was necessary for optimal resource allocation, it was doubtful whether higher interest rates in El Salvador would have much effect on capital flight, capital repatriation, or savings. Capital movements into and out of El Salvador were dependent on factors other than financial yield alone. Higher deposit rates would be unlikely to attract significantly higher savings, given the change in liquidity preference that normally occurred in situations of uncertainty. However, the impact of much higher rates would be felt immediately on borrowing and production costs. Given the recent declines in output, the costs of such increases would be greater than the benefits that could reasonably be expected.

The Salvadoran authorities placed a high value on the Fund's advice, particularly that given by the Executive Board, Mr. Senior stated. They would appreciate the many helpful comments by Directors and looked forward to continued support from the Fund. In that regard, the authorities had already expressed an intention to request additional Fund assistance once the present arrangement expired, probably in the form of a new stand-by arrangement.

The Executive Directors then took the following decision:

1. El Salvador has consulted the Fund in accordance with paragraph 16 of the letter of June 7, 1982 annexed to the stand-by arrangement for El Salvador (EBS/82/106, Sup. 1, 7/20/82) in order to reach understandings with the Fund regarding policies and measures that the Government of El Salvador will pursue during the remainder of the stand-by arrangement.

2. The letter of April 27, 1983 from the Acting Minister of Finance of El Salvador and the President of the Central Reserve Bank, together with the attached memorandum of policy,

shall be annexed to the stand-by arrangement for El Salvador, and the letter of June 7, 1982 shall be read as supplemented and modified by the letter of April 27, 1983. Accordingly, the targets for the overall balance of payments referred to in paragraph 7 and Table 1 of the letter of June 7, 1982 shall be those referred to in paragraph 4 and Table 1 of the memorandum attached to the letter of April 27, 1983, and the limits on external payments arrears referred to in paragraph 7 of the letter of June 7, 1982 shall be those referred to in paragraph 4 and Table 2 of the memorandum attached to the letter of April 27, 1983. Also, the limits on the net domestic assets of the Central Reserve Bank referred to in paragraph 12 and Table 3 of the letter of June 7, 1982 and the limits on the net credit of the banking system to the nonfinancial public sector referred to in paragraph 13 and Table 4 of the letter of June 7, 1982 shall be those referred to in paragraph 7 and Table 4 and paragraph 6 and Table 3, respectively, of the memorandum attached to the letter of April 27, 1983.

3. El Salvador may make purchases under the stand-by arrangement notwithstanding the restriction on the making of payments for insurance premiums and other personal services.

4. The Fund approves the exchange restriction described in paragraph 3 above until the completion of the next Article IV consultation with El Salvador or the end of July 1983, whichever is earlier.

Decision No. 7409-(83/76), adopted
May 27, 1983

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/75 (5/23/83) and EBM/83/76 (5/27/83).

3. ARGENTINA - MODIFICATION OF PERFORMANCE CRITERIA UNDER STAND-BY ARRANGEMENT AND EXCHANGE SYSTEM

1. Argentina has consulted the Fund in accordance with paragraph 5 of the letter dated January 7, 1983 from the Minister of Economy and the President of the Central Bank of the Republic of Argentina attached to the stand-by arrangement for Argentina (EBS/83/8, Sup. 1), and paragraph 4 of the stand-by arrangement.

2. The letter dated May 16, 1983 from the Minister of Economy and the President of the Central Bank of the Republic of Argentina shall be attached to the stand-by arrangement for

Argentina, and the letter dated January 7, 1983, attached to the stand-by arrangement, shall be read as modified by the letter of May 16, 1983.

3. Accordingly, subparagraphs (g)(i) and (ii) of the stand-by arrangement shall read:

(i) imposes or intensifies restrictions on payments and transfers for current international transactions other than the extension of the practice described in item 2(d) of Appendix IV of EBS/83/8 to foreign loans for which the domestic borrower obtained an exchange rate guarantee during 1982, or

(ii) introduces or modifies multiple currency practices except as referred to in paragraph 7 of the Memorandum of Understanding annexed to the attached letter dated January 7, 1983, as modified by the attached letter dated May 16, 1983.

4. The Fund grants approval for the retention of the modified exchange practices referred to in 3 above until July 31, 1983.

Decision No. 7410-(83/76), adopted
May 23, 1983

4. *ECUADOR - 1982 ARTICLE IV CONSULTATION - POSTPONEMENT*

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to postpone its consideration of the 1982 Article IV consultation with Ecuador until not later than June 15, 1983.

Decision No. 7411-(83/76), adopted
May 23, 1983

5. ETHIOPIA - EXCHANGE SYSTEM

The approval of the retention by Ethiopia of certain exchange restrictions under Decision No. 7134-(82/81), adopted June 11, 1982, is extended until August 31, 1983 or until the completion of the 1983 Article IV consultation with Ethiopia, whichever is earlier.

Decision No. 7412-(83/76), adopted
May 25, 1983

6. IVORY COAST - 1982 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance Over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to postpone its consideration of the 1982 Article IV consultation with Ivory Coast until not later than June 10, 1983.

Decision No. 7413-(83/76), adopted
May 23, 1983

7. ENLARGED ACCESS POLICY - REVIEW

1. The Executive Board has reviewed Executive Board Decision No. 6783-(81/40), adopted March 11, 1981, entitled "Policy on Enlarged Access," in accordance with paragraph 15 of that Decision.

2. The Executive Board will consider further various aspects of the application of the Decision before the next meeting of the Interim Committee.

Decision No. 7414-(83/76), adopted
May 25, 1983

8. PENSION COMMITTEE - NOMINATION

The Executive Board approves the proposal set forth in EBAP/83/140, Supplement 1 (5/25/83).

Adopted May 26, 1983

9. STAFF COMPENSATION - 1983 SALARY SCALE

The Executive Board approves the salary scale reflecting the decision on the 1983 adjustment to staff compensation taken at Executive Board Meeting 82/73 (5/20/83) and set forth in EBAP/83/124, Supplement 1 (5/20/83).

Adopted May 23, 1983

10. COMMISSION OF THE EUROPEAN COMMUNITIES (CEC) - RELEASE OF INFORMATION - CHANGE IN PROCEDURE

The Executive Board approves the proposal set forth in EBD/83/143 (5/18/83).

Adopted May 24, 1983

11. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment set forth in EBAP/83/142 (5/24/83).

Adopted May 26, 1983

12. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 82/162 through 82/166 are approved. (EBD/83/141, 5/17/83)

Adopted May 23, 1983

13. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/137 (5/20/83), EBAP/83/139 (5/23/83), and EBAP/83/141 (5/24/83) is approved.

14. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/83/135, Supplement 1 (5/23/83) is approved.

APPROVED: October 19, 1983

LEO VAN HOUTVEN
Secretary