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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/77

10:00 a.m., June 1, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	L. Doe, Temporary
	P. Péterfalvy, Temporary
	P. D. Péroz, Temporary
A. Donoso	J. Delgadillo, Temporary
R. D. Erb	C. H. Dallara
	T. Alhaimus
	I. R. Panday, Temporary
	Y. Okubo, Temporary
R. K. Joyce	
A. Kafka	C. Robalino
	H. Arias, Temporary
	G. Grosche
	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	T. de Vries
	K. G. Morrell
	O. Kabbaj
	J. A. K. Munthali, Temporary
M. A. Senior	J. L. Feito
	A. Lindø
	C. Taylor
Zhang Z.	Wang E.

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; E. R. J. Kalter. Legal Department: H. Elizalde, S. A. Silard. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. E. Bonangelino, A. Caetano Filho, M. Caiola, C. Cha, R. A. Elson, M. R. Figuerola, D. S. Hoelscher, J. S. Lizondo, E. V. Zayas. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, J. R. N. Almeida, C. J. Batliwalla, S. E. Conrado, S. El-Khouri, P. Kohnert, P.-C. Maganga-Moussavou. Assistants to Executive Directors: H. Alaoui-Abdallaoui, R. Bernardo, J. Bulloch, T. A. Connors, G. Ercel, C. Flamant, G. Gomel, W. Moerke, J. G. Pedersen, G. W. K. Pickering, E. Portas, J. Schuijer, Shao Z., D. I. S. Shaw, J. C. Williams.

1. REPORT BY MANAGING DIRECTOR

The Managing Director commented that he had traveled to Europe the previous week on the occasion of the World Day of Peace, organized in Vienna at the headquarters of the United Nations Industrial Development Organization. On May 24, he had visited the President of the Swiss National Bank, Mr. Leutweiler, in Zurich for useful discussions on international banking matters, cooperation with the Swiss National Bank with regard to the Fund's finances in the upcoming period, and the contribution that the Bank for International Settlements (BIS)--of which Mr. Leutweiler was President--could make to the Fund's borrowing plans. He had indicated to Mr. Leutweiler, who had been most cooperative and understanding, the liquidity position of the Fund, the financial requirements that were likely to develop in 1983 and later, as well as the necessity of a 1983 borrowing operation.

He had explained the thrust of the Fund's objectives and the importance of not earmarking the new ordinary resources that would result from the increase in quotas by heavy lending commitments in 1983, the Managing Director continued. He had indicated the consequences of such earmarking and thus had pleaded for more than bridging assistance until the quota increases took effect. The Fund Treasurer would attend the next meeting of the Board of Governors of the BIS, scheduled to take place in Basle on June 10, and would be at the disposal of Mr. Leutweiler and other representatives from the central banks to discuss possible collaborative actions with the Fund. While in Europe he had also discussed general banking and Fund matters with the President of the Austrian National Bank, Mr. Koren, who had been very understanding.

He would return to Europe, the Managing Director stated, to visit the German authorities--the Minister of Finance on June 6 and the President of the Bundesbank on June 7--before going to Belgrade to address the UNCTAD VI meetings. At the beginning of July, he would attend the monthly meeting of the BIS in Basle in order to try to finalize lending arrangements.

2. ECUADOR - 1982 ARTICLE IV CONSULTATION, AND REQUEST FOR STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1982 Article IV consultation with Ecuador, together with a request by Ecuador for a stand-by arrangement equivalent to SDR 157.5 million (SM/82/192, 9/21/82; EBS/83/91, 5/11/83; and Cor. 1, 5/24/83). They also had before them a report on recent economic developments in Ecuador (SM/82/198, 10/4/82).

The Chairman said that Ecuador had implemented the fiscal measures required to reduce the fiscal gap to the size indicated in the program. Negotiations between Ecuador and foreign commercial banks on the rescheduling of Ecuador's external debt and on new loans needed to finance the 1983 balance of payments were continuing and might be completed soon.

Because of the critical importance of the commercial banks' financing package to the program, he proposed that Ecuador's request for a stand-by arrangement be approved in principle only, and that the stand-by arrangement should become effective when the financial commitments from the banks were assured. At that time, appropriate decision language would be circulated for adoption on a lapse-of-time basis.

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

> The following tax measures were enacted during the month of May: a 35 per cent reduction in all import duty exemptions; an increase in the selective tax on cigarettes; the adoption of time-based telephone tariffs; an increase in electricity tariffs of 10 per cent (20 per cent in the case of commercial and industrial users), to be followed by adjustments of 2 per cent a month; and an increase in tax rates on alcoholic beverages. The authorities estimate that these revenue measures should yield about S/. 3.8 billion during the remainder of 1983 and S/. 6.5 billion on an annual basis, or 1.3 per cent of GDP.
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> Together with the adjustment measures that have been adopted, the Congress has approved an increase in the monthly minimum wage from S/. 4,600 to S/. 5,600, to be effective in July 1983 for the private sector and in October 1983 for the public sector. The latter measure should increase public expenditures by S/. 1.1 billion in 1983. The allowance for a general salary increase contemplated in the program was S/. 2.5 billion, as shown on page 8 of EBS/83/91.
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> In line with the authorties' intention to reduce subsidies and ensure more realistic pricing of goods subject to controls, in May the Government increased the domestic prices of cigarettes by about 30 per cent on average, wheat flour by 43 per cent on average, rice by 40 per cent, butter by 35 per cent, edible oil by 28 per cent, beer by about 8 per cent on average, and cement by 21 per cent.
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> Import prohibitions have been lifted for items shifted from the official market to the free market.
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> As of May 27, 1983, the exchange rates in the official market were S/. 43.80 per U.S. dollar (buying) and S/. 44.68 per U.S. dollar (selling). Following the modification of the exchange system of March 19, 1983, the exchange rate in the free market has been fluctuating between S/. 80 and S/. 85 per U.S. dollar.

Mr. Robalino made the following statement:

> I would like to thank the staff for the clarity of the documents prepared with respect to the Article IV consultation, as well as for the documents relating to Ecuador's request for a stand-by

arrangement in an amount of SDR 157 million. My authorities are in general agreement with the contents of document EBS/83/91 of May 11, 1983.

The Recession and the Measures of 1981 and 1982

In early 1981, the Ecuadoran authorities began to implement certain measures in an attempt to correct the distortions apparent in the economy.

Fiscal policy

The average price of Ecuadoran oil fell to $34.33 a barrel in 1981 and the $32.54 a barrel in 1982. In order to offset the decline in public revenue that resulted from falling oil prices in the world market, as well as to curb the rapid growth of domestic demand for fuel, Ecuador's authorities decided to increase the domestic prices of oil products on several occasions starting in February 1981, breaking with a traditional policy of holding such prices constant that had been followed for 20 years.

The first increase in the prices of gasoline and other petroleum derivatives was of the order of 200-300 per cent. In 1982, the authorities once again decided to raise the price of gasoline, this time by 100 per cent.

In addition, the authorities adopted several tax measures, among which were increases in the import tax and the cigarette tax and others intended to control tax evasion better in Ecudaor. Utility tariffs, including electricity rates, began to increase in 1981, and the wheat subsidy was abolished in 1982.

On the expenditure side, cutbacks were started in investment projects under the development plan. Certain transfers from the Central Government to other public sector institutions were also reduced.

In spite of the measures taken in the fiscal area, the public sector deficit increased to 5.8 per cent of GDP in 1981, and to 7.5 per cent of GDP in 1982. The additional deficit, notwithstanding the measures taken with regard to government revenue and expenditure, resulted mainly from the increased interest payments required to service the external and domestic debt of the public sector. In 1981 and 1982, interest payments included in the national government budget increased by 0.2 per cent and 1.8 per cent of GDP, respectively.

Balance of payments and exchange rates

The border conflict and the President's death in 1981, the adverse shift in the terms of trade, the declining price of oil, the interest rate rises in the international money market, the fiscal deficit which increased in spite of the measures taken by the Government and the increased external debt service burden, in conjunction with the uncertainty prevailing in Ecuador, caused the current account deficit to increase to 8.2 per cent and 9.1 per cent of GDP in 1981 and 1982, respectively.

The magnitude of the deficits meant that they could not be financed entirely through increased net capital inflows, with the result that Ecuador's net external reserves declined by $294 million by late 1981 and by $460 million by late 1982.

The larger decrease in reserves in 1982 resulted from the suspension of external loan disbursements, both under existing loan contracts and under new borrowings. The Ecuadoran public sector had not received any new external loans since the third quarter of 1982, and the private sector was being faced with reductions in the lines of credit from international commercial banks.

As a result of these developments, the foreign exchange market fell into imbalance, represented by spreads of 50 per cent to 100 percent between the dollar rates in the official market and in the free exchange market.

In their attempt to continue facing up to the severe imbalances in Ecuador, the Government's authorities decided in February 1982 to raise interest rates, and in May 1982 the par value of the currency was changed from S/. 25 to S/. 33 per U.S. dollar and certain temporary measures were imposed, including the prohibition of certain imports and other measures cited in the report.

Monetary policy

My authorities concur with the opinion that interest rates should be managed with greater flexibility. With a view to increasing the volume of domestic saving and improve the allocation of resources in the economy, the Ecuadoran Government increased all interest rates in 1982.

Interest rates were simplified and increased again in 1983. In this way, my authorities are giving proof that they have the necesary flexibility in their handling of this instrument of monetary policy.

1983 and the Fund Program

In spite of the measures taken by the Ecuadoran authorities to restrain the rate of growth of aggregate demand and restore the overall equilibrium of the economy, the problems have become even more serious at the beginning of 1982 as a result of the international economic crisis which makes it difficult to increase Ecuadoran exports, the further drop in world oil prices, and the suspension of credit flows from international commercial banks to Ecuador.

Two factors have been added to these since the beginning of the current year. One factor arises from the forces of nature. A series of floods, landslides, and washouts has caused serious damage to Ecuador's road network and to many plantings whose crops were to have supplied domestic requirements and export demand. The Ecuadoran authorities estimate that the losses resulting from these floods and washouts amount to S/. 4 billion.

The second factor arises from a further drop in oil prices in the world market. Oil exports today account for 65 per cent of Ecuador's total exports. In order to correct the impact of these factors on the Ecuadoran economy, my authorities have requested the present stand-by arrangement.

Extending his remarks, Mr. Robalino said that the international reserves of the Central Bank on May 25 were $176 million, and that the rate of growth of money supply, on an annual basis, was 14.3 per cent on March 13.

Mr. Erb stated that he had problems of a general nature in approaching the discussion of the proposed program for Ecuador. The previous week he had reluctantly agreed to forgo the rule calling for four weeks' notice of an item to be considered by the Board and had been willing to discuss the program earlier. He found the remaining uncertainty on the financing side of the program troublesome. He also found it difficult to assess the information provided by the staff that morning on a number of fundamental policy changes. Although additional policy measures had been anticipated in the original staff document, the staff had not presented an analysis of the implications for the overall program of the new policy steps in its statement.

Previously, Mr. Erb continued, he had been reluctant to go along with the program because of uncertainties regarding fiscal policy, subsidized prices, and the interest rate policy. The program provided for drawings up to 150 per cent of quota under the enlarged access policy, but he had serious reservations about whether the full limit was appropriate, not only because of the uncertainties that he had mentioned regarding immediate policy measures, but also because of the lack of assurance that the program was adequate to achieve a viable payments position over the foreseeable time period. Although a paragraph on page 18 of EBS/83/91 dealt with the medium-term balance of payments prospects, as a staff assessment of the medium-term prospects of Ecuador it left a great deal to be desired. It suggested that further adjustments would be necessary beyond the current year, and that the financial situation, including the external situation, would be precarious beyond the end of 1983. But the reader was not provided with any indication of how the Government might respond to problems of domestic policy or external financing beyond the end of the year. Because of the lack of a medium-term analysis, the appropriateness of providing Fund resources up to 150 per cent of quota was questionable.

With respect to exchange rate policy, he was concerned that the spread between the official rate, which was being depreciated through a crawling peg system, and the free market rate was extremely large, Mr. Erb commented. He urged the authorities to move to a unified, flexible rate as soon as possible. Meanwhile, the authorities should consider speeding the rate of minidevaluations in the official market so that the free and official rates could converge earlier than currently envisaged. While some importers were entitled to foreign exchange at an official rate, the official exchange rate was not guaranteed, so that the authorities had the option of providing official foreign exchange at a much-depreciated rate, which need not differ from the free rate. Perhaps the staff or Mr. Robalino could explain why that option had not been followed. He noted that only 20 per cent of exports and imports were estimated to be going through the free market, which seemed grossly inadequate. It would be desirable for a much greater proportion of trade, especially on the import side, to be channeled through the free market, rather than through the official market at an overvalued rate.

Compared with projected 1983 inflation rates, the nominal interest rate structure appeared to be much too low, Mr. Erb stated. It was his understanding that the staff was projecting a much lower rate of inflation in the second half of 1983, since the corrective price increases had already affected price indexes in the first part of the year. Therefore, the present interest rate structure might not be as out of line with expected rates of inflation as the annual inflation figures seemed to indicate. It was important to follow a flexible interest rate policy that was compatible with a more stable exchange rate policy, and to reverse the capital outflows of the past year. Such a policy might entail interest rates that were substantially higher than the ones currently prevailing.

Flexibility should also be employed in the setting of administered prices, Mr. Erb remarked. Substantial adjustments had been made for certain products, but gasoline prices still seemed low when the free-market exchange rate was used to convert local currency prices into international prices. What exchange rate had been used to calculate the elimination of the wheat subsidy? Was there an implicit subsidy involved in the exchange rate that was used in calculating whether or not the wheat subsidy existed? Percentage changes in administered prices from unknown base prices were difficult to judge without comparisons to international prices. He urged the authorities to follow a policy that would entail the periodic review of administered prices, so that controlled prices remained consistent with developments in inflation and exchange rates.

The program's success would depend to an important extent on a reduction of the fiscal deficit, Mr. Erb noted. Most tax measures were in place, and the authorities were intent on restraining expenditures. He urged the authorities to stand ready to make compensatory adjustments to both expenditure and revenue, if it appeared that the fiscal targets were in danger of being missed. He was concerned about the law passed in March 1983, described on page 7 of EBS/83/91, that allowed for increases in exceptional circumstances, such as emergency expenditures because of natural disasters or higher debt servicing. It seemed that if those exceptional circumstances occurred, and additional expenditures were needed, other less needed expenditures should be cut back.

Although he had not been prepared to go along with the request earlier, Mr. Erb commented, the additional information that had been provided, and his necessarily limited analysis of it, had argued for his support. However, he would make his final decision after considering other Executive Directors' reactions to the request. In conclusion, he emphasized the importance of discussing Article IV consultations in the Board soon after they were completed, and he hoped that in the future there would not be delays such as those experienced in the present case.

Mr. Donoso remarked that the policies implemented by the Ecuadoran authorities were appropriate to move the economy toward correcting its imbalances due to adverse external conditions, in terms of both lower export prices and rising interest rates, together with expansionary demand management. Ecuador faced important balance of payments problems, a rising rate of inflation, and a zero rate of growth of GDP.

Significant adjustments would be required to improve the country's deteriorated economic position, Mr. Donoso continued. The program was aimed at reducing the overall public sector deficit from 7.5 per cent of GDP to 4.2 per cent in 1983, and reducing the rate of increase of net domestic assets of the Central Bank, consistent with the projected rate of inflation and a loss in reserves of $100 million. The interest rate structure would be simplified, deposits and loan rates increased, and a more flexible exchange rate system established. A system of a series of minidevaluations had been introduced after the devaluation of March 19, and the transfer of transactions from the official to the free market should help to limit the effects on production and employment, tighten demand, and solve external imbalances.

The authorities not only had designed a program but had already adopted many important measures for the attainment of their objectives, Mr. Donoso stated. Those actions gave assurance of the authorities' determination and commitment to obtain a viable balance of payments situation. During 1982, the authorities had increased gasoline prices and eliminated the wheat subsidy. They had submitted tax measures to Congress, which had approved many of them during the year. In 1983, the rates paid on bank deposits had been increased, and measures had been adopted that would increase fiscal revenue for the year. In March 1983, Congress had approved a law that limited public expenditures and foreign borrowing, which should facilitate the implementation of the fiscal program for the year. In the circumstances, he wished to express strong support of the stand-by arrangement for Ecuador and the proposed decisions.

Because of the magnitude of the adjustment, close monitoring of the program would be necessary to ensure the timely identification of any problems, Mr. Donoso commented. It might be difficult to dispose of the prevailing restrictions on exchange rate transactions if the authorities did not manage interest rates so as to eliminate incentives for private capital outflows. There had been increases in interest rates with positive results on demand deposits, but the rates were still negative in real terms. He urged the authorities to accelerate the application of their policies relating to interest rates so as to reduce pressures on the foreign exchange market and increase the availability of financing for the private sector. He recommended the establishment of interest rate levels that would make domestic deposits more attractive than those abroad; interest rates should be positive in real terms, and at least compensate for the expected depreciation of the sucre. Finally, restrictions on exchange transactions and multiple currency practices should be eliminated.

Mr. Taylor said that his authorities were concerned that the Board had not been given an opportunity to consider a report on the Article IV consultations with Ecuador in advance of the stand-by proposal. Consultations had been initiated about one year previously, and the stand-by negotiations that had taken place had been long and complex. In the circumstances, consideration of an Article IV paper at an earlier stage would have aided understanding of the economic situation and contributed to the negotiations; he hoped that that aspect of the Fund's surveillance could be tightened up in future. He also shared Mr. Erb's comments about the lateness of the important information that had just been received from the staff.

He agreed with the staff appraisal and he supported the proposal that the decision be approved on a conditional basis, Mr. Taylor stated. Unlike a number of countries in the Latin American area, Ecuador still enjoyed a positive rate of growth, relatively low inflation, and a comparatively modest balance of payments deficit. A short-term stabilization program seemed to be the feasible approach, and, as the immediate adjustment needs were fairly manageable, he agreed that in the circumstances a stand-by arrangement, rather than an extended arrangement, had been appropriate. The present program envisaged a strong adjustment effort, and he therefore attached considerable importance to the mid-term review as a means of ensuring that the program remained on track. The review could monitor progress in exchange rate policy, debt refinancing, and the elimination of arrears, as well as present an opportunity to consider the case for a multiyear arrangement.

It was important to look at the medium-term balance of payments prospects, Mr. Taylor commented. There were two danger signals that were symptoms of an underlying weakness in the balance of payments position. First, he wondered whether the staff's forecast for the short term was not extremely optimistic. The serious floods could affect export performance and agricultural production. Also, exports of oil had been low, reflecting the weakness in world markets. Could the staff say whether the projected increase of about 16.5 per cent in the volume of oil exports in 1983 would stand or whether it would be revised downward? The projected cut of 25 per cent in imports also seemed optimistic, although it would no doubt owe much to the implementation of a substantial exchange rate adjustment.

Second, Mr. Taylor continued, even after debt renegotiation, the projected debt service ratio would remain high for 1983, about 38 percent of exports. If the forecasts turned out to be on the sanguine side, a more sustained adjustment effort than envisaged at present would be necessary.

Improvement in the external situation would depend largely on further downward adjustments of the exchange rate, Mr. Taylor considered. The substantial devaluation of the sucre in March signaled the authorities' willingness to adopt a more flexible policy, but he had misgivings about the pace of reunification of the exchange markets. The differential between the official and the free market was expected to narrow, but he would have appreciated a timetable for the reunification. The proposed speed of adjustment of the exchange rate seemed slow: S/. 0.04 per U.S. dollar per working day. His calculations indicated that, by the end of 1983, a rate of S/. 0.50 per U.S. dollar would be reached, whereas the current free market rate was S/. 0.79 per U.S. dollar, a substantial gap.

A timetable for the elimination of import restrictions would be helpful for the program review, Mr. Taylor remarked. Meanwhile, he could go along with the proposed temporary approval of those restrictions.

His authorities considered the liquidation of external arrears by November 30 an important criterion of the program, Mr. Taylor stated. However, from present indications, its accomplishment would be difficult; the Central Bank was currently reported to be four months behind in settling arrears, which was not surprising given the low level of reserves. He wondered if the staff felt that the target was a realistic one, and whether any further measures or modifications could be introduced in the program if the target for arrears elimination looked as though it might not be achieved.

With regard to domestic policy, the reduction in the overall public sector deficit to about 4 per cent of GDP by the end of 1983 was a key element, Mr. Taylor observed. The authorities were to be commended for having proposed and put in place comprehensive revenue measures, and he welcomed the confirmation that they had enacted. Nevertheless, the revenue base was narrowly concentrated on the petroleum sector, and, given the uncertain prospects for that sector of the economy, the authorities would be well advised to give consideration to broadening the revenue base. Similarly, the strengthening of tax administration through a revision of earmarking could yield benefits in the medium term. He welcomed the improvements that were taking place in the control mechanisms on the expenditure side. As there might be a need to provide in the budget for emergency expenditure to counteract flood damage, had that expenditure been quantified and taken into account in projections?

On monetary policy, he welcomed the action by the authorities to simplify the structure and to raise the level of interest rates, Mr. Taylor commented. He hoped that they would persevere with their plan to review the rates periodically and to move them toward positive real levels.

Finally, Mr. Taylor remarked, it would be unfortunate if structural questions were overlooked. For example, there had been no clear reference in the staff paper to the need to strengthen the agricultural sector. It was not too early to start thinking about the implementation of structural reforms.

Mr. Grosche commented that economic performance in Ecuador had been disappointing because of unfavorable external factors as well as expansionary demand policies and an overvalued exchange rate. To deal with the adverse developments, the authorities had adopted a number of measures but had not been able to prevent a further weakening of the balance of payments. The measures taken in recent months were a more determined effort to cope with the main problem areas of the economy. The program agreed to by the staff and the authorities was suitable in present circumstances, and he could support it. However, like Mr. Erb, he had some doubts about the appropriateness of applying the full limit of 150 per cent.

He agreed on the main objectives of the program, Mr. Grosche remarked, but he was concerned about one aspect. The program envisaged a doubling of the inflation rate in 1983, measured by both the GDP deflator and the consumer price index. Would not a more ambitious target have been appropriate, even considering the adverse effects of increasing controlled prices and a more flexible exchange rate policy? How would the substantial price increases be financed in view of the relatively moderate money and credit expansion? An overhang in liquidity from 1982 might provide an explanation.

Some features of the program were crucial to its success, Mr. Grosche continued. A substantial reduction in the budget deficit was forecast. If achieved, the Government would have gone a long way toward a more sustainable budgetary situation. What was the likelihood that the target would be achieved? It was encouraging that the authorities had adopted important measures to increase revenues and to control public expenditures. On balance, the Government appeared to have the determination as well as the means to achieve the budgetary target. On page 7 of EBS/83/91, the staff mentioned that Congress was considering a 50 per cent reduction in tax rebates granted under the fiscal incentive law for new investments. Would not such a policy have a marked detrimental effect on investment activity?

On monetary policy, Mr. Grosche said that the simplification of the interest rate structure and the introduction of a more flexible interest rate policy in the recent past were welcome. He attached great importance to the authorities' intention to review periodically the appropriateness of both the structure and levels of interest rates.

The authorities' firm stance against excessive wage adjustments demonstrated determination and courage, Mr. Grosche considered. In the past, large wage increases had apparently been one of the causes of excessive demand pressure and increases in the public sector deficit. It was crucial for the success of the program that the Government continue its present wage restraint policy.

A key element in the program was the modification of the exchange system, Mr. Grosche commented. It was understood between the authorities and the staff that the rate of minidevaluations would be accelerated so as to reduce substantially the difference between the official and the free exchange rates. At the mid-term review, close attention would be paid to the extent of success reached in achieving that objective. With regard to the external debt situation, the authorities had received some relief by successfully rescheduling part of the debt. However, as seen in Table 11 of the staff report, in 1984 the debt service ratio was projected to increase again and stay at a high level for a number of years. That development was worrisome and emphasized the need for a stronger adjustment effort than currently envisaged. He noted that the Central Bank would not incur losses in the proposed scheme to settle Ecuador's private debt to foreign commercial banks unless the private sector were to default. He would appreciate further comments by the staff or Mr. Robalino on the likelihood of such losses. To conclude, a number of important adjustment measures had been taken, but the task ahead was difficult. Great importance should be attached to the mid-term review.

Mr. Joyce stated that he agreed with the staff appraisal and supported both decisions. He appreciated the usefulness of having up-to-date information available for the Board's discussions, although he shared other speakers' concerns about the delays in its provision as well as in bringing forward the Article IV papers for discussion. There had been numerous discussions between the staff and the authorities in the intervening period; nonetheless, it would have been helpful to the Board, and he hoped also to the Ecuadoran authorities, if there had been an earlier discussion of the Ecuadoran economy and the measures under consideration by the authorities. He had supported the idea--in the interest of saving time--of bringing forward Article IV consultation reports and staff papers on proposals for programs under arrangements with the Fund simultaneously. Although still desirable, the idea was only appropriate when it did not involve too long a delay. In the present case, the delay in bringing the Article IV discussions to their conclusion indicated that two discussions of Ecuador's situation would have been more suitable.

The authorities were to be commended for the commitments that they had undertaken and the actions that they had taken to bring about changes in the economic situation in Ecuador during the course of the stand-by period, Mr. Joyce remarked. Those measures warranted support for the program of the magnitude proposed. Nevertheless, caution was required in the administration of the policy of enlarged access, and, no one could presume that in every instance 150 per cent of quota was the most desirable access limit for a country with a program. The economic policies outlined in the staff paper paper should help Ecuador to redress its current external and internal imbalances, but the country had little room for maneuver, and great care would have to be exercised to avoid any slippage in the adjustment program. At least two significant events in 1983 had created problems for the authorities: floods, and a further drop in oil prices. The authorities had taken into account the impact of those events in designing the program, but given the already low level of the Central Bank's foreign currency holdings and the need to increase gross foreign assets and improve the working balances of the Central Bank, there was clearly little margin for error. He therefore stressed the importance of holding a mid-term review in order to discuss the progress of the program.

The authorities' success in reducing the fiscal deficit from 7.5 per cent of GDP to 4.2 per cent in 1983 would depend upon the implementation of revenue measures already in place and upon continued tight control of expenditures over the coming months, Mr. Joyce commented. The reduction in subsidies would be an important factor, and he welcomed the increase in domestic petroleum prices as well as other steps taken to reduce or eliminate subsidies. However, the price for high octane gasoline was only 95 U.S. cents a gallon, and for diesel 40.5 cents a gallon, which seemed quite low. Another key area would be the policy on wage increases, and he was pleased to note that the increase in the minimum wage, at 21.7 percent, would be well below the expected increase in the consumer price index. As the increase would not take effect until October 1983, the impact on public expenditures in the current year should be manageable within the program parameters.

The authorities should complement demand management policy with a flexible interest rate policy, Mr. Joyce said. He wondered whether the proposed increase in savings deposit rates would be sufficient to attract domestic savings to the financial system or to keep such savings in the country, given the small magnitude of that increase compared to the cost of living increase. The authorities should look closely at interest rates and, if necessary to attract additional savings, should be prepared to increase the rates further.

On exchange rate policy, Mr. Joyce welcomed the continued growth in the parallel exchange market, the devaluation of the sucre in March, and the continued depreciation on a daily basis to reduce the spread between the official and free rates. However, he supported the staff view that there might be a need for an accelerated rate of minidevaluations; the current rate, 0.04 sucre per working day, was equivalent to an annual rate of about 25 percent, well below the projected inflation rate. He also noted that the free-market rate had recently fallen to more than 80 sucres per dollar, which resulted in a continued wide differential between the official and free exchange rates.

With regard to debt renegotiation, the Ecuadoran authorities had announced the previous week that talks with the steering committee for creditor banks on the rescheduling of $2.56 billion of private and public debt would be successfully completed, Mr. Joyce reported. The debt was to be rescheduled over seven years, with a two-year grace period and an interest rate of 2.25 per cent over the London interbank offered rate (LIBOR), or 2.125 per cent over prime. The creditor banks had agreed to grant Ecuador a new loan of $431 million over six years, with a grace period until January 1985. He understood that the authorities planned to hold additional talks with the creditors, possibly leading to a further refinancing of the public debt or to a refinancing of debts maturing in 1984. He would appreciate any additional information that could be provided.

Mr. Senior stated his strong support for the request by the Government of Ecuador for a one-year stand-by arrangement. The economic situation in Ecuador during the past two years had deteriorated markedly. In 1982 in particular, economic activity had stagnated, the inflation rate had accelerated substantially, and the balance of payments position had deteriorated sharply. As in other developing countries, the worsening of the international financial situation had aggravated the balance of payments difficulties experienced by Ecuador. The scope of important policy measures adopted by the authorities during 1982 had been limited by the extremely restricted access of Ecuador to foreign borrowing. The authorities had recognized the need to continue the adjustment of the economy and had designed an economic program to prevent a further deterioration of the balance of payments, while setting the basis for sustained economic growth. The program contained an appropriate balance of policy measures, most of which had already been implemented.

In the fiscal area, Mr. Senior continued, the substantial reduction of the public sector deficit from 7.5 per cent of GDP to 4.2 per cent seemed feasible and necessary. On the expenditure side, the law regulating outlays of the Central Government and autonomous entities would assure the control of public outlays, while on the revenue side, several tax measures and substantial increases in tariffs and prices of public goods and services previously adopted were programmed to result in a 37 percent increase in revenues in 1983. The doubling in October 1982 of gasoline prices, which had not been adjusted for 20 years, illustrated the determination of the authorities and the importance that they attached to the fiscal adjustment contemplated in the program. Fiscal adjustment was adequately accompanied by a flexible interest rate policy and prudent credit expansion to avoid excess demand pressures. To that end, interest rates had been raised recently, while credit operations by the Central Bank had been reduced significantly.

In the external sector, determined and firm action had already been taken by the Ecuadoran authorities, Mr. Senior commented. Of particular importance was the decision to modify the exchange rate system by adopting a crawling peg after more than 12 years during which the official rate had been fixed. The depreciation of the official rate in March 1983 and the authorities' decision to allow a depreciation in the course of the program would reduce the difference between the free and official rates. He agreed with the staff that those actions, together with a gradual transfer of transactions from the official to the free market, were key elements of the program. In addition, the authorities had eliminated most of the export tax certificates and had reduced substantially deposits on imports of semiessential goods.

The agreement reached in January 1983 between the authorities and commercial banks to reschedule public debt amortizations falling due in 1983 would reduce significantly the pressures on the balance of payments, Mr. Senior observed. However, as in other developing countries, the new interest rate and other additional charges imposed a heavy burden, offsetting to a certain degree the favorable impact of the debt relief. During the review of Mexico's program, that situation had been mentioned in the Board, and the Acting Managing Director had stated that, while the Fund might not have jurisdiction over the matter, it should be of concern to the Board, possibly requiring further study by the Fund. Could the staff advise the Board on the current situation with respect to the negotiations on the private debt owed to commercial banks? Refinancing of that debt was necessary for the achievement of the balance of payments target.

Mr. Alhaimus stated that he agreed with the main thrust of the staff appraisal and supported Ecuador's request for the use of Fund resources in support of its stabilization effort. The authorities had begun adjustment measures, including those taken in May, before the imbalances had become severe. The proposed program, as well as the policy measures already taken, addressed the factors that had contributed to the weakening of the balance of payments. At the end of the program period, imbalances were estimated to be reduced substantially, although understandably it could take longer than one year for their complete elimination. It was to be hoped that the tempo of policy implementation would be maintained after the program period until the imbalances had been eliminated and the ground laid for sustainable growth with financial stability.

The Ecuadoran authorities' efforts in the fiscal area, both in revenue expansion and in expenditure control, were particularly noteworthy, Mr. Alhaimus commented. The new tax measures taken in May and included in the staff statement of May 31 were broad based and, in part, structural. However, an increase in revenue resulting from the elimination or reduction of subsidies and the reduction in the rebates on new investment were mostly once-for-all efforts, and some of them might also have had implications for economic growth. Similarly, nonpetroleum tax revenue in absolute terms had stagnated over the past few years, while the country had witnessed inflationary conditions. Also, a reduction in real wages through incomes policy could be attempted only at great social risk if continued for an extended period. Resource mobilization and sustained improvement in the fiscal position essentially depended on an expansion in investment and economic growth.

In recent years, the rate of growth in the economy had declined, Mr. Alhaimus remarked, and it would receive a further setback during the program period. The reduction in tax rebates on new investment, other constraints on increases in investment expenditure, and a substantial decline in imports during 1983 were likely to affect economic growth adversely. Together with the limits on an increase in public employment, those developments could further aggravate the already acute problem of unemployment and underemployment in Ecuador. It was to be hoped that a zero growth rate would not be allowed to continue.

Mr. Caranicas expressed his agreement with the staff's view that the set of policies implemented by the authorities was appropriate to redress Ecuador's balance of payments situation, and he supported the proposed decision on the Article IV consultation and the requested one-year stand-by arrangement in an amount equivalent to SDR 157.5 million. He took into account the nuance indicated by the Chairman at the beginning of the meeting that the exact period of the stand-by arrangement would be determined later.

The success of the program in correcting the maladjustments prevailing in Ecuador would hinge crucially on the degree of response of the domestic economy to external impulses and policy actions, Mr. Caranicas stated. The domestic measures envisaged in the program were standard and did not warrant detailed discussion. Administered prices and public charges were closely monitored and reviewed, leading to an informal but apparently effective indexation mechanism for public sector nontax revenues. The desired fiscal outcome seemed reasonable, since most changes to be effected both on the revenue and on the expenditure sides had already been set in motion in the legislative process or in other ways. If problems arose, they would be confined to the implementation and control of policies already decided upon.

Conversely, the external economic environment remained uncertain, and indeed depressed, if the new adverse factors described by Mr. Robalino were taken into account, Mr. Caranicas stated. It was important to recall not only those problems due to the prolonged contraction of the world economy that greatly influenced small open economies like Ecuador, but also the problems specific to the Latin American region. No country in the area had been able to insulate itself from systemic stress. Nevertheless, some room for maneuver was available to the authorities in the conduct of exchange rate policy directed at helping to achieve the program targets, which were framed in terms of net official reserves. Despite inherent weaknesses associated with its dual market features, the exchange system of Ecuador seemed best suited to maintain the competitive position of the country. The recently announced trade liberalization measures would also help. As to the inclusion among the performance criteria of undertakings concerning the removal of trade restrictions and multiple currency practices, he would appreciate further comment by the staff or Mr. Robalino, particularly on two questions: first, the estimated speed of convergence of the two exchange rates, given that a fairly small fraction of trade transactions were through the free market; second, the estimated budgetary costs of maintaining a dual market system.

In regard to the external debt situation and its medium-term prospects, the rescheduling of public sector debt recently agreed upon with foreign banks was a positive outcome, Mr. Caranicas commented. It was to be hoped that the current talks between the authorities and the commercial banks would be concluded soon in a satisfactory manner so as to give some breathing space to Ecuador in its burdensome debt servicing obligations. He would appreciate information about the amount of private debt involved in current negotiations and the implications of a possible agreement for the country's debt service outlook.

Finally, he had felt somewhat uneasy when the Chairman had announced that the stand-by arrangement for Ecudor would have to be approved in principle pending the outcome of the renegotiations between Ecuador and its creditors, Mr. Caranicas remarked. While there had been conditional approvals in the past where receipt of an official request had been delayed, or pending clarification of certain figures, he did not recall the approval of a request for a stand-by arrangement "in principle." Perhaps it would be useful to discuss the matter further.

Mr. Malhotra said that he supported the proposed decisions. The adjustment program appeared appropriate in the circumstances of Ecuador and comprised sound measures, some of which had already been initiated. Above all, the authorities were taking determined steps to reduce the public sector deficit from 7.5 percent of GDP to 4 percent, to improve revenues, and to bring expenditures under control. He also commended the moderate stance of wage policy.

There was considerable evidence of greater flexibility with regard to both exchange rate policy and interest rate policy, Mr. Malhotra continued. He urged the authorities to achieve interest rate policy objectives early so that interest rates might become positive in real terms. It was disturbing that the rate of inflation, currently about 17 percent, was forecast to reach 30 percent, partly as a result of policy measures on exchange rates and public prices. The authorities should persist in their efforts, especially through budgetary restraint, to ensure that the target of limiting the public sector deficit to 4 percent of GDP was achieved. It was important to bring down the rate of inflation. Considering the circumstances of Ecuador as described in the staff report and the latest information made available, the amount of financial support envisaged by the Fund--150 percent of quota--seemed appropriate.

He shared the concerns expressed by Mr. Caranicas about approving the program in principle, Mr. Malhotra stated. The program appeared well designed to achieve its objectives, and the authorities had already given sufficient proof of their resolve to tackle the difficult problems that confronted them; therefore he would have preferred it if the Board could have given its final approval to the program. He appreciated that management might wish to bring a degree of persuasion to bear on other creditors in order to promote rescheduling, and it was in that context that he could understand the proposal. But as a matter of policy, such cases should be rare; normally the approach should be to sanction proposals, taking into consideration the quality of the program, the measures taken by the authorities to adjust, and the need for financing. If those were appropriate, the program should be entitled to financial support.

Mr. Suraisry remarked that the economy of Ecuador suffered from many problems in the domestic sector as well as in the external sector. To deal with those problems and to bring the economy back on track, the Ecuadoran authorities had taken strong measures. In that regard, he supported the proposed decision, with the proviso mentioned by the Chairman. The program was strong in many respects, and its implementation would not be easy;

however, considering the state of the economy, the program seemed to be necessary. The seriousness of the situation gave no room for slippages and limited the policy choices available to the authorities; determination and close monitoring were necessary conditions for the success of the program.

The authorities' stance with regard to wage policies was commendable, and continuation of that prudent policy was important, Mr. Suraisry continued. In the light of the adjustment measures taken heretofore, the planned 11 per cent increase in the wage bill was sensible and would not threaten the program if granted. The final outcome, however, would depend on the reaction of the private sector to such an increase.

The ratio of public debt to GDP was high, Mr. Suraisry commented, and the rapid growth of public debt and the shortening of its maturity structure contributed to Ecuador's balance of payments problems. A cautious approach was required to correct imbalances in that area not only for 1983 but also for the years beyond, especially in light of the weakness in the balance of payments that was expected to prevail over the medium term. Reducing the budget deficit was important if the program was to succeed, and he commended the authorities' decision to reduce the deficit substantially. However, more measures needed to be taken in several areas, particularly of trade policy. Like the staff and other Directors, he urged the authorities to remove restrictions and multiple currency practices, as well as to reach an early unification of the exchange rates of the sucre. He looked forward to the next review of the program.

Mr. Kabbaj remarked that the unfavorable international economic environment and a long period of expansionary policies had resulted in a marked deceleration of real economic growth in Ecuador, high inflation, and substantial fiscal and external deficits. The relaxation in demand management policies, soaring international interest rates, and the decline in prices of Ecuador's main export commodities had contributed to the deterioration of economic activity and to the widening of domestic and external imbalances in 1981 and 1982.

The Ecuadoran authorities had reacted swiftly to the worsening situation with a number of actions designed to stabilize the economy and improve the balance of payments position, Mr. Kabbaj continued. They had also approached the Fund for assistance, and the ensuing negotiations had been long and difficult. The measures implemented had been insufficient to cope with the situation despite the harshness of some, including a 32 percent devaluation of the sucre, spending cuts, the doubling of gasoline prices, the elimination of the subsidy on wheat, and various tax measures. In fact, the set of measures adopted in 1982 had been undermined mainly by the continued deterioration in oil market conditions and by the deep recession in Ecuador's principal trading partners.

With regard to the program for 1983, which was to be supported by the requested stand-by arrangement, Mr. Kabbaj noted that further strong measures had already been implemented by Ecuador, including those reported by the staff earlier and in the report on the 1982 Article IV consultation. The measures seemed to be appropriate, while the prospects for a successful program were much greater than in 1982, as a stabilization of the petroleum market was taking place and a modest economic recovery was under way in Ecuador's trading partners. The 1983 program appropriately focused on fiscal and external policies to bring about substantial reductions in budgetary and external account deficits. Those policies were also complemented by adequate measures under monetary, price, and incomes policies, despite the adverse effect expected from the last on the already high inflation rate.

With regard to the fiscal program, Mr. Kabbaj said, the early implementation of most of the envisaged measures, particularly on the revenue side, should help to achieve the ambitious target of reducing the overall budgetary deficit from 7.5 per cent of GDP in 1982 to 4.2 per cent in 1983 The attainment of the fiscal targets was also dependent upon tight control of expenditure and close adherence to the projected spending cuts, which should yield an additional 1.9 per cent of GDP, mainly through lower limits on the operations of the Central Government and autonomous entities, particularly the financing requirement for any additional investment expenditures.

The key element of external policy was the large depreciation of the exchange rate in the official market, accompanied by the so-called crawling peg, aimed at substantially reducing the differential between the official and free exchange rates, Mr. Kabbaj observed. A further liberalization should also be achieved through a gradual extension of the free market's scope and through a relative relaxation of the various import deposit requirements.

As to monetary policy, the authorities' objectives of attracting domestic savings to the financial system and keeping them in the country might be undermined by the continued high inflation in 1983 and the preannounced depreciation of the currency, Mr. Kabbaj commented, despite the simplification of the interest rate structure and the upward adjustment in deposit and loan rates. Further comments on the matter from the staff or Mr. Robalino would be appreciated.

In conclusion, Mr. Kabbaj considered that the program was strengthened by the continuation of the restrained wage policy initiated in 1982 and the series of domestic price adjustments aimed at eliminating subsidies and greatly improving the efficient use of Ecuador's resources. The program was a strong one and deserved the Fund's assistance; he therefore supported the two proposed decisions.

Mr. Zhang stated that he also supported the two decisions. He could go along with the Chairman's statement about the effective date of the decision and stand-by arrangement, although he hoped that it would not set a precedent.

Mr. Morrell said that he was in broad agreement with the staff appraisal and supported the decisions on the basis put forward by the Chairman. However, he shared some of the reservations expressed by other Directors about the use of the approval-in-principle technique. He wondered whether it would not have been possible to have amended the stand-by decision so that perhaps the first drawing could not have been made until additional preconditions had been met relating to the rescheduling of the debt.

The objective of the program had been stated in the paper as simply to limit the loss of net international reserves of the Central Bank of Ecuador to no more than $100 million, Mr. Morrell observed. However, despite the simplicity of the statement, it masked a complex set of interrelated measures that, despite the short duration of the program, addressed structural problems, namely, the need for greater efficiency in the use of resources in both the public and the private sectors. The authorities had already demonstrated a commitment to the measures in the program by recent actions, including both a number of tax measures and flexibility in exchange exchange rate arrangements. However, like others, he would have liked to see a faster rate of depreciation of the sucre and a more positive commitment to moving the two exchange rates together. He welcomed the doubling of the prices of gasoline and the elimination of the wheat subsidy. Like Mr. Erb, he found it difficult to assess those numerical figures without the base from which they had come; while they indicated some impact on the rates of inflation, they did not necessarily show the subsidy compared with world prices. He also welcomed the adjustments in the interest rates and the indication of the authorities' commitment to maintaining a more flexible interest rate policy. It was regrettable that because of the continued weakness in oil prices and the mildness of the global recovery, there was no economic growth in prospect for the present year, nor perhaps for 1984, so that perhaps another stand-by arrangement might become necessary.

The spreads above LIBOR being charged Ecuador on its rescheduled debt were apparently even higher than those for Mexico, Mr. Morrell noted, and it was a matter of concern whether those spreads, on top of the continuing high international interest rates, were doing Ecuador or the banks any good in the long run. He looked forward to seeing a staff study of the matter and to discussing it in the Board in the future.

The staff representative from the Western Hemisphere Department, replying to questions, stated that in the staff report it had been indicated that some tax measures--the 50 per cent reduction of the fiscal incentive and the income tax surcharges--had been submitted for congressional approval but had not yet been approved. Those two measures were expected to yield about S/. 3 billion. Because the discussions in Congress were continuing and the two revenue measures had not been adopted, the Executive Board had approved several revenue measures not requiring congressional approval that would yield S/. 3.8 billion, a higher level of revenue than envisaged in the program. Similarly, regarding wage adjustments, a budgetary appropriation of S/. 2.5 billion had been made, but actual salary increases would imply expenditures of only S/. 1.1 billion.

It had been asked what the definition of "exceptional circumstances" would be in making budgetary appropriations, the staff representative recalled. In passing the law on public sector expenditures, the authorities had been faced with difficulty in projecting two categories of expenditures. First, there had been heavy floods on the coastal area requiring emergency expenditures, and it was estimated that those expenditures would amount to S/. 4 billion. Under the program, the authorities had included S/. 2.4 billion for emergency expenditures to be financed domestically and S/. 3 billion to be financed by a loan from the Credit Commodity Corporation. Hence, there was a small safety margin on the amount of emergency expenditures. The damages in the coastal area would affect production mainly of basic grains rather than of exports, and the shortfall in production would be covered by a loan provided by the Government of the United States.

The second problem, the staff representative continued, was the interest rate to be paid on external debt, especially the debt to foreign commercial banks. The law on public expenditures not only applied to 1983 but also set the basis for the preparation of future budgets; as the first such law passed in Ecuador, it was extremely important. The authorities could not determine the interest rate that they would have to pay, because the interest rates charged by the banks were related to LIBOR and it would be difficult to set a ceiling on those amounts. Notwithstanding that uncertainty, the program was not affected. Since ceilings had been set on both government borrowing on a net basis abroad and borrowing from the banking system, if the Government should have to pay higher interest rates than budgeted, some expenditures would have to be cut or additional revenues raised.

Regarding the adequacy of the program in the medium term, the staff representative went on, the problems of Ecuador could not be solved during 1983 but would require several years of intensive effort and the implementation of additional corrective measures. In 1983, however, the authorities were trying to set the basis for the future through the adoption of structural changes. The fixed exchange rate of 12 years had been modified into a flexible exchange system. Subsidies had been drastically reduced, and controlled prices of products had been periodically increased. Electricity tariffs had been raised, which was important in order to make electricity companies self-sufficient while opening the door for possible loans from the World Bank and the Inter-American Development Bank.

On the fiscal side, the staff representative remarked, new tax measures, as well as the law regulating the level of expenditures and the budgetary procedures to be followed by the Central Government and autonomous entities, had been introduced. More would have to be done to broaden the tax base, which had been too dependent on the oil sector. Controls had been established on external debt. The interest rate structure had been streamlined and made more flexible, while rates had been adjusted upward. Tax certificates to provide tax rebates for exporters and the use of advance import deposits had also been eliminated because the authorities believed that the use of the exchange rate and other policies was more appropriate to achieve their objectives. Nevertheless, it was difficult to forecast prospects for 1984 at the present stage because of the large amortizations falling due. Much depended on the negotiations between the authorities and the foreign banks regarding the debt due in 1983 and in future years. Without renegotiation, the debt service would be extremely high at least for the next three years, therefore the authorities and the steering committee representing the foreign banks were considering also a renegotiation of amounts falling due in 1984.

Regarding the exchange rate policy, the staff representative commented, the objective of the program was to narrow substantially the spread between the official and the free exchange rates. It had been a novelty for Ecuador to shift from a fixed exchange rate system to a flexible one with a crawling peg, but the country had absorbed the idea. It was hoped that the unification of the two markets would be achieved speedily through a faster rate of depreciation of the official rate, and through larger transfers of operations from the official to the free market during the remainder of the year. A legal obstacle in 1983 was that any kind of import permit issued by the Central Bank entitled the importer automatically to foreign exchange in the official market at an official rate. Given the large backlog of transactions approved before March 19, it would seem that during 1983 no more than an average of 20 per cent of exports and imports could be transferred outside the official market. Once the backlog had been eliminated, more transfers could be made. As stated in the letter of intent, the authorities intended to continue to make transfers outside the official market.

The authorities had implemented an increase in interest rates and a simplification of the system, the staff representative stated. When compared with current rates of domestic inflation, the interest rates seemed negative in real terms. However, more than half of the rate of domestic price increase--forecast at 30 per cent for the calendar year 1983--was due to corrective price adjustments. During 1982, there had been a depreciation of the sucre from S/. 25 to S/. 33, an increase in gasoline prices, and the elimination of the subsidy on wheat flour; already during 1983, there had been a further depreciation of the sucre and a large increase in controlled domestic prices. For example, the price of wheat flour had been increased in October 1982 by 65 per cent and in May 1983 by 43 per cent, or by over 100 per cent in six months. Similarly, prices of basic staples for Ecuadorans, such as rice and milk, had been substantially increased. Most of the price increases had taken place during the first half of the year, while price increases of only 14-15 per cent on an annual basis were envisaged for the second half.

At present, the staff representative continued, imports of wheat were passing through the official market, so that the relationship of the domestic price was related to the official exchange rate. However, in October 1982, the price increase had been well above the depreciation of the exchange rate in that the official market.

Regarding export projections, new oilfields were coming into production, and the Ecuadoran authorities were confident that they would be able to export the yield, the staff representative reported. The sharp increases in the domestic prices of gasoline and other petroleum derivatives should help to restrain domestic consumption. Projections for oil export prices were on the conservative side owing to the uncertainty in that area. If exports did not reach the level projected in the program, the authorities would have to transfer more transactions out of the official market in order to meet the balance of payments target. The level of imports would depend on the amount of trade credits that the private sector could obtain during the year, especially those credits relating to imports that had been transferred into the free market and that would not affect the balance of payments outcome for the net international reserves of the Central Bank. The large depreciation--of about 100 per cent--for imports that had been transferred from the official to the free market, import duties paid at a more depreciated rate, import surcharges, and a tight credit policy should all have a considerable impact on the import level and unfortunately on investments as well. In addition, while in previous years the Central Bank had carried out transactions in the services account at official market rates, transactions were being transferred from the official to the free market, so that pressure on the official market had been reduced substantially.

The Ecuadoran authorities and a steering committee had reached an agreement in principle on the renegotiation of the country's foreign debt, the staff representative said. However, there remained a few details to be ironed out. For example, in the case of the public sector, it had to be determined whether the renegotiated debt should be assumed by the Central Government or should be transferred from the Central Government to the Central Bank. It was a legal matter, and the discussion could be lengthy. In addition, the steering committee, having agreed in principle on the terms of renegotiation, the interest rate, the grace period, and the maturity of the new loan, now had to contact the banks in order to obtain their formal approval. Regarding the private sector, while several loans had already been paid off, some banks had a very small exposure in Ecuador and would have to elect whether to renew loans directly with the private sector, request the Central Bank to assume the liability, or choose another alternative. The amount of private sector debt subject to renegotiation was between \$800 million and \$1 billion, depending on which loans had been paid off.

A comment had been made about the arrears and whether they could be liquidated by November 30, and about the Central Bank's four-month backlog of payments, the staff representative recalled. One reason the Central Bank had been unable to liquidate some of the payments was that new money from the banks had been delayed. Once agreement had been reached with the banks and the terms of the renegotiation actually agreed upon, some of the arrears would automatically disappear either because of the renegotiation or because new money was coming from the banks. The staff was still confident that the arrears would be eliminated by November 30. The external arrears in Ecuador consisted of a combination of genuine external arrears because payment had not been made abroad and internal arrears in foreign exchange. Some importers had purchased foreign exchange in the free market and had already made the payment abroad, although they still had a claim on the Central Bank because they were entitled to foreign exchange in the official market. The Central Bank was not responsible for the foreign exchange but actually for the exchange differential between the free market rate and the official rate. Unfortunately, as many of the operations had not been handled by the Central Bank but by commercial banks, there was not a complete recording, and only a rough estimate of external arrears could be made.

Both the authorities and the staff agreed that the agricultural sector should be strengthened, the staff representative remarked. In the program, the authorities attempted to de-emphasize the oil sector and to put incentives into other sectors where Ecuador could compete successfully. In the agricultural sector, the depreciated exchange rate would have some effect because 30 per cent of Ecuador's exports of agricultural goods would be passing through the free market rather than the official market. In addition, with the elimination of domestic subsidies, the producer was being provided a considerable incentive. However, the staff did not expect significant results in 1983, as the program was setting the groundwork for those sectors to be revitalized in 1984.

It was possible that the reduction of tax rebates on fiscal incentives would be detrimental to investment, the staff representative observed. The issue was still being debated in Congress and had not yet been approved. The implications and repercussions for Ecuador were such that it warranted an ample discussion.

The acceleration of the rate of depreciation of the sucre had been advised by many speakers, the staff representative from the Western Hemisphere Department commented, and it would be one of the key issues to be discussed during the mid-term review. The review, which would take place no later than the beginning of September, would provide the opportunity to discuss the rate of depreciation, the fiscal outcome, and the progress of the entire program. The existence of a dual exchange market with an official rate higher than the free-market rate implied certain budgetary costs for the public sector. That sector had had a substantial surplus in foreign exchange, which--if it had been sold at a more depreciated rate--would have yielded higher revenues and made it easier to close the fiscal gap but would have reduced somewhat the authorities' incentive to take additional tax measures. The authorities had modified domestic taxes, thus laying a better foundation for the future and avoiding dependence on the exchange rate to close the fiscal gap. In conclusion, the program's objectives were not only to limit the loss of the Central Bank's net international reserves to $100 million, but also to introduce structural changes in the economy of Ecuador to help in future renegotiations.

The Deputy Director of the Exchange and Trade Relations Department explained that enlarged access of 150 per cent of quota was a matter of judgment. The staff believed that Ecuador's program was sufficiently strong to justify enlarged access; it emphasized prior actions in the fiscal, exchange rate, and other areas, and contained a robust clause on mandatory consultation, taking into account not only the exchange rate system and arrears, but progress in external debt financing and the fiscal area as well. Another factor was the obviously substantial needs of Ecuador in relation to its quota. It was necessary not only to finance moderate levels of imports but also to eliminate external payments arrears in a relatively short period. In terms of quota, the Fund's holdings of sucres stood at 100 percent, and the present program would take holdings to 250 percent. If the program were adequately implemented, it would go a long way toward resolving Ecuador's balance of payments problems. Although some problems would remain at the end of the program period, there would be adequate scope, in terms of quota limits, at the end of the 12-month program for such further adjustment programs with the Fund as might be necessary.

With regard to the delay in bringing the matter to the Board, the Deputy Director agreed that there was no ideal time to schedule Board discussion in the context of protracted and difficult negotiations. But the staff did not regard that as a sufficient reason for the long delays, and the present case was among those that influenced the staff in its preparation of the Annual Review of the Implementation of Surveillance (SM/83/43, 3/1/83). That paper, which had been discussed in the Executive Board on March 28, 1983, recommended a much stricter approach in the scheduling of consultations.

It would have been helpful, the Deputy Director considered, both to the staff and to the Ecuadoran authorities, for the Board to have had the opportunity to give its guidance at an earlier stage in the consultation. The staff's general views on frequency of consultation had been supported by the Executive Board's discussion of the question of surveillance, and he referred to the staff appraisal containing the sentence recommending that the next consultation with Ecuador be held on a standard 12-month cycle.

Several Directors had questioned the procedure that had been recommended to the Board with respect to the stand-by arrangement, the Deputy Director recalled. While the procedure of approving the stand-by arrangement in principle was unusual it was by no means without precedent. In one case an identical procedure had been followed because the extent to which external debt would be restructured was not clear, and therefore the program could not be considered to be fully financed. In other cases staff papers had been issued, without a decision, and the Board discussion had taken place only after a group of donors had met and pledged support sufficient to assure the financing of the program. Different techniques might have been used; there had been cases where the amount of debt rescheduling involved had been so considerable that the Board had approved a program, but only a nominal purchase, in advance of debt restructuring and a fundamental review with the Fund at a later stage. Yet another technique was the Chairman's decision not to bring the paper to the Board's agenda, or not to issue the paper, until such time as creditors or donors had pledged the necessary support. The main thrust of those techniques was that the Board should not be asked to take a decision on a program until it was fully and adequately financed.

Some had asked whether it would be possible to amend the stand-by arrangement so that Ecuador would have to meet further preconditions before the arrangement became effective, the Deputy Director of the Exchange and Trade Relations Department stated. He assumed that such an approach would be intended to avoid asking for approval in principle only by the Executive Board. If Executive Directors felt it appropriate, perhaps the decision could be amended to state that the stand-by arrangement would become effective only on the date that the Fund found that satisfactory financing arrangements had been made with respect to foreign financing from commercial banks. The Board would then take a decision at a later date that satisfactory arrangements had in fact been found for the financing.

The Chairman suggested that a revised text of the decision could be circulated to show the amendment suggested by the Deputy Director.

Mr. Robalino noted that Ecuador's authorities had been taking the necessary measures to correct the imbalances in the economy. The prices of oil products in Ecuador had remained unchanged for 20 years until the authorities' recent drastic increase of 200-300 per cent. The rate of interest had been fixed for 12 years until the authorities' introduction of a flexible system. The rate of exchange had been fixed since August 1970, and his authorities had not only depreciated the sucre but had also adopted a new exchange rate system. Therefore his authorities had shown flexibility in correcting the imbalances of the economy and determination in pursuing their efforts.

Mr. Erb said that he appreciated the additional information that the staff representatives had provided with respect to both the implications of recent policy changes and the elaboration on the economic prospects beyond 1983. The lack of that explanation in the program had been troublesome; in looking at the application of enlarged access he considered that one of the criteria was whether the program was adequate to achieve a viable payments position and whether a three-year program was necessary for its interpretation and application. In most cases, a one-year program was appropriate, but information on the further adjustments likely to be necessary beyond the following year and some reference to the likelihood of an additional follow-on program and the Government's response would be pertinent.

With respect to the needs test of the enlarged access policy, Mr. Erb observed, in one sense Ecuador's need was quite large, while in another it was not. The amount being provided under the stand-by arrangement was over 50 per cent of the current account deficit, which reflected, in addition to the many structural problems on the domestic side, the serious financial restructuring in 1983 and beyond. It was important for the commercial banks to maintain their approach to restructuring the external financial situation. He could go along with the contingent nature of the decision as put forward.

The Chairman noted that the figures in Table 11 of EBS/83/91 for the debt service ratio after renegotiation of debt were 45.8 per cent for 1982, 28 per cent for 1983, and 41-45 per cent for 1984-86. He asked for confirmation of his understanding that assumed that no further debt renegotiations would take place.

The staff representative confirmed that the figures assumed that only 1983 debt was being renegotiated with no grace period.

The Chairman indicated that, under the circumstances, further action would probably be needed both on the side of the Ecuadoran Government and on the side of the creditors. He then made the following summing up:

Executive Directors expressed their agreement with the thrust of the staff appraisal and gave their approval in principle to Ecuador's request for the use of Fund resources pending successful completion of negotiations between Ecuador and a group of commercial banks. Directors observed that economic conditions had weakened in recent years, noting the slowdown of GDP growth, the increase in inflation, and the deterioration in the balance of payments position. Expansionary fiscal policies and an overvalued exchange rate had strongly contributed to these unfavorable developments.

Directors welcomed the strong adjustment effort implied in the stand-by arrangement and expressed support for the authorities' strategy of focusing on improving the balance of payments position through the combination of exchange rate action, interest rate adjustment, realistic pricing policies, and tighter demand management policies. Directors commended Ecuador on recent exchange rate measures, which they felt would be helpful in restoring balance of payments equilibrium. They believed, however, that the present rate of depreciation of the official exchange rate was insufficient to narrow the large spread between the official and the free market exchange rates. They urged the authorities to accelerate the rate of depreciation in the official market in order to narrow that spread as well as to ensure compliance with the net international reserve target and to move resolutely toward the unification of the exchange market as soon as possible.

Directors noted the adjustments in domestic interest rates. They stressed, however, that further increases were warranted and needed to encourage domestic savings, to reverse capital outflows, and to reduce the exchange pressure in the parallel market as well as to rationalize the use of scarce domestic credit.

Directors observed that the fall in the world petroleum price and the economic slowdown had resulted in a decline in fiscal revenue and a sharp increase in the public sector deficit. They commended the authorities on the large corrective increases in petroleum derivative prices and the adoption of strong tax measures. They stressed that Ecuador should continue reviewing tariffs and prices set by the public sector in order to eliminate subsidies and to ensure more efficient use of its resources. Directors also stressed the need to curb the growth of current expenditure and to broaden the revenue base through appropriate tax reform. They commended Ecuador's restraint in granting wage adjustments and expressed the hope that the policy would be maintained.

Given the climate of uncertainty in international financial markets and in the world economic outlook, and noting that some aspects of Ecuador's short-term economic forecast appeared to some Executive Directors to be on the optimistic side, they stressed that the Ecuadoran authorities had no margin of maneuver and should stand ready to take appropriate additional action to achieve their targets. Directors attached considerable importance to the provision for consultation under the stand-by arrangement in order to monitor developments closely. Early elimination of payments arrears and of import restrictions was urged.

It is expected that the next Article IV consultation with Ecuador will be held on the standard 12-month cycle and, on that occasion, the medium-term outlook for Ecuador's economy will be examined in more detail. The heavy external debt burden that Ecuador will face for a number of years reinforces the need for the resolute and continuous pursuit of external adjustment policies.

The Executive Board then took the following decision:

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Ecuador's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1982 Article IV consultation with Ecuador, in the light of the 1982 Article IV consultation with Ecuador conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Ecuador maintains restrictions on the making of payments and transfers for current international transactions in the form of external arrears and bilateral payments arrangements and multiple currency practices, as described in EBS/83/91. The Fund encourages Ecuador to continue the simplification of its multiple currency practices with a view to the early unification of its exchange rate, and approves the restrictions and multiple currency practices, as the latter may be adapted by transfers of transactions from the official to the free market, until the end of the stand-by arrangement, or the next Article IV consultation, whichever is earlier.

Decision No. 7415-(83/77), adopted
June 1, 1983

Mr. Malhotra, referring to the proposed decision on the stand-by arrangement, asked whether the decision would be distributed for approval on a lapse of time basis or whether the Board would meet again to determine whether satisfactory financing arrangements had been made; the procedure might be more cumbersome than originally envisaged.

The Secretary explained that when the condition in paragraph 3 of the decision submitted for approval at the present meeting had been fulfilled, a decision giving effect to the stand-by arrangement would be circulated for approval on a lapse of time basis, and the appropriate date would be inserted in the text of the stand-by arrangement.

The Executive Board then took the following decision:

Stand-By Arrangement

1. The Government of Ecuador has requested a stand-by arrangement for a period of one year in an amount equivalent to SDR 157.5 million.

2. The Fund approves the stand-by arrangement attached to EBS/83/91, subject to 3 below, and waives the limitation in Article V, Section 3(b)(iii).

3. The stand-by arrangement set forth in EBS/83/91 shall become effective on the date on which the Fund finds satisfactory arrangements have been made with respect to financing from foreign commercial banks.

Decision No. 7468-(83/77), adopted
June 1, 1983

2. GUATEMALA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Guatemala (SM/83/76, 5/11/83). They also had before them a report on recent economic developments in Guatemala (SM/83/71, 5/11/83).

Mr. Senior made the following statement:

I would like to express the appreciation of my Guatemalan authorities for the work done by the recent Fund mission in regard to the 1983 Article IV consultation with Guatemala, and the initial negotiations for a future request of use of Fund resources. In principle, there is already agreement between the staff and the Guatemalan authorities as to the program which is to be supported by the Fund's resources, and a mission will be going to Guatemala to finish the details of the negotiation immediately after the conclusion of the Board's discussion. In general, the authorities are in agreement with the staff documents and appraisal regarding recent developments in the Guatemalan economy and its prospects for the near future. They would suggest, however, a slightly different emphasis concerning the various factors that have given rise to the present situation, their performance under the first tranche arrangement approved in November of 1981, and the need for adjustment in relation to at least two important variables or policy instruments.

During the last five years, after the coffee boom of 1976-77, the economic and financial situation of Guatemala has continually deteriorated due to a combination of both external and internal factors, albeit with a greater incidence of the former. In effect, real GDP growth, which during 1976-77 averaged 7.5 percent a year, declined to 3.5 percent in 1980, less than 1 percent in 1981, and for the first time in the last 50 years observed a negative growth rate of 3.5 percent in 1982. For 1983 it is expected that real GDP will again contract by a negative growth rate of 2.5 percent. As our chair indicated in the buff circulated in November 1981, when the request of Guatemala for use of the Fund resources in the first credit tranche was discussed, this very marked deterioration in Guatemala's economic situation can only be analyzed in its proper perspective if seen in the context of developments in the world economy and in Central America during the last five years.

There is no need to recall here in detail the bleak world economic situation of the last five years, which was characterized by a depression of economic activity, high rates of inflation, and massive external imbalances. While some of those characteristics have lately begun to improve, suffice it to say that their persistence for such a prolonged period of time severely affected the terms of trade of oil importing developing countries, markedly reduced their purchasing power, and increasingly exacerbated their financing problems to a near-crisis degree. In Guatemala, exports in value terms by the end of 1982 were less than 10 percent above the level of 1978, while in volume terms exports were only 7 percent above the level of 1978. Indeed, exports in Guatemala have fallen by more than 20 percent in the last two years in value terms, and by about 7 percent in volume terms. The terms of trade have continuously deteriorated since 1978, and at the end of 1982 they had declined by about 25 percent in relation to five years ago.

At the same time, mounting social and political tensions in the Central American region in general, and of Guatemala in particular, have further aggravated the situation, eroding private sector confidence and investment, promoting massive capital flight, and virtually interrupting the country's access to international capital markets at a time when the banks were already curtailing such access to developing countries, particularly those of Latin America. As correctly pointed out in the staff report, Guatemala has traditionally followed a conservative economic policy stance. It was only under the above-mentioned circumstances that the authorities found it necessary to implement compensatory fiscal and monetary policies in an effort to maintain economic activity, safeguard a required minimum of employment, and preserve a degree of social stability, a precondition itself for economic growth. Such relaxation in policies was however moderate, and external factors have contributed more importantly to external and internal disequilibrium. Furthermore, the deterioration in economic activity was not wholly arrested, as indicated before, in spite of the compensatory policy stance, as the incidence of exogenous factors continued to increase, although the policy stance must surely have contributed to at least partially offsetting a much more significant deterioration in output and employment. The negative rate of growth of real GDP in 1982, which implies a 3 percent reduction in total consumption and a 6 percent reduction in per capita consumption, has deteriorated significantly the living standards of the population and contributed to a worsening of the employment situation. The Guatemalan authorities have estimated that in 1982 the unemployment rate, including underemployment, is of the order of 36 percent.

The 1982 adjustment program of Guatemala, which was supported by a one-year stand-by arrangement in the first credit tranche, had as a main objective to hold the loss in net official reserves in 1982 to no more than $50 million. The main variables of the program that were under the control of the authorities were almost fully met. Even though government revenue was affected in 1982 by the weakness of the domestic and foreign sectors of the economy, government outlays were increasingly adjusted, so that the overall fiscal deficit was in line with program projections. In this regard it is noteworthy that government outlays declined from 16 percent of GDP in 1981 to 13 percent of GDP in 1982. While the share of the deficit financed with domestic bank resources was in excess of the program targets, this was mainly due to a shortfall in external financing; growth in total credit was in line with the program because of a much weaker than expected expansion in credit to the private sector. The latter was due in part to the sharp downturn in economic activity, which contributed to weak credit demand, but also, due to a significant extent, to an accumulation of payments arrears for foreign commercial transactions, which served in itself as a source of financing. As the staff mentions, these arrears may have also contributed to the strong growth in deposits observed in 1982.

Regarding the program targets, the objective for net official international reserves was achieved, and price performance was better than expected in 1982, but, contrary to program assumptions, exports fell for the second consecutive year, and real GDP declined by 3.5 percent instead of a projected growth of 2.5 percent. Once again we are confronted with a case in which the criteria on instrumental variables are met, although the outcome of the program in relation to its objectives falls substantially short of expectations. In this connection, the authorities' commitment to adjustment is underscored, at the same time that their preoccupation with reactivating economic activity must also surely come to the forefront.

Before touching upon two aspects of economic policy which have been at the forefront of discussions in Guatemala, I would like to reiterate that Guatemala has traditionally followed conservative financial policies. Even when compensatory fiscal and monetary policies were adopted, deviations were relatively small by international comparison. Although I am aware of the difficulties involved in such comparisons, I think it is safe to say that when compared to other countries of similar size and at a similar stage of development, Guatemala has repeatedly shown financial prudency. In the fiscal area, for example, while true that the overall central government deficit increased rapidly from the 1.1 percent of GDP that it represented in 1978, it never surpassed the figure of 7.4 per cent of GDP that it reached at its peak in 1981. Although high, this latter figure compares favorably with some of the latest we have seen in this Board for countries which have requested the use of Fund resources. Furthermore, as the rest of the public sector is generally in balance or surplus position, this figure represents more or less the overall public sector deficit; it has already been adjusted downward in 1982 and is expected to fall further to 3.7 per cent in 1983.

In the external sector, Guatemala traditionally had a surplus in the balance of payments, accumulating international reserves in substantial amounts, to the point that it was the only non-oil developing country that lent to the Fund for the supplementary financing facility. It has been mainly the political strife in the region in general, and in Guatemala in particular, that has mostly contributed to massive capital flight and the deterioration of the country's financial situation. Thus, for example, during the period 1974-78 capital inflows were substantial, averaging some $220 million per year, or the equivalent of nearly 5 per cent of GDP. After 1978, however, net capital inflows dropped sharply and became negative in 1982. The sharp drop resulted from a large outflow of short-term private capital, which totaled more than $1 billion between 1979 and 1982. This is indeed a very subtantial amount for a country of Guatemala's size.

Regarding external debt management, Guatemala again has traditionally followed a conservative policy, contracting only relatively modest amounts and mostly on concessional terms from multilateral agencies and bilateral lenders. At the end of 1982, Guatemala's external outstanding debt represented only 13.5 percent of GDP, even after sharply increasing from the 10.5 percent of GDP it represented in 1981. And service payments on the external debt for 1982 amounted to only about 1 percent of GDP, or about 8.5 percent of exports of goods and nonfactor services. Once again, this compares favorably with the corresponding figures for non-oil developing countries in general, and for most countries Executive Directors have examined lately in particular.

By international standards, Guatemala's main financial problems are not so deep-rooted or so much a consequence of persistent internal financial excesses. Mostly, it would appear, current problems are mainly due to a mix of terms of trade losses, capital flight--caused by political uncertainties--and the virtual closure of access to international markets for developing countries in general and Central American countries in particular. The latter factor, especially, has become important and constitutes one of the major restrictions to economic reactivation and development under more normal circumstances.

I think it should be clear that capital flight in Guatemala since 1979 has been more a consequence of uncertainty, linked to mounting political tensions in the region, than an effect of low or negative real interest rates. In this regard, it is undeniable that, under normal circumstances, interest rates play an important role in the flow of capital movements. Under severe conditions of uncertainty, however, such a role is substantially diminished, if not wholly eliminated. It is doubtful that higher interest rates in Guatemala would have stopped capital flight or even diminished it substantially. Only exchange controls, though temporary or even undesirable in principle, could bring about such a stop. In Guatemala, controls were extemporaneously introduced, when massive capital flight had already taken place. Under the 1982 program with the Fund, interest rates were increased, but the effects of such a move on savings or capital flows are not very clear. The effect of higher interest rates on production costs, however, was immediate, and mounting pressures from the productive sector were also immediately evident. With an unprecedented fall in output and exports, as well as taking into account a substantial drop in inflation and in international interest rates, the authorities decided at the end of last year to reduce local interest rates. At present, lending rates are generally positive in real terms; deposit rates are slightly negative or slightly positive in real terms, depending on the measure used for inflation. With the maintenance of prudent financial policies, it is expected that inflation will be kept in check, and thus there should be no need for substantial adjustment of interest rates. Furthermore, it is felt that a substantial increase in interest rates would be counterproductive, as it would constitute a hindrance to the recovery of output and exports.

As has been mentioned by the staff, the authorities have expressed their strong intent to maintain the existing parity of the quetzal. Although the quetzal has appreciated in the past two years, mainly because of the strong appreciation of the U.S. dollar, it had depreciated in the four previous years. More importantly, the authorities believe that there are no clear indications that exports have suffered from diminished competitiveness. As mentioned before, the fall in exports in the past two years has been almost wholly due to external considerations, or to political uncertainties that have increased the risk of production. The prices of Guatemala's main exports have been substantially affected by the world economic recession, and more recently they have also been affected in volume by the introduction of restrictive quotas, as for coffee and sugar. Other important crops, such as cotton, have been affected by political tensions in the region. As can be seen in other countries in the region, this particular crop is especially sensitive to uncertainties, and the planted area can vary considerably from one year to the other, as it is an annual crop. Finally, the authorities consider that the exchange rate is but one of an array of policy instruments, and that adjustment can be brought about by a concerted effort in areas other than that of exchange rates. An adjustment in the present parity would make fiscal discipline difficult, as there would be pressures for increased subsidies and preferential rates; and the measure itself could be more than defeated by demands for substantially increased wages and excessively increased prices. The cost of such a move, and negative effects on the economy, appear to the authorities far greater than the possible benefit that could be derived from it.

Mr. Arias remarded that in spite of low economic activity caused by weak international demand, Guatemala's economic performance during 1982 had been good, and the authorities should be commended for their efforts under tight financial circumstances. Fiscal policy had been strengthened, resulting in a substantial reduction in the public sector deficit to 4.5 per cent of GDP. Tighter control of nominal government expenditures, reflected in cuts in public investment programs and a freeze in government salaries, had offset the fall in revenues due to weaker economic activity in 1982. He welcomed the intention of the authorities to improve tax collection, and to take various measures including a shift from the existing stamp tax system to a value-added tax, that would produce higher revenue collections and provide the incentive to continue strengthening public finances.

In the monetary field, Mr. Arias continued, performance had been broadly in line with the 1982 program, following a restrained policy to limit overall bank credit and to stimulate savings. Lending rates and most deposit rates were positive in real terms, and his authorities endorsed the staff's recommendations that interest rate movements should be managed with more flexibility.

He shared the Guatemalan authorities' view that weak competitiveness had not been the cause of export lags, Mr. Arias stated. On the contrary, powerful factors, such as a deterioration in the terms of trade, the world economic recession, and political conditions in the region, had been responsible. Guatemala had followed the 1982 economic program very well, supported by a one-year stand-by arrangement, and he commended the authorities' determination to manage the economy efficiently.

Mr. Delgadillo commented that, despite the recent implementation of an adjustment program in Guatemala, supported by Fund resources, the country was still facing serious difficulties, reflected mainly in a record negative growth of GDP, reduced exports, worsening terms of trade, and high unemployment. As in many other similar countries, the open Guatemalan economy was highly vulnerable to external developments. In addition, regional as well as local political factors had strongly constrained an adequate economic performance. He was glad that a Fund mission was about to visit Guatemala and that there already was basic agreement between the authorities and the staff on a new program. He hoped that Guatemala's previous experience would be useful in designing a meaningful program aimed at restoring sustainable growth.

New policy initiatives on the fiscal side were focused on further compressing the overall public sector deficit, which underscored the effort that the authorities would be making to restrain expenditure while raising revenue through strengthening tax administration and introducing new tax measures, Mr. Delgadillo noted. The authorities were to be commended for their intention to adopt further adjustment measures. The fiscal adjustment would allow a significant reduction in net bank credit expansion for the public sector, and the expansion in credit to the private sector would not be significant, as there was no evidence of an upturn in economic activity. Therefore the increase in overall bank credit would be consistent with the goal of equilibrium in the overall balance of payments and a significant reduction in payments arrears. It would also indicate that the current level of domestic interest rates--all of them positive in real terms--was appropriate. However, the authorities must be encouraged to maintain flexibility in their fiscal policy and to phase out current distortions in the interest rate structure.

It was important to maintain wages under strict control, Mr. Delgadillo stated. Only then would it become feasible to achieve a full restoration of the competitiveness of the economy without altering the exchange rate. After so many years of fixed exchange rates, he tended to think that exchange rate changes would be more costly than beneficial for the country. The stability associated with fixed exchange rates was desirable and should be pursued by means of appropriate fiscal and monetary policies insofar as wage policy was flexible enough to facilitate adjustment to a better external balance without excessive costs in production.

The elimination of payments arrears was a necessary condition for the restoration of Guatemala's external credit standing, Mr. Delgadillo concluded. He hoped that the exchange restrictions currently affecting the external side would be temporary and would be eliminated as soon as feasible.

Mr. Taylor commented that he was pleased to review Guatemala's economic progress, including the performance under the recent stand-by arrangement, following two-and-one-half years since the previous consultation. He appreciated the opportunity to look at the economy before considering the stand-by arrangement, a practice that he recommended in such cases.

He supported the authorities' aim to reduce the public sector deficit from 5 percent of GDP in 1982 to 3.5 percent in 1983, Mr. Taylor remarked. Continued further expenditure restraint combined with the introduction of new revenue measures was an appropriate move forward. The freeze on government wages would be essential, given that wages and salaries accounted for a large proportion of public sector expenditures. He endorsed the rationalization of the public sector investment program, but wondered whether the staff had considered the impact of strong capital expenditure restraint on the productive capacity of the economy and future growth potential, given the fragile state of confidence in the region. Perhaps there was no immediate danger of crowding out private sector activity. He supported the introduction of new revenue measures, especially the intention to introduce a value-added tax in July, and he would appreciate confirmation that it was on track. Since domestic activity and foreign trade were expected to be lower than anticipated in the budget, he wondered whether the staff could comment on the feasibility of the Government's revenue projections for 1983.

The authorities' intention to continue running the operations of the parastatal enterprises to yield a small surplus was commendable, Mr. Taylor commented. Those enterprises were important in the economy, as they accounted for the bulk of total investment by the public sector, and they should continue to operate on a sound footing. He welcomed the authorities' intention to review pricing policy in the telecommunications and electricity authorities. Telecommunications tariffs, for example, had not been adjusted for seven years. Although there was a legal obligation for the telecommunications enterprise to transfer surpluses to the Government, no transfers had been made since 1968, and he wondered whether the staff considered that those transfers could be resumed or whether more attention was to be paid to the level of tariffs.

He urged the authorities to maintain positive real interest rates in the domestic banking system and to take steps to allow more flexibility in interest rate movements, Mr. Taylor said. In the absence of realistic interest rates, the authorities' goal of attracting external financing would be difficult to attain in the present economic climate. Interest rates had an important role to play in domestic credit restraint and in the allocation of credit in the economy.

On the external front, he would have appreciated more details on the main elements of the trade projections for the year, Mr. Taylor remarked. It was a crucial area, and there had been large declines in exports over the past two years, reversing the progress made earlier. He believed the established exchange rate policy to be inadequate, although he appreciated the authorities' wish to have financial discipline. Perhaps the discipline should come from the compendium of policies and the motivation of the authorities to correct the situation. There was evidence that there had been a substantial loss of competitiveness since 1980, as indicated in Chart 1 of SM/83/76. The emergence of a parallel market with a premium of about 30 per cent over the official rate was an indication that an element of depreciation in the currency would be wise, and unavoidable without considerable further fiscal restraint or a further intensification of import controls or exchange restrictions. Action to achieve external adjustment through corrective policies that would emphasize market forces would be required at an early stage and should be considered an essential element in the proposed arrangement. The elimination of external payments arrears should also be considered a central objective of an adjustment effort in such an arrangement.

In November, the Guatemalan authorities had intensified exchange restrictions as part of their import policy, but had not made it clear whether the measures were temporary, Mr. Taylor recalled. A commitment to eliminate the exchange restrictions on an agreed timetable should be considered a precondition to the stand-by arrangement, and progress to eliminate those restrictions before the end of the program should be explicitly mentioned in the arrangement. Generally, structural change should be a prominent feature of an adjustment program. The authorities' intention to phase out import quotas before the end of 1984 was welcome and he hoped that they would adhere to it, but he wondered whether the quotas might be replaced by temporary import surcharges.

He agreed with the principal elements of the staff appraisal, Mr. Taylor concluded, and he noted the nonapproval of Guatemala's exchange restrictions. Given the authorities' intention to seek a stand-by arrangement later in the year, he urged them to commit themselves to the reinforcement of sound adjustment policy that would, inter alia, permit the early phasing out of those restrictions.

Mr. Dallara stated that he too agreed with the staff appraisal and with the decision not to recommend approval of Guatemala's exchange restrictions at the present time. The staff had noted and analyzed the mixed and, on balance, somewhat less than satisfactory performance of the Guatemalan economy under the first credit tranche program, which had expired in November 1982. Regarding further relations between the Fund and Guatemala, he considered, first, that the size and phasing of any program should reflect, inter alia, the actual pace of the adjustment effort, and should take into account the performance under the program as well as the performance since its conclusion.

Second, Mr. Dallara continued, while recognizing that the objective of dealing with arrears had to be a primary one at the moment, he hoped that the authorities would plan to increase over time the level of international reserves. Third, if the policy of enlarged access was to be applied to Guatemala, he would hope that the program would be fully consistent with the principles and criteria applicable to the policy. It would be helpful if the staff were to include in any documentation accompanying a request for the use of Fund resources some discussion and material on how the request related to the principles and criteria of the enlarged access policy.

With regard to the exchange rate, he shared the doubts of others on its appropriateness, Mr. Dallara remarked. While he appreciated the authorities' intention to maintain the existing parity of the quetzal with the U.S. dollar and the philosophy underlying that policy, he doubted the economic efficiency and desirability of that approach at the present time. Whatever success the authorities might have in restoring financial discipline and stability in the near future--supported by appropriate policies currently being designed--the endogenous and exogenous developments of the past few years had caused an erosion of financial stability and competitiveness. Those developments must be taken into account when the authorities framed their policies to restore medium-term payments sustainability without undue restraint on domestic activity. In that connection, the recent performance of exports cast doubts on the adequacy of the exchange rate, which were reinforced by the recent tendency to rely on fiscal proxies as a substitute for adjustment of the official exchange rate. The emergence of the parallel market was troublesome, and he would appreciate more information on the authorities' intentions in that regard and on the extent to which international transactions were diverted through that market.

The system of exchange restrictions in place was comprehensive, and he hoped that a new program would include an explicit timetable for the removal of exchange restrictions as well as for the timely elimination of payments arrears, Mr. Dallara commented. References to a plan to settle two thirds of the arrears in 1983 and 1984 seemed vague, particularly considering the uncertainty regarding the actual level of arrears and the lack of specificity surrounding the timing and method of arrears reduction. He would welcome further information on that matter.

The authorities' decision to correct the lack of buoyancy in the tax system through relatively small but significant changes was a step in the right direction, Mr. Dallara stated. He encouraged the authorities to move expeditiously to implement the new value-added tax under consideration; that measure had the potential of contributing to both short-run stabilization objectives and the sound execution of the public investment program. Given the uncertainty surrounding economic prospects in Guatemala, the revenue objectives currently set forth might be difficult to achieve, and the situation should be monitored closely for possible need of further actions. The prime objective of the authorities over the medium term should be to restore revenues to their historical level in relation to GDP. The recent decision to scale down various expenditure items below previously budgeted amounts, although appropriate as a temporary response, was not suitable for formulating fiscal policy on a long-term basis. He was interested in any information that could be provided on the structural adjustment needs of the Guatemalan economy and he expressed his interest in seeing those areas addressed, as appropriate, in any documentation that might be forthcoming in connection with a request for a stand-by arrangement.

If achieved, the fiscal targets would be conducive to a significant reduction in net bank credit expansion to the public sector, which in turn could significantly contribute to the authorities' overall credit policy objective, Mr. Dallara commented. It was regrettable that the Central Government had exceeded the program targets by 60 per cent, and obviously such slippages in the future would be disturbing. He hoped that the authorities would monitor credit developments closely in the future.

Mr. de Vries observed that the pervasive influence of political uncertainty in the region was strongly felt on economic developments in Guatemala; production, investment, government expenditure, taxation, and capital movements were all severely affected. It was difficult to reach a clear conclusion as to what advice the authorities in Guatemala should be given to deal effectively with the problems. In fact, it would be difficult to prescribe the elements that should be included in the stand-by arrangement so that the country could move confidently toward a sustainable situation.

Despite political uncertainties, the Government had taken a number of measures that seemed useful but would perhaps need further implementation and reinforcement, Mr. de Vries commented. The budget deficit was being reduced, in conformity with the conservative financial tradition of the country. He urged the implementation of a more realistic interest rate policy, and agreed with others on the harmfulness of arrears.

He noted that the exchange rate had had a one-to-one relationship with the U.S. dollar for 60 years, reflecting the traditional cautiousness of the authorities, Mr. de Vries remarked. Once that relationship was given up, he believed that it could never be resumed. Reference had been made to the parallel market and the 20-30 per cent difference from the official rate. International Financial Statistics listed two exchange rates: the first of Q 1 = $1, and a second fluctuating rate of Q 1 = about $1.07. If the authorities were intent on continuing their traditional cautious approach while keeping the economy open, enough price flexibility might result to maintain the old relationship. He believed that once that certain element was lost, the symbol of the effort of the Government to return to more normal, stable, traditional circumstances would be lost, and devaluation would presumably follow devaluation.

He would appreciate some comment on the type of stand-by arrangement that would be envisaged with the authorities in the present uncertain situation, Mr. de Vries said. The objectives might be difficult to determine, and, in the circumstances, the Government would not have much control over economic policy. He believed a relatively market-oriented approach would be necessary.

With regard to exchange restrictions, Mr. de Vries continued, the country had suffered a great deal from the export of capital, which seemed clearly related to the political uncertainty. The staff encouraged the authorities to abolish some of those restrictions, but he believed that in the circumstances savings would leave the country for a safe storage place; a system of exchange restrictions could somewhat discourage the outflow of capital that had plagued the country. For countries in unusual circumstances, such as Guatemala, the Board should adapt its usual policy advice to the situation.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/76 (5/27/83) and EBM/83/77 (6/1/83).

4. MAURITIUS - REPRESENTATIVE RATE FOR MAURITIAN RUPEE

The Fund finds, after consultation with the Mauritian authorities, that the representative exchange rate for the Mauritian rupee, under Rule O-2(b)(i), against the U.S. dollar is the mid-rate of the U.S. dollar calculated daily by the Bank of Mauritius. The Bank of Mauritius will promptly advise of any change in the definition of the representative rate for the Mauritian rupee. (EBD/83/151, 5/24/83)

Decision No. 7416-(83/77) G/S, adopted May 27, 1983

5. EXECUTIVE BOARD COMMITTEES

The Executive Board approves the proposal set forth in EBD/83/153 (5/26/83).

Adopted May 31, 1983

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/143 (5/26/83) and EBAP/83/144 (5/27/83) and by an Advisor to an Executive Director as set forth in EBAP/83/144 (5/27/83) is approved.

APPROVED: October 19, 1983

LEO VAN HOUTVEN
Secretary