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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/91

3:00 p.m., June 24, 1983

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

| Executive Directors | Alternate Executive Directors |
|---|---|
| | T. Ramtoolah, Temporary |
| J. de Groote | H. G. Schneider |
| | A. Le Lorier |
| | J. Delgadillo, Temporary |
| R. D. Erb | T. A. Connors, Temporary |
| M. Finaish | |
| | I. R. Panday, Temporary |
| | T. Yamashita |
| R. K. Joyce | M. Casey |
| | G. W. K. Pickering, Temporary |
| | D. I. S. Shaw, Temporary |
| A. Kafka | C. Robalino |
| G. Laske | P. Kohnert, Temporary |
| G. Lovato | L. Barbone, Temporary |
| | A. S. Jayawardena |
| | S. El-Khouri, Temporary |
| | E. M. Ainley, Temporary |
| J. J. Polak | |
| | K. G. Morrell |
| G. Salehkhou | O. Kabbaj |
| | E. I. M. Mtei |
| | E. Portas, Temporary |
| J. Tvedt | |
| | C. Taylor |
| | Wang E. |

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

H. Barber, Governor of the Bank of Jamaica. African Department: I. S. McCarthy. Asian Department: D. A. Citrin, S. Kimura, G. Szapary. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, P. C. Hole, H. B. Junz, J. K. Salop, B. J. Nivollet, J. Somogyi. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Allen, G. Belanger, M. Guitian, S. Kanesa-Thasan, M. Nowak. External Relations Department: H. P. Puentes. Fiscal Affairs Department: H. Bierman. IMF Institute: I. Szalkai, Participant. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder, J. M. Ogoola, J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; G. T. Abed, R. H. Floyd. Research Department: K.-Y. Chu, N. M. Kaibni, E. C. Meldau-Womack, E. A. Milne, A. Muttardy, B. E. Rourke. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat. Western Hemisphere Department: S. T. Beza, Associate Director; J.-C. K. Brou, A. Baumgarten, Jr., O. Gronlie, M. E. Hardy, Z. Hodjera, H. E. Khor, A. S. Linde, C. Ross, M. C. Spinola, S. J. Stephens, L. M. Valdivieso, E. S. Williams, J. E. Zeas. Advisors to Executive Directors: S. R. Abiad, J. R. N. Almeida, L. Ionescu, H.-S. Lee, P. D. Péroz, P. Péterfalvy. Assistants to Executive Directors: H. Arias, R. Bernardo, J. Bulloch, M. Camara, M. B. Chatah, L. E. J. Coene, G. Ercel, I. Fridriksson, A. Halevi, M. Hull, H. Kobayashi, P. Leeahtam, W. Moerke, Y. Okubo, J. G. Pedersen, J. Schuijer, M. Toro, Wang C. Y., J. C. Williams.

1. ARAB REPUBLIC OF EGYPT - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Directors considered a proposal for postponing the Executive Board's consideration of the report for the 1983 Article IV consultation with Egypt (EBD/83/176, 6/22/83).

Mr. Taylor noted that the Egyptian authorities had requested a postponement of the Executive Board discussion of the staff report for the 1983 Article IV consultation in order that it might coincide with the negotiations on a stand-by arrangement that Egypt was likely to request. His chair usually tried to be as helpful as possible in responding to such requests, but important matters were at stake in the present case. As a general rule, it was useful to discuss an Article IV consultation in advance of the completion of protracted discussions on the possible use of the Fund's resources by the country concerned; the Board discussion enabled the Executive Directors to contribute to the formulation of the country's policies. Egypt was an important economy, and the staff report for the 1983 Article IV consultation showed that remedial policies were urgently needed. The problems facing the Egyptian economy were not new, but they had intensified during the previous year. Hence, the Executive Board discussion of the staff report should be held at a reasonably early date, and at least before the staff mission left for Cairo in July to discuss a possible arrangement with the authorities.

Mr. Joyce stated that he agreed with Mr. Taylor. He had never rigidly maintained that the discussion of the staff report for the Article IV consultation with a member should precede the negotiations with that country on its possible use of Fund resources. However, if the Article IV mission's report was ready for the Executive Board's examination, the discussion would be useful, especially as the Executive Directors' views could influence the negotiations. In any event, acceptance of the proposal could be seen as treating Egypt's request somewhat differently from recent requests, such as those from Portugal and Tanzania. In those cases, the Executive Board had insisted that the Article IV consultations should be completed before negotiations on a new Fund-supported program were begun.

Mr. Erb said that he strongly supported Mr. Taylor's proposal.

Mr. Kohnert commented that Mr. Taylor's suggestion was acceptable.

Mr. Polak considered that the three-month rule on the completion of an Article IV consultation was important and should be broken only for compelling reasons. Such reasons did not exist for Egypt. The relevant staff report had already been circulated to the Executive Board, and, even in the absence of the coming negotiations between the staff and the authorities, it would be proper to discuss the report at the earliest convenience of the Executive Board and the authorities.

Mr. Finaish said that he wondered whether there were any precedents governing the consideration of Egypt's request. As previous speakers had noted, the Egyptian economy was important, and, although the problems

facing the economy were not new, the staff report for the 1983 Article IV consultation had already been circulated to the members of the Executive Board. He could, therefore, understand the argument for not postponing the Board discussion. On the other hand, the Board could not ignore a member country's wish with respect to scheduling, particularly if the country concerned was not represented by an Executive Director.

The Secretary remarked that the three-month deadline had been extended in a number of cases. In some of those cases, the extension had been considerable, involving several weeks. In recent months, however, there had been an increasingly strong feeling in the Executive Board that it should, if at all possible, complete an Article IV consultation with a member before negotiations on a program were undertaken with that country.

The Director of the Middle Eastern Department recalled that on a previous occasion the Egyptian authorities had asked the Executive Board to postpone the discussion on the Article IV consultation with Egypt; management had responded that there were no compelling reasons for a postponement. The authorities had subsequently informed management that they would be unable to send a representative to participate in the Executive Board discussion if it took place during Ramadan, in July. They had noted that a mission was scheduled to visit Cairo around mid-July to discuss a possible Fund-supported program, and they had suggested that the Executive Board discussion on the Article IV consultation with Egypt could usefully be postponed until after the negotiations had been completed. The authorities had also had in mind that the budget year began on July 1, and they intended to introduce additional measures in presenting the new budget. The staff was aware of only some of the new measures and could not say whether all of them would be accepted by the legislature. One possible solution was to hold the Executive Board's discussion on the 1983 Article IV consultation with Egypt immediately after Ramadan and subsequently initiate the negotiations for a possible arrangement with Egypt. If that approach was acceptable to Executive Directors, the staff could ask the authorities if it would be possible for them to make arrangements for having Executive Board consideration of the consultation with Egypt in late July, prior to the departure of the staff mission to Cairo to discuss an adjustment program.

The Executive Board accepted the proposal of the Director of the Middle Eastern Department. 1/

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1/ A decision extending the period for the Executive Board's consideration of the 1983 Article IV consultation with Egypt was adopted on July 6, 1983 (EBD/83/176, Sup. 1, 7/1/83).

2. HUNGARIAN PEOPLE'S REPUBLIC - STAND-BY ARRANGEMENT - MID-TERM REVIEW

The Executive Directors continued from the previous meeting (EBM/83/90, 6/24/83) their consideration of the staff paper on the mid-term review of the stand-by arrangement for Hungary (EBS/83/110, 5/27/83).

Mr. Polak said that in 1982 Hungary had encountered a number of external difficulties, some of which other countries had faced, such as weak export markets, and some of which were unusual, such as Hungary's limited access to credit markets despite its relatively good economic policy record. Hungary had suffered from the poorer economic performance of neighboring countries; it had experienced capital outflows, and the expected capital inflows had not materialized. The authorities had responded, in part, with traditional measures such as a reduction in investment, cuts in real income, and a tightening of the budget.

Hungary's package of measures was striking in two respects, Mr. Polak remarked. First, absolute priority had been given to improving the balance of payments; all policy measures had been subordinated to the achievement of that objective. That priority, as the staff had noted, posed a conflict between short-term and medium-term goals and involved certain costs, uncertainties, and risks which, as the staff had concluded, had to be taken. The other unusual aspect of the policy package was the promptness with which it had been adopted. It had become increasingly clear in the second quarter of 1983 that additional measures would be needed, and the authorities had taken drastic steps--including a cut of about 0.75 percent in real domestic demand--even before the quarter had ended. Few countries were able to make such a rapid response.

The staff had concluded, Mr. Polak noted, that the Government's new measures would release resources that would be used to strengthen the balance of payments, and, like Mr. Zhang, he wondered precisely how the improvement was expected to take place. A number of the measures that the authorities had adopted were particularly welcome. The decision to maintain import restrictions in 1983 was understandable, and the greater use of the exchange rate was commendable. During the discussion on the previous Article IV consultation with Hungary, he had expressed some doubt whether the Government had fully accepted the role that could be played by the exchange rate. The cumulative adjustment of the exchange rate seemed somewhat small, and he had been pleased to learn from Mr. de Groote's opening statement at EBM/83/90 that a further adjustment was expected in the immediate future. Previous speakers had mentioned the extent of the real appreciation of the forint over a number of years. However, purchasing power parity comparisons over long periods were not very convincing; the adequacy or inadequacy of the exchange rate should be judged by current developments rather than by price and exchange rate comparisons over a long period.

Important adjustments were being made in the Hungarian economy, Mr. Polak considered. There had been a decline of about 10 percent in investment in the socialist sector and an increase of the same magnitude

in investment in the private sector. That change might not be favorable in a centrally planned economy: the main industries were owned by the Government, so that a sharp cut in investment in those industries and a sharp increase in investment in lower-priority areas were not necessarily desirable. He wondered whether the investment developments in Hungary were the result of a deliberate choice by the authorities, or of the relative inability of the authorities to control investment in the private sector.

In principle, Mr. Polak remarked, it was appropriate for profits to stimulate investment in various enterprises. In Hungary's centrally controlled sector, however, it seemed that measures were being introduced to break the relationship between enterprise profitability and investment. The staff had noted the authorities' use of large blocked investment funds and had mentioned that some investment funds had been canceled. In addition, taxes on investment, and the uncertainty regarding enterprises' disposition of profits had undoubtedly had a negative influence on the ability of prices to guide economic activity.

For some time, Mr. Polak went on, the authorities had paid insufficient attention to relative prices. Subsidies were a sizable budget item, and although the budgetary and global demand effects of the subsidies could be compensated by the imposition of turnover taxes on consumption expenditure, the taxes did not provide compensation at the relevant level, where choices of commodities were made on economic terms. The authorities should be encouraged to make the necessary adjustments in the prices of individual commodities, and to avoid hiding the cost to the economy of those commodities under a blanket of subsidies. In that context, it would be useful to know more about the evolution of energy prices in Hungary.

The staff seemed to be moderately pleased about the increase in household savings from 5.0 percent to 5.2 percent of disposable income, Mr. Polak said. The increase had occurred in part because households had become much freer to engage in investment in housing. Apparently, however, the additional expenditures had exceeded the additional savings; the increase in investment by households was equivalent to 0.5 percent of disposable income, a situation that was inconsistent with the tendency to squeeze resources out of the economy in order to support an improvement in the balance of payments. The increased investment by households was perhaps not inappropriate; there was undoubtedly an intangible income from the householders' ability to spend their own money on their own homes. The distribution of such income through the population was an important source of the cohesion of Hungary's economic system.

Mr. Taylor considered that the authorities had amply demonstrated their firm commitment to achieving the adjustment objectives. Even before undertaking the adjustment program they had made good progress in improving the external current account in convertible currencies; the deficit had been reduced by the equivalent of 2.5 percent of GDP in 1982. The authorities were to be commended for their willingness to

tighten the program for the remainder of 1983 despite the unexpectedly strong domestic demand and the lower than expected trade surplus in convertible currencies. It was encouraging to see that, with the strengthened adjustment program, the target of a current account surplus of $600 million still seemed just about achievable, despite the many setbacks that had become apparent in the first quarter of 1983. However, the authorities should regard the target as a minimum, rather than a maximum, because the weakness of the capital account would permit little, if any, easing of the adjustment effort in the coming two years.

The large net outflow of capital in 1983 was a reflection of the continued uncertainty of commercial bankers about Hungary's economic prospects, Mr. Taylor remarked. To restore confidence and to stabilize external debt at a lower and more manageable level, the convertible current account surplus would have to be further improved in 1984 and 1985. If the adjustment effort were to continue for several years, the authorities would have to minimize both the distortions in the domestic economy and the possible long-term damage to economic viability that had emerged as a side effect of the quick-acting medicine administered by the authorities during the previous year. Such an effort might well be less easy for a centrally planned economy to make than a market economy. Any progress that the authorities could accomplish in allowing market forces freer play to affect such variables as savings and investment more directly and to improve the efficiency of the operations of the enterprise sector should enhance the productive potential of the economy. In that connection, the Prime Minister's remarks to Parliament, which Mr. de Groote had mentioned, seemed to express appropriate general lines of policy.

In three main areas, the thrust of structural change might be beneficial, Mr. Taylor commented. Subsidies in 1983 seemed to be exceeding the original estimates by some F 7 billion, or by approximately the same magnitude as excess domestic demand. Apparently enterprises and firms were being shielded from the effects of external adjustment. Table 9 seemed to confirm that view; it showed that consumer price support was forecast to increase by 5 percent in 1983, representing a modest reduction in real terms. The increase in import subsidies would probably undermine the effect of the exchange rate devaluations in 1982. The high level of subsidies would certainly be undesirable in the longer run, as it would constitute a burden on government expenditure and would perpetuate the distortions in demand. The staff had shown how the failure to pass on the effects of the devaluations to consumer prices had contributed to excessive personal consumption expenditure in 1982, and the authorities' intention of passing on the full effects of future devaluations was certainly welcome. Thus far, a disproportionate share of the adjustment burden had been borne by investment, rather than by personal and public consumption. Over time, that trend could begin seriously to erode the economy's productive potential and its export performance; and it raised the question whether more purposeful action to cut private consumption should not be contemplated than the measures described on page 13 of EBS/83/110.

Institutional changes in interest rate policy would also help to create favorable conditions for economic growth, Mr. Taylor continued. The progress that had been made was most encouraging; real interest rates were strongly positive and should contribute to the projected increase in household savings. The adoption of the more flexible interest rate policy and the unification of the interest rate structure were welcome steps toward the achievement of a more rational determination of resource allocation. Institutional changes in the trade policy area would also facilitate economic growth. Progress in reducing the trade restrictions was being made. While the authorities' commitment to eliminating the remaining restrictions by the end of 1984 was welcome, he hoped that they would do so earlier if at all possible. The institutional changes that he had mentioned--particularly the reduction of subsidies--were obviously sensitive issues, and the authorities should not be encouraged to do more than was practical. However they should take whatever opportunities were available to reverse some of the slightly worrying supply-side trends.

The external capital account left the authorities little room for maneuver, Mr. Taylor remarked, and the prospects for 1984 seemed to confirm that fact. It would be prudent to bear in mind that the capital inflow of $1 billion needed for 1984 might not be available from the commercial banks. Moreover, the foreign exchange reserves might not sustain capital flows in 1984 at the same rate as in 1983. Hence, in the absence of a considerable volume of official assistance, Hungary faced the prospect of balance of payments difficulties in 1984. The authorities would undoubtedly be mentally prepared to deal with that situation, particularly if the expected volume of commercial capital inflows did not materialize. It was not clear to him whether the authorities had given any thought to a further approach to the Fund. Although it was early for them to be thinking of such an approach, they should use the present opportunity to adjust the economy in the areas that he and previous speakers had emphasized. The staff should maintain a dialogue with the authorities to ensure that any setbacks in the program would be quickly addressed. The proposed decision should be approved.

Mr. Barbone commented that the authorities had demonstrated their ability to adapt their adjustment effort to various problems, some of which had been caused by factors beyond their control. The external environment had been less favorable than originally assumed, thereby making it particularly difficult for the authorities to achieve the external targets. He had been skeptical of the original export growth projections and had not been surprised to see that the estimates of export market growth had been lowered from 4 percent to 2 percent. The expected trade surplus was to be achieved mainly through a strong reduction in imports, and exports were expected to grow only moderately. Under the original scenario, exports were to have increased, and imports were to have remained unchanged. Given the difficulties facing the economy, the authorities had no alternative to slowing the pace of the elimination of the import restrictions introduced in September 1982.

Although the control of trade flows should help the authorities to achieve the external targets, internal demand management and external competitiveness had to play key roles in the adjustment effort.

The case of Hungary, Mr. Barbone continued, provided another opportunity to evaluate the effectiveness of the Fund's program design for centrally planned economies. Although the traditional quantitative performance criteria had been observed, developments in the domestic demand components--particularly in the nonsocialist sector--in the first stage of the program for Hungary had not been fully in line with the needed adjustment. There was a clear need for the Fund to be imaginative and innovative in its dealings with centrally planned economies. At the same time, the monthly monitoring of the cash incomes of the population, which had not been included as a performance criterion at the request of the authorities, had proved to be an effective way of keeping the situation under scrutiny and had given the necessary warning to the authorities that additional measures were required. A detailed discussion of that informal performance criterion would have been useful, particularly as it constituted an important precedent.

The various additional measures that the authorities had recently adopted were broadly appropriate, Mr. Barbone considered. However, he shared the staff's concern about the possible conflicts between the needed short-term adjustments and the desired medium-term and long-term improvements in economic efficiency. Moreover, there seemed to be a certain proconsumption bias, as reflected in the projected reduction of 5 percentage points in the ratio of domestic capital formation to GDP in just two years. That worrying feature should be kept in mind when a medium-term development program was formulated.

He, like previous speakers, Mr. Barbone said, wondered how the expected increase in the personal savings ratio was to be achieved. Real disposable income was expected to decline in 1983, for the first time since at least 1970, and an increase in the savings ratio in such circumstances would be a remarkable achievement.

Previous speakers had usefully requested a somewhat more extensive discussion of the appropriateness of the present exchange rate position, Mr. Barbone remarked. The issue was particularly important in the light of the stiff competition facing Hungarian exports, which was reflected in the need to provide export financing. That the authorities had decided to permit recent exchange rate adjustments to be reflected in consumer prices, in order to prevent a further increase in implicit consumer subsidies, was certainly welcome. However, the behavior of export prices seemed to be somewhat out of line in comparison with that in other countries with similar income levels and it had apparently halted the previous impressive growth in the volume of Hungarian exports.

On the whole, Mr. Barbone remarked, the program was broadly on track and deserved the Fund's continued support. Nevertheless, the economic situation in Hungary was still critical; in particular, there was likely

to be an increasing strain on the convertible currency reserves. Moreover, the medium-term outlook summarized in Table 16 was a cause for concern. Hungary was still classified as a developing country and should ideally be a net capital importer. In fact, however, it would probably continue to run sizable current account surpluses in the foreseeable future while maintaining a high debt service ratio. One of the main reasons for those developments was the change in the attitude of the banking community, which had shut its doors more tightly to Eastern Europe than to the rest of the developing world and, in so doing, had caused considerable problems even for countries like Hungary, whose economic management continued to be competent. In the circumstances, the Fund's assistance was doubly necessary and meritorious.

Mr. Tvedt noted that the authorities' efforts to liberalize and restructure the economy had been seriously hampered by world economic developments, particularly in the capital markets. In many respects, the circumstances in Hungary were relatively unfamiliar to the Fund; in other ways, however, the problems facing the authorities were conventional ones.

During the discussion on Hungary's request for the present stand-by arrangement, Mr. Tvedt recalled, the staff and a number of Executive Directors had remarked that, given the decline in investment over a long period, private consumption would have to carry a relatively large share of the adjustment burden. It had been clear that the growth potential of the economy would be reduced if investment were not revived. For various reasons, investment in 1982 had been lower than expected, while personal consumption had been higher. As a result, reducing private consumption, mainly through a decline in real wages, was still an important, and fully appropriate, objective.

There had been some doubt during the previous discussion on Hungary that a general increase in interest rates would stimulate savings, Mr. Tvedt continued. The present staff report gave the impression that interest rate policy and various measures encouraging private financial savings were receiving increasing attention from the authorities. It would be useful to know what had led the authorities to change their attitude toward interest rates. Had the public proved to be more responsive to interest rate changes than the authorities had expected? If so, the authorities might have at their disposal yet another instrument for influencing private consumption. The rationalization of the interest rate system as a whole was welcome, as it would undoubtedly facilitate a smoother and more efficient working of the economy.

The objective of increasing relative prices to realistic levels was an important element of the restructuring effort, Mr. Tvedt considered. Although there had been short-term problems in that area, the importance of maintaining the policy in order to improve the allocation of resources should be underscored. The authorities' intention of permitting the effects of recent and prospective devaluations to be fully reflected in

consumer prices and profits and their commitment to reducing various subsidies were welcome. Their flexible exchange rate policy would be the cornerstone of a realistic price policy.

The medium-term outlook for the Hungarian economy was clouded by the large debt service burden foreseen in 1984-85, Mr. Tvedt remarked. The authorities had maintained a prudent external borrowing policy in recent years and had been victims of developments caused by factors beyond their control, some of which were not purely economic. The present basic objective of economic policy was to achieve a large and lasting improvement in the external current account in convertible currencies. The unduly hostile external environment of the previous 18 months had raised the need for drastic domestic policy measures, which might suppress economic growth in the short term. The determination with which the authorities were coping with the present adverse conditions was impressive. All the performance criteria had been met to date, and the policies for the present year could be expected to achieve the desired results. He had no difficulty in accepting the proposed decision.

Mr. Shaw said that he agreed with the staff appraisal and commended the authorities for the determination that they had shown in implementing the adjustment program despite the difficult external environment. He was pleased that the authorities were willing to adopt additional measures in response to unanticipated developments, and that all the performance criteria had been met.

The authorities' economic strategy was appropriate, Mr. Shaw continued. In response to the deterioration in the external sector, they had adopted measures designed to reduce domestic demand by an additional 0.75 percent of GDP. However, like the staff, he was worried that the measures taken to restrict investment could have an adverse effect on the efficiency of the economy. He was particularly concerned that the arbitrary and unpredictable nature of decisions affecting resource allocation had been made more difficult in an environment where market forces were permitted to interact on a continuous basis. He understood the reasons for that situation, which seemed to be an unavoidable aspect of the reformation of the economy. However, since external financial constraints would continue for some time, the authorities should move quickly to implement the institutional reforms designed to increase the role of market forces. In that connection, the recent statement by the President to the legislature, which Mr. de Groote had reported, was welcome. A recent article in the London Financial Times had highlighted the problem by describing the cross-flow of capital and labor between the private and socialist sectors in Hungary.

Since the bulk of the original restraint under the adjustment program was in the field of investment, Mr. Shaw remarked, the present emphasis on containing household incomes and reducing price controls and consumer subsidies was welcome. The decision to permit the effects of the depreciation of the exchange rate to be passed through to domestic prices was also commendable.

He was somewhat concerned about the effect of arbitrary measures on savings and investment, Mr. Shaw commented. Those measures were needed to achieve short-term adjustment objectives, but the authorities should be urged to continue to reduce their reliance on arbitrary measures. A flexible interest rate policy influenced by market forces and affecting both savers and borrowers, together with other structural adjustment measures, would increase the ability to mobilize domestic financial resources in the most efficient manner and, just as important, would reduce the dependence on foreign financing.

Commenting on fiscal policy, Mr. Shaw said that the authorities' strong efforts to reduce the budget deficit were commendable. Still, he was concerned about the unexpectedly large expenditures on consumer subsidies, especially as they had resulted from the Government's failure to pass on increased costs to consumers. The decision to pass through the effects of future exchange rate depreciations to consumer prices was welcome, but the authorities should be urged to make a more aggressive effort to reduce the gap between domestic producer and consumer prices. It was perhaps correct, as the authorities had argued, that at the macroeconomic level the increase in subsidy expenditures was offset by the rise in the turnover tax. However, economic efficiency was adversely affected, as relative prices did not adequately reflect supply and demand.

The authorities were to be commended for the increase in the volume of exports despite the poor external market environment, Mr. Shaw commented. They were clearly committed to maintaining competitiveness in the export markets. Given the authorities' conservative projection for export prices, there was good reason to believe that the current account target would be met and, perhaps, exceeded. On the import side, however, the stricter import allocation system introduced in September 1982 was regrettable. It was unfortunate that the restrictions were not to be removed in 1983, and he wondered whether there was a revised timetable for their removal in 1984. The system could lead to unwarranted stockbuilding and to the development of a grey market.

The continued reliance on import controls, Mr. Shaw continued, suggested that, despite the depreciation of the exchange rate in the previous 12 months, a more flexible exchange rate policy was required. The authorities should be urged to dismantle the import controls if the improvement in the current account turned out to be greater than they now expected. He agreed with Mr. Laske that a key policy objective should be to increase the reliance on exchange rate policy and to permit more frequent changes in the rate, thereby ensuring smoother adjustment within the economy. He welcomed the announcement by Mr. de Groote that the exchange rate was to be further adjusted. Finally, the performance criteria for the final half of the program and the proposed decision were acceptable.

Mr. Connors stated that he broadly agreed with the staff appraisal and accepted the proposed decision. The authorities were to be commended for acting quickly to reduce domestic demand to a level broadly consistent

with the achievement of the external targets. Timely adjustment of policies should increase the market's confidence in Hungary's financial management in difficult circumstances.

That the authorities felt unable to relax the existing import restrictions because of the worse than expected liquidity situation was regrettable, Mr. Connors commented. He shared the staff's concern about the reliance on the stricter import allocation system and the inefficiency inherent in the allocation of imports on the basis of past import needs. In addition, such an approach could give rise to a parallel exchange market. In his opening statement, Mr. de Groote had noted the authorities' planned adjustment of the exchange rate, and he wondered whether there were signs that the parallel, or black, market for foreign exchange was large or growing. What was the difference between the official and the parallel exchange rates? Finally, he strongly agreed with the staff that the difficult external situation had led to the implementation of policies that were expedient in the short run but not well suited for the longer term; the authorities' intention of accelerating their economic reform program was therefore welcome.

The staff representative from the European Department said that the data base for calculating trade elasticites was inadequate. The short-term elasticity for total exports calculated by the staff on the basis of partial data was less than 1. However, it was important to pay attention to the longer-term elasticities, particularly for the nonagricultural portion of Hungarian exports; there was no evidence suggesting that in Hungary, contrary to the findings for comparator countries, those were not larger than 1. There was a clear need for the large gains in market shares--particularly for nonagricultural exports--to be consolidated. Accordingly, the recent exchange rate adjustments certainly had been necessary, and the staff fully supported the authorities' move to a more flexible exchange rate policy. For the moment, the import restrictions were a regrettable necessity and did not seem to have distorted the demand and supply pattern unduly.

The gap between the official exchange rate and the rate quoted outside Hungary had been somewhat wider than usual in the first months of 1983, the staff representative had noted, mainly because of the decline in confidence. More recently, however, the margin between those rates had been considerably narrowed, because confidence had increased and there were no undue payments distortions, a situation notably different from that in a number of other countries.

It was difficult to account for the attitude of the commercial banking community toward Hungary in recent months, the staff representative commented. It seemed likely that the banks were responding less to the environment in Eastern Europe than to their more general portfolio concerns about countries outside the Group of Ten; that conclusion was supported by the range of banks that had chosen not to replace their deposits in Hungary. However, following the Deutsche Bank syndication of April 1983,

there had been an inflow of deposits to Hungary, suggesting that the attitude of the banking community was now changing; after a lag, the banks were beginning to recognize the accomplishments of Hungary's adjustment effort. Moreover, the conditions of the Deutsche Bank loan were somewhat better than those that Turkey had recently received and were about the same--with the exception of a somewhat larger management fee--as those attached to the Manufacturers Hanover loan in 1982. A number of other sovereign borrowers had been facing harder terms in 1983 than the previous year. On the whole, it was clear that Hungary's position had improved despite the overall deterioration in the credit market climate.

The revised projections of the balance of payments for 1983, the staff representative said, showed lower imports and about commensurately lower exports. Although the drop in import prices was smaller than that in export prices, it was sizable. Comparisons of unit values between countries were always difficult to make; much had to do with the composition of trade and of the particular transaction currencies. The trade flows were expressed in U.S. dollars, even though much of Hungary's trade involved non-dollar transactions. Accordingly, the appreciation of the dollar had by itself contributed to the perceived fall of foreign trade prices. In addition, agricultural prices had fallen considerably compared with the previous year and were well below the initial projections.

A question had been asked, the staff representative recalled, about the performance of cash incomes as an indicator of demand pressures in the economy. It was the only timely indicator of such pressures and it seemed to have been effective as an early warning system, even though its relationship to changes in disposable income was not as close as one might wish it to be. It was clear that the authorities monitored developments in cash incomes closely and had reacted to the indication of an overshooting of the target for the growth of incomes in the opening months of 1983.

For the moment, the staff representative commented, the real rate of return on most savings deposits was negative; the authorities had undertaken to increase the average deposit rate in 1983. The ability to purchase a home had been expanded, and a considerable portion of savings was related to the extension of housing credit at preferential rates. The savings rate was projected to increase in 1983 by 0.2 percent and investment by households, mainly in housing, by an estimated 0.5 percent. Those developments, rather than indicating an inflationary gap, probably provided a longer-run stimulus to the propensity to save. There were only a few savings instruments in Hungary, and the range of financial assets was limited. It was therefore important to give income earners a reason to save. In addition, rental housing was heavily subsidized, and an increase in home ownership at the expense of rental housing provided an immediate relief to the budget.

There was some so-called bond financing of the fiscal deficit, the staff representative explained, but as the bonds were held by the banking sector, such financing in Hungary should be regarded somewhat differently

from traditional bond financing. Nevertheless, it represented a first step in the creation of instruments that could eventually be used for intervention by the authorities, once the financial market was established. A more important development, in terms of tying up savings and permitting enterprises to make their own investment decisions, was the first issuance--by the oil and gas trust--of bonds by the enterprise sector; it paved the way for possible expansion of the financial markets and for enterprises to invest in each other's activities. Such developments were particularly important in the light of the authorities' determination to move forward decisively with the economic reform effort.

The performance criteria on net foreign liabilities in convertible currencies for specialized banks and new long-term debt contracted by nonbanks were sensible, the staff representative considered. The staff had hoped that the international financial community would wake up earlier than it actually had to the progress that Hungary was making in the adjustment process. It might have been possible for some of the specialized banks and nonbanks to borrow abroad, and those transactions could have interfered with the National Bank's ability to manage the credit and monetary aggregates. Traditionally, Hungary had not taken up trade credits but, it had been forced, partly by circumstances, to change that attitude during the previous year, and it was possible that enterprises could borrow directly for import financing. Hence, it seemed appropriate to have the performance criterion on foreign borrowing by nonbanks in place, although the staff certainly did not wish to interfere with the needed inflow of foreign exchange. The performance criterion in question was admittedly loose but, given the various uncertainties, it had not been considered practical to set performance criteria more than six months in advance.

The increase in subsidies had been limited to consumer items, the staff representative noted. The authorities had continued to move producer prices for energy prices in line with changes in world market prices. Energy supplies received in Hungary at below world market prices were marked up, so that enterprises paid world market prices for all energy imports. There were still heavy subsidies for heating oil, electricity, and other energy products used by households. However, prices had been adjusted upward, and when differences in taxation between Hungary and neighboring countries were taken into account, gasoline prices in Hungary were comparable with prices elsewhere. However, the staff felt that the subsidies on household energy consumption were one area in which the authorities would have to take further steps in the coming period.

The needed inflow of medium-term capital of $1 billion in 1984 that Mr. Taylor had noted was the gross inflow, the staff representative explained. The projected outflow was $1.6 billion. Accordingly, the situation in Hungary was different from that of a number of other countries, as repayment of maturing debt exceeded assumption of new debt; in other words, Hungary required no net new money. In part because of the more positive attitude that the financial community had recently taken toward Hungary and, the staff hoped, would continue to take, the gross borrowing

need was likely to be met. The authorities felt that the debt burden was excessive and were determined to reduce it in the coming years.

As for the import restrictions, the staff representative from the European Department said, the authorities were determined to make every effort to reduce them as soon as possible. While the authorities were not yet in a position to specify a precise timetable, they were committed to removing the restrictions by the end of 1984.

Mr. de Groote commented that the reduction in public sector investment was regrettable. However, with the decline in controls, the rate of return on the reduced level of investment was expected to be fairly high. In the past, a portion of public sector investment had not been fully effective. Still, reducing investment would not be an acceptable solution in the long run. At present, investment was fairly substantial--approximately 26 percent of GDP--and the expected decline was in any event relatively small.

In assessing the savings performance, Mr. de Groote commented, Executive Directors should bear in mind that the rents on houses were to be substantially increased in the immediate future; some of the higher rents would be more than doubled. In the past, rental payments had been heavily subsidized, and the increase in rents would create a strong incentive for home ownership.

The authorities, Mr. de Groote remarked, clearly intended to continue monitoring the exchange rate in the light of changing circumstances and the needs of the economy. He agreed with Mr. Polak that it was not particularly helpful to base an assessment of the need for further exchange rate adjustments on calculations of comparative costs in the distant past.

It was obvious to the authorities, Mr. de Groote commented, that the level of subsidies was excessively high. The level, and even the idea, of using subsidies, would be one of the main policy questions to be dealt with in the second half of 1983 in preparation for the negotiation with the Fund on the program for 1984. There was broad agreement among government officials, party leaders, and in academic circles that the subsidies would have to be gradually reduced and, perhaps, eliminated. The relevant decisions would of course be difficult to take, but movement in the desired direction was clear.

In a recent statement, Mr. de Groote noted, the Foreign Minister had said, "Hungary's joining the IMF and the World Bank has further strengthened our country's position in the world economy, and widened and further strengthened also the system of our relationships worldwide and with all countries." The authorities were determined to continue to implement the adjustment program at a steady pace in the belief that there was a clear need to accelerate the liberalization of the economy.

The Chairman considered that the Fund was developing a close and effective relationship with Hungary, which was making important changes in its economic framework and policy stance. The authorities were to be commended for their rapid and decisive implementation of needed measures and for their close cooperation with the Fund. He looked forward to further cooperation between the Fund and the authorities and to the continued implementation of the adjustment measures.

The Executive Directors then turned to the proposed decision.

Miss Le Lorier remarked that, under the fourth performance criterion mentioned on page 29, there would be a $50 million limit on the contracting of new foreign debt during the coming nine months. However, the volume of borrowing by the nonbanking sector from the banking community was very small. Performance criteria on external financing were always rather loose, as accurate estimates of future financing needs were difficult to make. However, excessively loose criteria were of little value.

Mr. de Groote said that he agreed with Miss Le Lorier that the third and fourth performance criteria mentioned on page 29 were unnecessary. It was not useful to introduce limits that were unlikely to be exceeded. The performance criteria in question should perhaps be introduced under the next arrangement with Hungary, but not under the present one.

The staff representative from the European Department said that it was true that the $50 million limit seemed large in relation to the present volume of foreign borrowing. However, there could be some direct borrowing by enterprises to finance imports. Such borrowing was an integral element of the ceiling on net domestic assets, and the performance criterion in question gave the National Bank the control over credit that it would need.

The staff representative from the Exchange and Trade Relations Department remarked that the case of Hungary raised two policy questions: the circumstances in which ceilings on foreign borrowing were appropriate, and the function that the ceiling was expected to perform. In previous discussions, the Executive Board had concluded that, in cases in which the size of the external debt of a member country was a factor in the design of its adjustment program, limits on external borrowing should be included as performance criteria in upper credit tranche programs. That guideline was certainly applicable to the present case; there was widespread agreement on the large size and the seriousness of the debt. Hence, as a general policy principle, the inclusion of a ceiling on foreign debt was warranted. Therefore, the only remaining question was the size and nature of the performance criterion on foreign debt. The limits specified in the program were needed to reinforce the demand and supply targets and would not inhibit Hungary's capacity to borrow in amounts, and in ways, that would be consistent with the program.

The Chairman remarked that a high ceiling on foreign debt would not be inherently inappropriate. The authorities would note that if conditions improved, they would have the flexibility to borrow up to $50 million

through the nonfinancial institutions. In any event, the authorities had insisted on keeping the subceiling at $50 million, although the staff would have been willing to accept a somewhat lower ceiling. It seemed best to retain the ceiling of $50 million.

The Executive Board then turned to the proposed decision, which it approved. The decision was:

1. Hungary has consulted in accordance with paragraph 4(b) of the stand-by arrangement for Hungary (EBS/82/206, Sup. 2, 12/9/82) and paragraph 12(f) of the letter dated October 13, 1982 annexed thereto in order to review policies and to establish performance criteria subject to which purchases may be made by Hungary during the period after June 29, 1983 through January 7, 1984.

2. The letter dated May 9, 1983 from the Deputy Chairman of the Council of Ministers and the Vice-President of the National Bank of Hungary setting forth the policies and measures which the Government of Hungary will pursue for the period through January 7, 1984 shall be annexed to the stand-by arrangement for Hungary, and the letter of October 13, 1982 shall be read as supplemented by the letter of May 9, 1983.

3. Hungary will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Hungary's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota;

a. during any period in which the data at the end of the preceding period indicate that:

(i) the limit on net domestic assets of the National Bank of Hungary specified in paragraph 11(a) of the annexed letter of May 9, 1983; or

(ii) the limit on net credit from the banking system to the state budget specified in paragraph 11(b) of the annexed letter of May 9, 1983; or

(iii) the limit on net foreign liabilities in convertible currencies of the specialized financial institutions specified in paragraph 11(c) of the annexed letter of May 9, 1983 has not been observed; or

b. if the limit on the contracting of new foreign debt in convertible currencies specified in paragraph 11(d) of the annexed letter of May 9, 1983 is not observed.

Decision No. 7444-(83/91), adopted
June 24, 1983

The Chairman then left the meeting, and the Deputy Managing Director took the chair.

2. PANAMA - 1983 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1983 Article IV consultation with Panama and a request by Panama for a stand-by arrangement for 18 months in an amount equivalent to SDR 150 million (EBS/83/102, 5/24/83; and Cor 1, 6/10/83), together with a request for a purchase equivalent to SDR 58.9 million under the compensatory financing facility (EBS/83/103, 5/24/83; and Sup. 1, 6/23/83). They also had before them a report on recent economic developments in Panama (SM/83/121, 6/10/83).

Mr. Robalino made the following statement:

I would like to thank the staff for the excellent papers on the Article IV consultation, Panama's request for a stand-by arrangement, and the proposed purchase under the compensatory financing facility. My authorities are in full agreement with the views expressed by the staff.

In the period 1979-81 my authorities successfully implemented an economic stabilization program. Real GDP grew at an annual average rate of 5 percent, the public sector deficit was reduced from 15.4 percent of GDP in 1978 to 11.8 percent in 1979 and to less than 5.5 percent of GDP in 1980 and 1981, and the ratio of external public debt to GDP dropped from 80.5 percent in 1978 to 67 percent in 1981. Moreover, the adjustment in public finances was accompanied by a significant improvement in confidence as reflected by a surge in private and foreign investment, particularly in construction, the expansion of the free zone, and the development of tourist facilities.

The 1982 stand-by arrangement called for a continuation of cautious fiscal policies aimed at further strengthening public finances and easing the debt service burden, while preserving a propitious climate for sustainable economic growth. The program limited the overall public sector deficit to $255 million or 6 percent of GDP equal to the limit on net external public borrowing. The program was based on the assumption that GDP would continue

to grow by about 5 percent, and that the inflation rate would be less than 10 percent. In fact, production and prices both rose by 4 percent, a very rspectable performance.

The investment budget for 1982 gave priority to three sectors. In the first, energy, the construction of the hydroelectric plant La Fortuna has been financed with assistance from the World Bank and the Inter-American Development Bank. The completion of this plant by late 1984 should allow Panama to meet its electricity needs by hydropower. The change in energy policy followed by my authorities will save net oil imports, at today's prices, of about $65 million, which is equivalent to 1.5 percent of GDP and to almost one fifth of the projected current account deficit in 1983.

In the second investment area, housing, the government used the financial resources of the social security system for the construction of low-income and medium-income housing. Traditionally, demand for this type of housing has not been met by private real estate developers, who usually cater to higher-income residences and office space.

The third investment sector, agriculture, remained stagnant during 1979-81 owing to low rates of investment, insufficient technological advances, and the deterioration of commodity prices in the international market. My authorities decided to channel resources to this sector through extension services and credit to provide incentives for investment.

However, the process of economic development in 1982 was sluggish. Panama's economic performance has always reacted to the world economic conditions because of the openness of the economy. Thus, as is known, factors such as recession in the industrial world, the consequent deterioration in terms of trade, and weak foreign demand for Panamanian exports of goods and services have had adverse consequences on economic activity in Panama.

The overall deficit of the nonfinancial public sector amounted to $464 million (11 percent of GDP), well in excess of the program limit. The deficit was financed through heavy reliance on foreign credit, which raised the outstanding external public debt to 73.5 percent of GDP at the end of 1982, still significantly below the proportion that had prevailed before the stabilization program of 1979.

The deviation from the financial program is attributable to departures from both revenue and expenditure targets, due to the impact of the recession. Rigid limits on the wage bill were observed, and wage payments actually were kept well below the level foreseen in the budget. To reduce the government deficit,

my authorities have proceeded with great courage to eliminate inefficient plants and enterprises, for example, in the sugar sector. The Government of Panama has for some time been trying to find a solution to La Victoria's financial problems, which, apart from weak sugar prices, are related to high production costs. Unable to find interested private buyers for the mills, the authorities decided early this year to cut short the harvest season and to close down permanently the Felipillo Plant, the largest and least efficient of the mills that comprise the La Victoria complex. Budget implementation was also affected by unforeseen developments in the consruction of the hydropower project La Fortuna, which required additional payments to the prime foreign contractor to compensate for past cost overruns. Panama agreed to make these payments to avoid further costly delays in commissioning the project. Outlays in the housing project of the social security agency over and above budget appropriations also contributed to the increase in the public sector deficit.

The new program, for which the support of the Fund is requested, calls for a decisive improvement in the financial performance of the public sector. The overall public sector deficit will fall to the 6 percent level originally forseen for 1982. Public sector savings are expected to improve from 1.5 percent of GDP in 1982 to 2.5 percent in 1983, and public investment is to focus only on projects of high priority. In addition, my authorities have taken a number of decisions to stop financial transfers from the government budget to certain public enterprises and decentralized agencies. Reference has already been made to the large reduction in the scope of state activities in the sugar sector. In addition, last February a luxury hotel belonging to the portfolio of the National Development Corporation (COFINA) was sold by public bidding. At the end of 1982, the state-owned Banana Corporation was closed due to excessive losses. The National Airline and the Contadora Island Hotel have required government financial assistance. To avoid further subsidies, my authorities have been looking to sell the hotel and hope to do so soon. Another action to tackle the public sector deficit has been the determination to eliminate subsidies on rice. Numerous other measures designed to improve the operating efficiency of the Panamanian economy have also been adopted, as described by the staff. There have been preliminary agreements between the Government of Panama and the staff of the World Bank on a structural adjustment loan package. Many of its recommended measures have already been taken by the Government, and there is a World Bank staff mission at present in Panama conducting final negotiations.

As for the 1983 budget, restraint on current spending will be an important task. Strict cash expenditure limits for each ministry and government agency have been adopted.

Under the new program, tax measures have already been implemented and are to contribute an equivalent of about 1 percent of GDP on an annual basis. These include import tariffs on automobiles, increases in tariffs on petroleum imports, ship registration fees and import duties on items with low tax rates. Quota restrictions on some consumer goods have been replaced by tariff protection, which should improve customs revenue collection. My authorities are also placing strong emphasis on improvements in tax administration. Fund technical assistance is being provided in the customs area. Adoption of the Brussels Nomenclature to update the existing one is envisaged, and the introduction of ad valorem import tariffs to replace specific taxes is under review.

My authorities are conscious of the level of the external debt and are cautious about further substantial increases. Thus, the new public sector deficit of $270 million programmed for 1983 is very conservative but is appropriate in present world financial circumstances. The financing of the programmed deficit would be from multilateral and bilateral agencies and not from resources of the National Bank, commercial credits, or foreign bond placements.

Regarding the request for a drawing under the compensatory financing facility, the export shortfall was related mainly to a drop in bunkering services and in exports of sugar and refined petroleum products. Exports are expected to recover owing to a sharp increase in export petroleum derivatives. The volume and prices of export commodities such as sugar and marine products are also projected to rise owing to ecological and weather factors, as explained in the staff papers.

My authorities are convinced that the implementation of the program and the accomplishment of its objectives will enable Panama's economy to attain again a stable and substantial growth rate. I hope that my colleagues can give their support to Panama's requests.

Mr. Portas said that he agreed with the staff analysis and accepted the proposed decisions. The economic performance of Panama in the period 1976-81 constituted a success story, as the authorities had made important structural adjustments while achieving sustained real growth and low inflation rates. The strengthening of the public finances had been accompanied by a considerable diversification of the economy, particularly the impressive development of the energy and service sectors. The progress had been facilitated by the control of the Canal Zone and the development of Panama as an international financial center.

In 1982, Mr. Portas went on, the economy had continued to grow at a respectable rate--4 percent in real terms--while the rate of inflation--less than 5 percent--had been much lower than expected. At

the same time, important progress had been made in broadening key sectors of the economy, such as energy, housing, and agriculture, which had been given high priority by the Government. However, because of the deviations from both revenues and expenditure targets, the overall deficit of the nonfinancial public sector as a proportion of GDP had increased significantly. Given the high degree of openness of the Panamanian economy, the world recession had adversely affected Panama's exports and public revenues. In addition, the inefficient operation of several public enterprises and the implementation of investment projects had caused a further increase in expenditure.

The program for 1983-84, Mr. Portas noted, correctly involved a substantial fiscal adjustment, including a reduction of the overall public sector deficit from 11 percent of GDP to 6 percent. As the staff had noted, the planned adjustment would take place in unfavorable circumstances. The conditions in the international economy in 1978-81 had helped development of the country, but in 1982-83, the adjustment process had been made difficult by the problems facing Panama's main trading partners in the region and by the reluctance of foreign lenders to increase their exposure. He was pleased that, as the staff had noted in its opening statement, the commercial banks were taking a more positive attitude toward Panama and were negotiating a loan that showed their confidence in the Government's adjustment effort.

Given the present difficult world economic environment, Mr. Portas commented, a major effort to use efficiently the limited domestic resources of the public sector was called for. The public sector deficit was to be financed without net recourse to commercial credit, and a major effort to increase savings was expected to result in an increase to at least 2.5 percent of GDP. Most of the fiscal improvement was to come from reductions in investment expenditure; projects that had been given a low priority were to be deferred. The investment program, which had been assessed by the World Bank, included the development of sound projects in electricity and communications. The increase in public sector savings was expected to result mainly from a cutback in the operations of several enterprises and from the closure of a number of others; the authorities expected to eliminate inefficient operations that had unduly increased expenditures in the previous year.

He agreed with the staff, Mr. Portas concluded, that the authorities were to be commended for their decisive action to replace import quotas by tariffs, gradually eliminate most price controls, and rationalize the producer prices of some agricultural products. The implementation of those measures and the rationalization of the public sector were significant and appropriate steps in reorienting the economy. As for the proposal to use the compensatory financing facility, the staff had clearly shown that the export shortfall was due largely to exogenous factors, and that the request met all other relevant criteria.

Mr. Polak commented that the proposed stand-by arrangement for Panama was the fifteenth arrangement in a virtually uninterrupted chain that had started in 1965. The close association with the Fund reflected in the stand-by arrangements had not prevented the current account deficit from reaching 11 percent of GDP in 1982. In Panama, which did not have its own currency, the current account deficit could not, by definition, exceed the amount of available external finance. As a result, the use of Fund resources was tantamount to financing the fiscal deficit and did not strengthen Panama's reserve position. For the Panamanian authorities, it might well be particularly tempting to use the Fund's resources primarily for financing and to underplay their role in promoting adjustment, but the Government had proposed a major adjustment program. The proposed assistance could be tantamount to an improvement in reserves if the Fund's resources were drawn only on a contingency basis--namely, when they were needed to prevent unduly deflationary internal developments--an approach that had been used under many previous arrangements. The proposed arrangement paid due attention to one of the basic problems facing the economy--the need to increase public sector savings. In 1982, they had fallen to 1.6 percent of GDP from 4 percent in 1981, although the target had been over 4 percent.

The amount of assistance under the proposed stand-by arrangement was close to the maximum annual permissible level of 150 percent of quota and was much higher than the level under previous stand-by arrangements with Panama, Mr. Polak noted. In the circumstances, it was natural to expect the Government to introduce a strong program under which adjustment was to come mainly from fiscal restraint, the only instrument available to the authorities. The lack of control over public expenditure, together with the revenue shortfalls, had caused the failure of the previous stand-by arrangements for Panama. The overall public sector deficit in 1982 had been twice as large as projected and, together with the disappointing public savings, had caused the overshooting of the borrowing ceilings. The proposed program constituted a vigorous attempt to improve the fiscal performance. The efforts to reduce the losses of inefficient state enterprises and the introduction of strict cash expenditure limits were particularly welcome. The planned fiscal adjustment in the coming period was adequate. However, the planned adjustment under the previous stand-by arrangement had also been adequate, but the implementation had proved inadequate. The strict phasing of the Government's access to Fund resources under the proposed arrangement should help to ensure that the implementation in the coming period would be effective. That point was particularly important because the volume of resources to be made available under the proposed stand-by arrangement was large in relation to the size of the country.

Surveillance of Panama was unusual because the country did not have its own currency and exchange rate policy, Mr. Polak commented. Nor did Panama have its own monetary policy; the National Bank was a domestic commercial bank and a fiscal agent, but not a central bank. In fact, the absence of an independent central bank had been one of the factors that had contributed to making Panama an island of stability. The absence

of an exchange rate had been beneficial in the sense that it had forced Panama to introduce conservative monetary measures. In a recent similar case, the link of Guatemala's currency to the U.S. dollar had provided valuable support for the Guatemalan Government in its effort to maintain conservative economic policies.

The proposed decisions were acceptable, Mr. Polak concluded, although he had one reservation about the request to use the compensatory financing facility. A large part of the export shortfall was related to petroleum products. The decline in exports of petroleum products had been due in part to price differentials, and the fall was to be overcome by a single large contract. It would be useful to know whether the authorities had reduced or eliminated the price differentials.

Mr. El-Khouri commented that the expansionary fiscal policy of 1982 had caused imbalances in the economy. The ratio of the public sector deficit to GDP had risen from 5.5 percent in 1981 to an estimated 10.7 percent in 1982. The fiscal deficit had been financed mainly through external borrowing, and the external debt of the public sector had increased by approximately 20 percent in 1982, reaching some $3 billion, or approximately 75 percent of GDP. That unsatisfactory performance had resulted in the interruption of purchases under the previous stand-by arrangement.

The authorities, Mr. El-Khouri went on, had shown a strong willingness to make the necessary adjustments. They had adopted a stabilization program in support of the proposed stand-by arrangement, which was fully acceptable. The centerpiece of the adjustment effort was the sharp reduction of the public sector deficit by about 5 percentage points of GDP in 1983. It was to be achieved mainly through a fall in capital expenditures of about 3.5 percentage points of GDP. The authorities and the staff believed that such a reduction would not harm the medium-term growth outlook of the economy; he was pleased that the World Bank concurred in that assessment and was negotiating a structural adjustment loan. His chair had always urged close coordination between the Fund and the World Bank whenever the public sector investment plan of a country represented a main element of the Fund-supported adjustment program.

There was little room for maneuver with respect to public sector current expenditure, Mr. El-Khouri remarked. The authorities intended to limit the increase in current outlays in 1983 to 3 percent, despite a 10 percent across-the-board wage increase for public employees. The target was to be achieved through a substantial reduction in government transfers to public enterprises and decentralized agencies; it would be important for that reduction actually to take place, and for the financial position of the enterprises to be strengthened through a reduction in their operating expenditures.

The authorities had also taken steps to increase public sector revenues by about 1 percent of GDP in 1983, Mr. El-Khouri continued. In the longer run, the authorities intended to improve customs revenue collections by substituting ad valorem import tariffs for specific duties and by

modernizing the customs administration. Those steps should improve the Government's revenue base in the long run, and the technical assistance being provided by the Fund in that area was welcome.

In general, Mr. El Khouri said, he agreed with the macroeconomic framework of the stabilization program and with the quantitative performance criteria. It was prudent at the present stage to establish financial targets only for the remainder of 1983 and to leave the formulation of the financial program for 1984 to a later date. Were the authorities on track for meeting the quantitative performance criteria for end-June 1983? Finally, the request to use the compensatory financing facility met all the requirements and should be accepted.

Mr. Lovato said that he accepted the proposed stand-by arrangement, although, given the authorities' track record, he harbored some reservations about their ability to implement the program. The staff had noted that the circumstances in which the adjustment effort was to be made were far more unfavorable than they had been in the period of the previous stand-by arrangement, which had been interrupted. In most cases, gradual adjustment was preferable. In Panama, however, the combination of a weak world economy and the high public external debt left little room for gradual adjustment. The authorities' clear understanding of the interdependence of economies was encouraging. They realized that efforts to protect the domestic economy from the recession in the industrial countries by accelerating public sector investment could help economic growth and employment in the short run, but only at the cost of a large fiscal imbalance and the rapid accumulation of foreign debt that eventually precluded substantial foreign borrowing.

The authorities, Mr. Lovato went on, recognized the need to increase the weight of the private sector in the economy, in order to ensure a more rational use of available resources, to cut investment in the subsidized and protected sectors and to shift resources to areas in which Panama enjoyed a comparative advantage, and to liberalize to some extent the labor law. In sum, the authorities' intentions were clearly appropriate. However, the task of adjusting the economy would be difficult, because the Government did not have the option of using the exchange rate and could cover the resource gap only through foreign financing. As a result, the focus of adjustment was necessarily on the public sector.

The performance criterion under which the public sector would not have net recourse to commercial financing had important implications for the magnitude of the external debt, the composition of public expenditure, and the efficient use of resources, Mr. Lovato commented. The authorities should be urged to reduce the numerous trade restrictions, which constituted a misallocation of resources and deprived the Treasury of a potential source of revenue.

Mr. Laske said that he could accept the proposed stand-by arrangement, mainly because it was based on a strong adjustment program. He had had some reservations about the request because of Panama's inadequate

performance under the previous stand-by arrangement, and he hoped that the implementation of the new adjustment measures would be undertaken with greater determination.

He had some difficulty in accepting Panama's request to use the compensatory financing facility, Mr. Laske commented. The present request, like the previous one by Panama, in 1976, was based to a large extent on a shortfall in exports of petroleum products that had been refined from imported crude oil. A decline in Panama's exports of refined petroleum should be partly offset by a decline in the country's imports of crude oil. Hence, Panama should not need to be compensated for the full decline in its exports of refined petroleum products; instead, it should be compensated only for the net decline after deducting the import content from the export earnings. That issue had been discussed during the Executive Board's review of the compensatory financing facility in March 1977. On that occasion, the Economic Counsellor had confirmed his authorities' view that, in cases involving a high correlation between imports and exports, a deduction for the import content of exports could be made without changing the decision on compensatory financing. That such a deduction had not been made for Panama was regrettable, especially as the extent of the value added to the imported crude oil could be determined rather precisely, as revealed in a footnote in the staff report. Moreover, the decline in the supply of bunker oil, which had contributed to the calculated export shortfall, could constitute a lasting change in Panama's export structure and might not be merely a temporary factor. Hence, he wondered whether bunker oil should be included in the calculation of the export shortfall.

He wished to reserve his position on Panama's request for compensatory financing until he had heard the positions of other Executive Directors and the staff, Mr. Laske stated. In any event, defining "export earnings" to include the earnings of processed re-exports had consequences that might not be fully compatible with the purpose of the compensatory financing facility. The policy issue should be examined on another occasion, perhaps in the context of the scheduled comprehensive review of the compensatory financing facility. On that occasion, the staff could usefully suggest possible ways of making satisfactory allowance for the import content of re-exports in cases in which there was a high correlation between export earnings and import payments.

Mr. Delgadillo said that he broadly agreed with the staff appraisal and strongly approved the proposed decisions. Panama met all the requirements for using the compensatory financing facility. The calculated export shortfall in 1982 had resulted mainly from declining prices in international markets, lower sales resulting from the downturn in world trade, and some marketing difficulties beyond the control of the authorities that had adversely affected most of Panama's major exports.

Commenting on the proposed stand-by arrangement, Mr. Delgadillo said that the authorities' new program for 1983-84 was designed mainly to strengthen public sector finances, which had been considerably off target

under the previous stand-by arrangement. The new financial program appropriately called for a sharp contraction in the public sector deficit, through a combination of measures affecting both expenditure and revenue, while reducing the scope of the public sector in the economy and providing incentives for the private sector to assume the leading role in the generation of employment.

The large adjustment that was needed in the fiscal deficit in 1983, Mr. Delgadillo noted, was to be achieved by raising the public sector current account surplus by 1 percentage point and by reducing public capital outlays from 12.5 percent of GDP in 1982 to 8.5 percent in 1983. The authorities had already adopted a number of appropriate measures designed to eliminate inefficient plants and enterprises in the sugar sector, rationalize the operations of other enterprises, stop financial transfers from the government budget to certain public enterprises, and review the investment program to avoid projects of questionable economic worth. However, there was still room for the adoption of additional measures in the pricing field, particularly the prices for public entities, in order to move closer to the complete elimination of subsidies. In that connection, the ongoing redefinition of the regulatory functions of the Price Control Board as well as the rationalization of producer price policies were welcome. He hoped that they would result in a more efficient allocation of resources, particularly to the areas in which Panama enjoyed a comparative advantage. On the revenue side, measures had already been adopted to yield the equivalent of nearly 1 percent of GDP on an annual basis. To that end, the existing quota restrictions on a number of consumer goods were to be replaced by tariffs and selective tariff increases on a wide array of imported goods. The progressive elimination of the quota restrictions was certainly appropriate, but he wondered whether the selective tariff increases would not introduce additional distortions in resource allocation.

He agreed with the staff, Mr. Delgadillo remarked, that one of the key objectives of the new program was to slow the rate of accumulation of external debt while improving its maturity structure. The authorities should take a cautious approach to any further substantial increase in the current outstanding public external debt. The present negotiations with international banks on new loans were welcome, if they provided a more flexible maturity structure that could alleviate the external payments burden, at least in the short run.

Mr. Pickering recalled that during the Executive Board discussion on Panama in April 1982 (EBM/82/60), the country had been described as one of the outstanding success stories of the Fund and as "an island of stability in this perturbed world." Stabilization efforts begun in 1979 and maintained in the subsequent two years had enabled the authorities to make a significant improvement in the fiscal imbalance while achieving substantial economic growth and a declining rate of inflation. Developments in the previous year had caused a sharp reversal in many areas of the economy and showed how quickly the benefits of sound economic management could be eroded by the introduction of inappropriate policies.

The proposed adjustment program was fully acceptable, Mr. Pickering went on. It reflected the significant efforts that the authorities were making to tackle the main problem of inadequate fiscal restraint. Because of the narrow range of available policy tools, it was essential that fiscal policy be kept on track over the program period. Much of the projected reduction in the public sector deficit in 1983 was to stem from sharp cutbacks in capital expenditure. The help that the World Bank had given the authorities in assessing their investment program within a medium-term context had already resulted in some rationalization of investment projects, including the cancellation of some planned projects of questionable economic value. There had been a significant overrun in capital expenditure under the previous adjustment program, and the authorities should be especially vigilant to ensure that it did not recur.

Cutbacks in capital spending could not be a long-term means of restoring external and domestic financial balance, Mr. Pickering commented. Instead, the importance of implementing the intended reforms of the current expenditure programs should be stressed. Of particular concern were the subsidies to some agricultural producers and to state enterprises, which had contributed to the unexpectedly large government expenditures in the previous year and to the inefficient allocation of resources within the economy. Accordingly, the effort to be made under the proposed program to provide cash expenditure limits for all ministries and agencies and to establish a public credit section in the Ministry of Planning was welcome. During the scheduled reviews in September 1983 and January 1984, the staff should pay particular attention to the implementation of those measures and make recommendations to rectify any problems that might have developed.

On the external side, Mr. Pickering remarked, the process of replacing import quotas with equivalent tariff protection was a first step toward promoting better economic efficiency, but the authorities should be encouraged to proceed toward the eventual reduction of all forms of protection. The authorities wished to provide adequate time for domestic industries to adjust to foreign competition, but they should not let that concern needlessly delay the implementation of unavoidable structural adjustments. Establishing a public timetable for the reduction of the tariffs might be useful.

The external public debt, which amounted to 73 percent of GDP in 1983, Mr. Pickering commented, was a serious constraint on the economy, and it was essential for the authorities to begin to move toward reducing the ratio. The planned absence of public sector borrowing in external commercial markets would be an essential part of the adjustment program.

Given the poor performance under the previous stand-by arrangement, he, like Mr. Polak, had been struck by the large size of the currently proposed stand-by arrangement, which, at 225 percent of quota over 18 months, was the maximum available under the enlarged access policy, Mr. Pickering said. It was preferable for a member country receiving such substantial assistance to achieve a sustainable balance of payments

position by the end of the program period. The main targets for 1984 included a public sector deficit of the order of 5-6 percent of GDP, an external current account deficit of 6 percent of GDP, and external commercial debt of some 40 percent of GDP. Those targets suggested that Panama might not be in a sustainable position unless a large volume of capital inflows occurred.

Commenting on Panama's request to use the compensatory financing facility, Mr. Pickering said, there seemed to be an inconsistency between the staff reports. On page 8 of the paper on the stand-by arrangement, the staff said that, in view of the economic situation in Latin America, the short-term prospects for exports were not good. However, on page 2 of the paper on the purchase under the compensatory financing facility, the staff said that a strong export recovery was expected; according to the projections, the volume of exports would increase by 38 percent in 1983 and 14 percent in 1984. The fact that much of the strength of exports in the postshortfall years was to be derived from petroleum products related to a new contract with a multinational corporation, and the fact that a large part of the shortfall was in petroleum products, suggested that the shortfall might have been due to a lack of competitiveness. The staff itself had raised the question whether the shortfall was indeed largely beyond the control of the authorities. On balance, however, his concerns were minor, and he could accept the proposed purchase.

In concluding, Mr. Pickering noted that the staff had stated that "the authorities are determined to continue to maintain discipline in the public finance" and that "the authorities continue to emphasize the need to reduce the burden on Panama's domestic resources that stems from a large foreign debt." Those statements appeared in the staff report for the previous stand-by arrangement for Panama; however, given the large slippages during the previous year, they were even more pertinent at present.

Mr. Erb said that he generally agreed with the staff appraisal and accepted the proposed stand-by arrangement. However, like previous speakers, he wondered why the maximum limits under the enlarged access policy were being applied in the present case, especially in the light of Panama's performance under the previous stand-by arrangement. Even more important, he strongly doubted that the balance of payments position at the end of the program period would be sustainable. In that connection, a more extensive discussion by the staff of the medium-term context of the program would have enabled Executive Directors to judge whether a sustainable external position was likely to be achieved by the end of the program period.

Given the specific nature of the Panamanian economy, Mr. Erb went on, the adjustment program was appropriately focused on fiscal policy and particularly on reducing the high level of public investment expenditure. The decision to have the World Bank evaluate the overall investment strategy and specific investment programs was appropriate, and he

was pleased that a World Bank mission was in Panama at present. As he understood it, a structural adjustment program was to be proposed in the near future.

He agreed with the staff, Mr. Erb said, that the Government should move quickly to rationalize its regulatory role in the economy. During the scheduled review of the performance under the stand-by arrangement, the staff should present a more comprehensive medium-term analysis of the economy. It should incorporate the findings of the World Bank mission for the structural adjustment program and review the progress that had been made in dismantling trade restrictions and in eliminating price controls. The proposed purchase under the compensatory financing facility was acceptable, but he looked forward to hearing the staff's response to Mr. Laske's observations on the request.

Mr. Morrell said that he agreed with the staff analysis and that the proposed decisions were acceptable. The stand-by arrangement under consideration was the fifteenth for Panama. The previous one had been interrupted, partly for reasons beyond the authorities' control. The three-year arrangement for Panama had succeeded in markedly reducing the fiscal deficit and the external payments imbalance, and had contained the external debt while keeping GDP growth at 5 percent a year. The slippage in 1982 had occurred mainly in the fiscal sector; the overall deficit of the nonfinancial public sector had reached 11 percent of GDP, far exceeding the 6 percent target, as revenues had fallen and expenditures had increased sharply. The new adjustment program was appropriately designed to reduce the deficit, increase public sector savings, and create favorable conditions for capital formation, mainly through the rationalization of government regulatory policies.

The proposed measures appeared to be rigorous, appropriate, and consistent with the large size of the stand-by arrangement, Mr. Morrell considered. The program should strengthen public finances, rationalize public sector participation in economic activity, and reorient production and external sector policies to encourage greater efficiency in resource use. He agreed with the authorities and the staff that the phasing out of quotas on both industrial and agricultural products and the substitution of tariffs would go a long way toward moving the economy along the desired path.

The proposed purchase under the compensatory financing facility was acceptable, Mr. Morrell said, for a number of reasons: the test of cooperation had been met, the balance of payments need was evident in the increase in the current account deficit and the sharp fall in reserves, and the export shortfall appeared to be due to factors largely beyond the control of the authorities. However, he, too, looked forward to hearing the answers to the questions that Mr. Laske had posed. The issue of the direct relationship between a country's imports and exports had to do with products in addition to refined oil; for instance, in the recent case of Belize, imports of cloth were made into clothing that was exported.

The staff representative from the Western Hemisphere Department said that the deficit for May--$98 million--was consistent with the expectations under the financial program. The data for June should be available in mid-July.

Increases in customs duties were used to raise needed revenues because, in an open economy like Panama's, imports represented a high proportion of GNP, the staff representative explained. In addition, the average rate of taxation on imports was low because of the predominance of specific taxes that had not been adjusted for many years. The increase in customs duties had been a way of raising the average rate of taxation. The substitution of tariffs for import quotas should also provide additional revenues. The aim was not to impose prohibitive tariffs but rather to allocate resources more efficiently and, in the process, to improve revenue performance. A timetable for the replacement of the remaining quotas by tariffs was to be an important component of the structural adjustment loan being negotiated with the World Bank.

The projected reduction in the public sector deficit was only from 6 percent in 1983 to 5.5 percent in 1984, the staff representative remarked. It was important to note, however, that in both years the criterion used to determine the size of the deficit was the amount of resources available from international development agencies. That type of financing was being substantially increased, partly to complete the Fortuna hydroelectric project, which was to come on stream in late 1984. There was to be no net recourse to commercial financing in 1983 and 1984 by the public sector.

There was room within the new program to use the Fund's resources on a contingency basis, as Mr. Polak had suggested, the staff representative commented, provided that the public sector deficit was within the established limit. The funds could be set aside in the National Bank to strengthen its reserve position. The decision whether or not to do so was of course entirely in the hands of the authorities.

Panama's economy depended greatly on the provision of services to international commerce, the staff representative said, and thus it was the services sector that was likely to suffer in the coming period from the recession in neighboring countries. For that reason, it was not inconceivable that merchandise exports might recover on the strength of petroleum derivatives while the economy would remain in recession because of weakness in the dominant services sector.

As for the balance of payments position at the end of the program period, the staff representative from the Western Hemisphere Department concluded, the projections on debt service payments for the next five years took account of the prospective new financing requirement of the public sector over that period, particularly the commercial borrowing requirements. In making that estimate, the staff had assumed that, depending on conditions in international money markets, the deficit might not be as large as 5 percent of GDP.

The staff representative from the Exchange and Trade Relations Department commented that the proposed stand-by arrangement was for the maximum amount under the established guidelines, in support of the substantial fiscal adjustment that was expected to occur. As for the limited discussion of a medium-term framework, it was important to remember that the issue would be addressed in the context of the two reviews contained in the program, the first of which was to take place before the end of September 1983. Under the second review, the targets and performance criteria for 1984 would be established.

Mr. Erb said that he agreed with Mr. Polak that the phasing of the drawings was one of the stronger aspects of the proposed program. Apparently a smaller fiscal deficit would be possible beyond 1984, after the completion of the hydroelectric project, for which considerable financing was needed. Would the reduction of the deficit require any additional policy changes?

The staff representative from the Western Hemisphere Department replied that the saving in oil consumption from the hydroelectric plant was estimated at about $65 million. Additional measures beyond the saving in oil consumption might be required to reduce the fiscal deficit in later years.

The staff representative from the Exchange and Trade Relations Department recalled that, in 1979-81, when Panamanian adjustment efforts had been effective, a public sector deficit of about 5 percent of GDP had seemed sustainable. On that basis, the deficit of 5.5 percent of GDP projected for 1984 appeared reasonable and would probably be sustainable. Of course, unexpected developments, such as a considerable and persistent tightening of financing, could make the deficit unsustainable.

Mr. Pickering inquired whether the staff assumptions underlying the debt service projections for the period beyond 1984 had taken into consideration a low level of commercial lending and no further Fund assistance.

The staff representative from the Western Hemisphere Department replied that Fund charges and repurchases had been included in the debt service projections, and that no provision had been made for purchases under future financial arrangements.

The staff representative from the Research Department recalled that the possibility of netting out the import content of exports had been discussed during previous Executive Board meetings, including a discussion on Panama. For the purpose of export shortfall calculations, the practice had been to net out re-exports; however, the re-exports were defined on the basis of UN terminology and therefore included products whose physical characteristics had not changed in the country of transit. Accordingly, imports of crude oil that had been transformed into petroleum products--like exports of other items that had been transformed from imports--did not fit the definition of re-exports and, therefore, had always been included in total domestic exports in calculations under the

compensatory financing facility. That treatment had also been applied to other kinds of imports such as cloth, which, in Belize, was transformed into garments that were exported. Another example was the cutting and polishing of imported rough diamonds in Israel, which exported the polished diamonds. The domestic value added in Panama varied considerably: for garments, it was estimated at roughly 12 percent; for diamonds, it was about 50 percent; for petroleum it was about 20 percent.

The exclusion of the import content of exports was not as simple a matter as it might appear to be at first glance, the staff representative continued. In previous papers, the staff had noted that there was an indirect import content as well as a direct import content that would have to be taken into account if the import content of exports was to be excluded. For crude oil, and possibly some other products, it might be possible to exclude the import content of exports, although it would be difficult to establish firm rules. In previous discussions, some Directors had suggested that the import content of exports could be deducted if the import content exceeded a certain percentage. However, during the 1977 discussion on Panama cited by Mr. Laske, the Economic Counsellor had mentioned that, unless the Executive Board established a specific rule, too much discretion would be vested in the staff if it had to decide on a case-by-case basis whether a country should not qualify for compensatory financing because of the high import content of exports. Although the staff could review the matter in the context of a future discussion on the compensatory financing facility, it would probably be difficult to treat the matter in a uniform and reasonable way; he did not wish to prejudge the outcome, but that had been the staff's conclusion in the past.

The case of Panama was further complicated by the fact that in recent years refining activity had been directed more at meeting domestic demand than for exports, the staff representative remarked. The trend in recent years had been to export the surplus of heavier types of refined petroleum products after domestic demand had been satisfied. Thus, all the products of a barrel of imported crude were not exported, and allocating the imported crude between domestic sales and exports was difficult.

It had been suggested by Mr. Laske, the staff representative from the Research Department recalled, that the shortfall in bunker exports might not be temporary. As the staff had noted in its report, there had been structural changes in the pattern of trade through the Panama Canal since the mid-1960s. Traffic through the Canal had increased during the period of the closing of the Suez Canal, which had coincided with the rise in traffic due to the Viet Nam conflict. In the early 1970s, the volume of traffic had declined after the re-opening of the Suez Canal and the end of the Viet Nam conflict. In the recent past, the installation of a pipeline to carry crude oil from one end of the Panama Canal to the other had lessened the need for shipments through the canal by tankers. The staff's projection, made in conjunction with the authorities, implied that there would not be a recovery in the postshortfall period from the longer-term structural changes. Traffic through the Canal had also varied as a result of short-term factors. In 1982 it had been

adversely affected by the world recession, and a recovery in the volume of traffic and in the demand for bunkering was expected in the coming two years in line with a recovery in world trade. As a result, the staff felt that the shortfall in bunkering in the period covered by the proposed purchase was temporary.

Mr. Laske remarked that it was regrettable that the issue that he had raised had not been examined following the 1977 discussion on Panama. He was familiar with the arguments that the staff representative from the Research Department had made. However, he continued to feel that, in Panama, an attempt at netting out the import content of the exports of refined petroleum products would have been warranted in the light of the particularly large--nearly 70 percent--share of refined oil products in the total export shortfall. In addition, the value added in refining was only 20 percent. Compensating Panama for the full amount of the export shortfall would therefore not be consistent with the letter and the spirit of the decision on compensatory financing. He wished to make a formal request for a study of the issue that he had raised and a discussion of it in the Executive Board. The discussion need not take place in the immediate future; it could be held after the 1983 Annual Meeting. It was true that, in other cases, the import content of exports was much larger and the netting out of the imports would be much more complicated and could lead to unsatisfactory results. However, in the case of Panama, the difficulties in netting out the import content of exports were not particularly great, and the lack of justification for full compensation of the export shortfall was striking. He could go along with the proposed request, but he had strong reservations about its size for the reasons that he had mentioned.

Mr. Robalino considered that it would not be appropriate to change the established practice concerning the treatment of the import content of exports at the present meeting. He was therefore pleased that Mr. Laske was willing to see the matter taken up later, after the 1983 Annual Meeting. His authorities were strongly determined to maintain appropriate policies in order to ensure the full implementation of the proposed program.

The Acting Chairman made the following summing up.

> Directors expressed serious concern about the major weakening of the public finances of Panama in 1982 and the sharp increase in the external debt. While there was recognition of certain unforeseen factors, fiscal management had been inappropriately expansionary, and Directors drew attention to the large deviation in policies in 1982. Directors commended Panama's renewed efforts to put the public finances on a sound footing, and in this connection Directors noted that the present economic environment was far more difficult than in earlier years. The authorities' decision to avoid net recourse to debt contracted at commercial terms in 1983 and 1984 was approved, as it not only

took account of financial market conditions, but also addressed the need to improve the maturity structure of the external debt and gradually reduce the cost of servicing it. Directors observed that this policy should also facilitate efforts under way to refinance principal payments falling due this year and next. Directors welcomed Panama's approach to the market, with the aid of major international banks, to obtain a commercial loan to cover Panama's gross commercial borrowing requirement over the next 18 months.

Since a major part of the fiscal adjustment was to be achieved by cuts in investment spending, Directors welcomed the close collaboration between the staff of the Fund and the World Bank in assessing the adequacy of the Government's medium-term investment plans. Directors also regarded the new revenue measures adopted and the steps taken to streamline the operations of a number of state enterprises as appropriate and necessary to improve the savings performance of the public sector. Considerable stress was placed on the need for vigilance in implementing the fiscal plans for the coming year, since implementation in 1982 had been weak.

Directors urged the authorities to continue the ongoing reorientation of policies to allow for a freer play of market forces. They generally welcomed the replacement of administrative trade restrictions by import tariffs and the authorities' aim of establishing a low and uniform level of protection to induce local industry to compete more effectively with foreign producers and to shift the pattern of investment toward the export sector. Directors noted that the elimination of quota restrictions should permit the Government to phase out most price controls. The rationalization of industrial incentives and agricultural price policies should also provide the right signals for entrepreneurial activity and assist the economy in its recovery.

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

The Executive Board then turned to the proposed decisions, which were approved.

The decisions were:

Stand-By Arrangement

1. The Government of Panama has requested a stand-by arrangement for the period from June 24, 1983 to December 31, 1984 for an amount equivalent to SDR 150 million.

2. The Fund approves the stand-by arrangement set forth in EBS/83/102, Supplement 1.

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

Decision No. 7445-(83/91), adopted
June 24, 1983

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Panama for a purchase of SDR 58.9 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund notes the representation of Panama and approves the purchase in accordance with the request.

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

Decision No. 7446-(83/91), adopted
June 24, 1983

4. JAMAICA - EXTENDED ARRANGEMENT - CONSULTATION AND REQUEST FOR WAIVER OF PERFORMANCE CRITERIA AND PROGRAM FOR 1983/84

The Executive Directors considered the staff report on the consultation and request for a waiver of performance criteria under the extended arrangement for Jamaica and the program for 1983/84 under the extended arrangement (EBS/83/122, 6/13/83; Cor. 1, 6/21/83; and Sup. 1, 6/24/83).

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

On June 15, 1983 the Prime Minister of Jamaica announced a series of measures to be implemented without delay. The following day a Ministry Paper detailing the measures was tabled in Parliament. The measures consist of:

1. A reduction in central government capital expenditure by J$147 million in FY 1983/84 compared with the budget proposed in April. This reduction is consistent with the fiscal program for the third year of the extended arrangement, as outlined in EBS/83/122. The April budget for FY 1983/84 had included a higher level of capital spending on the assumption that additional external financing could be obtained. However, it was decided

to bring into force a contingency program for the third year of the arrangement when it became clear earlier this month that the expected additional external financing would not be forthcoming.

2. A shift of $531 million in payments for imports and services to the parallel market, or $47 million more than had been incorporated in the program for 1983/84 described in EBS/83/122. This higher level of transfers was intended to cover the delay in effecting the shift to the parallel market and as a precaution against official foreign exchange earnings falling short of the program targets, particularly in the tourist industry. All oil payments were shifted into the parallel market, instead of approximately half as described in EBS/83/122. On an annual basis, current cash payments remaining in the official market will consist of government direct imports ($24 million), food imports for the tourist industry ($12 million), government transfers ($12 million), payments in regard to education abroad ($2 million), and interest on public debt ($271 million).

3. Price increases of 29 percent for gasoline and 38 percent for diesel, reflecting the shift of oil payments to the parallel market. Subsequently, bus fares have also been raised by 20-100 percent, and other price increases have also been announced, inter alia, for cooking oil and detergents.

Mr. Joyce made the following statement:

The papers presented by the staff describe the changed circumstances that developed during the second year of the extended arrangement with Jamaica, the reasons why some of the performance criteria were not met on March 31, 1983, and the nature and extent of the program proposed for the third year of the arrangement.

The 1982/83 program

The Jamaican program was extremely successful in its first year, but started to run into problems in 1982/83 as the world recession deepened and prospects for economic growth and for expansion of Jamaican exports fell short of expectations. Nonetheless, Jamaica met all the quantitative performance criteria through December 1982.

The program for 1982/83 was based on the assumption that the economy would grow at a rate of 4-5 percent, including a 12 percent expansion in mining production. In fact, mining production declined by 17 percent, and economic growth did not exceed 2 percent for the year as a whole. Throughout this period, the Jamaican authorities continued actively to pursue the program's

adjustment objectives and, indeed, early in January the Government, with a view to encouraging greater inflows of foreign exchange, institutionalized the parallel market and further limited the range of transactions that could be effected at the official rate of exchange. Exchange control and import licensing provisions were also liberalized.

In the event, these measures proved insufficient. On March 31, 1983, Jamaica found itself unable to meet some of the monetary criteria. This resulted in part from the accumulation of larger Central Government fiscal deficits than expected, chiefly owing to a large shortfall in receipts from bauxite levies. Indeed, with respect to other fiscal components, such as tax revenues and the level of capital and current expenditures, Jamaica more than met the program's targets. These larger government deficits could not be financed externally because of more restrictive conditions on international lending markets.

In these circumstances, the Government was obliged to borrow more from the domestic banking system, and both the adjusted ceiling for net domestic credit to the public sector and the ceiling on net domestic assets of the Bank of Jamaica were exceeded, the first by J$137 million and the second by J$184 million. Moreover, as a result of weakness in bauxite exports and a fall in projected net capital inflows, net international reserves were J$102 million below the permitted level on March 31. Jamaica also reported arrears of J$24.6 million.

In summary, the 1982/83 program went off track for two main reasons. First, the world recession was much more pronounced and much more persistent than expected. This adversely affected export receipts and government revenues. Second, there was a much smaller inflow of foreign capital than expected and, indeed, a net outflow of private capital.

These developments contributed to the larger government deficit. They also led to increased public borrowing from the domestic banking system and the nonfulfillment of the criteria respecting bank lending, the assets of the Bank of Jamaica and net international reserves for March 31, 1983.

The program for 1983/84

Negotiations between Jamaica and the Fund regarding the program for 1983/84 were somewhat protracted. While there was ready agreement that a major adjustment effort was called for in the third year of the extended arrangement, there were differing views as to the extent and nature of the adjustment required and, indeed, what might be tolerable, given the already high levels of unemployment in the Jamaican economy. Both sides recognized that the adjustment effort would have to be intensified in view of Jamaica's failure to meet all the performance criteria on March 31, 1983.

The program now proposed will in fact necessitate a major adjustment effort by Jamaica in 1983/84. It aims not only at making up for past shortfalls but also is designed to permit the achievement of virtually all the targets originally set when the program was first conceived, even though the international environment has proved much less favorable than expected. The staff paper also sets out projections for 1984/85 and 1985/86, so that the adjustment path can be considered in the light of the medium-term prospects for the Jamaican economy.

The Government of Jamaica's commitment to the basic economic strategy underlying the program remains unchanged. It is the Government's view that the private sector must lead the economy back to prosperity, that growth must be export-led, and that achieving a sustainable balance of payments position requires a substantial reduction in Jamaica's dependence on external borrowing over the medium term. The Government also recognizes that the strategy will continue to necessitate major adjustments in agriculture and manufacturing, a reduced role for the public sector, and further growth and structural changes in both tourism and mining. Above all, success of the strategy requires renewed confidence in Jamaica's medium-term prospects, further inflows of private capital, and increased entrepreneurship by private businessmen. Some progress has been made in these directions; more needs to be done.

The 1983/84 program is premised on a growth rate of 3 percent, with inflation remaining in the 8-10 percent range. It calls for a particularly strong adjustment in the fiscal area. The three-year program, as originally conceived, envisaged a reduction in the overall deficit of the Central Government from 17 percent of GDP in 1980/81 to 10 percent in 1983/84, and a current account surplus of 1 percent in 1983/84. In fact, the budget deficit in 1982/83 was 15.7 percent.

It is now proposed that the Central Government's overall deficit be reduced to 10.3 percent of GDP by the end of the current fiscal year. This is to be achieved through additional tax measures, more efficient tax administration, a continued freeze on government employment, and additional cutbacks on capital account.

The new tax measures announced by the authorities include additional duties on cigarettes, sales taxes on real estate and motor vehicle transfers, and a special levy on the earnings of life insurance companies. These measures are expected to yield J$60 million in 1983/84. An additional J$60 million will result from further improvements in tax administration. The Government also expects to obtain J$100 million from transfers to the Exchequer of current and accumulated profits of the public enterprises and the Bank of Jamaica, and J$80 million from

special bauxite and alumina sales. Together these measures will increase Central Government revenues to 31 percent of GDP from 28.7 percent last year.

Central Government expenditures will also be reduced to 41.2 percent of GDP, or by 3 percentage points. The main burden will fall on capital expenditures, which will be cut to 8 percent of GDP, compared with 11.8 percent last year, reflecting further reductions in transfers to the public enterprises and a concentration on higher priority investments. The Government plans to continue the fiscal effort in 1984/85 and subsequent years and aims at bringing the overall deficit down to 8.5 percent of GDP by 1985/86.

Improvement in the management and operational practices of the public enterprises is also urgently needed, and the Government is prepared to effect major changes where needed. As pointed out in the staff papers, several enterprises have already been overhauled. The authorities also intend to pursue the policy of privatization, although, given recently depressed economic conditions, not as much progress has been made as planned.

It is estimated that these revenue and expenditure measures should lead to a reduction in the consolidated deficit of the public sector from 14.7 percent of GDP in 1982/83 to 8.7 percent in 1983/84.

The monetary program is based on a substantial increase in private sector deposits, which again assumes a decline in the velocity of circulation. The intent is that achievement of the Government's fiscal targets will sharply reduce public sector demands for domestic bank credit and allow more room for the financing of private enterprise. The program would permit a 19 percent increase in credit to the private sector in 1983/84. The Central Bank intends that interest rates will continue to be determined competitively. However, the Bank will continue to limit the growth of consumer credit.

The program adopted in April 1981 was also aimed at a substantial improvement in the overall balance of payments, as well as a rebuilding of Jamaica's foreign exchange reserves so that the economy could adjust to a more sustainable level of capital inflows. In fact, for the reasons set out above, during the first two years of the program Jamaica's overall balance of payments deteriorated by $100 million. This occurred despite a slightly larger than expected balance of payments surplus in 1981/82.

The 1983/84 program aims at the elimination of the arrears and an increase in net international reserves of $125 million. This would yield a minimum cumulative surplus over the three-year

life of the program of $21 million. The Government of Jamaica has already taken measures to help achieve this objective, including the transfer of a further $484 million in payments to the parallel market. This transfer will reduce the drain on the official resources and help ensure a more efficient marshalling and use of foreign exchange. It represents a further considerable move toward freeing the foreign exchange market. The proportion of nonbauxite transactions passing through the official market will be reduced from 75 percent in 1982/83 to 57 percent in 1983/84. In addition, steps have been taken to facilitate CARICOM payments.

A critical assumption underlying the program is that there will be a significant recovery in world trade and, hence, in the current external account. The program assumes that exports of bauxite and alumina will grow by about 18 percent a year through 1985/86. It also assumes that Jamaica will continue to hold its own in the growing regional tourist market and that exports of sugar, bananas, manufactured goods, and other nontraditional products will increase in 1983/84.

The aim of the program is to reduce the current account deficit of the balance of payments in 1983/84 to 3 percent of GDP from its current level of 13.4 percent. Most of this improvement, including sales under three new bauxite export contracts and further expansion in tourism, will occur in the second half of the program year. In addition, merchandise imports are expected to decline by 11 percent because of lower oil prices, planned reductions in capital investment, and controls on nonessential consumer imports. The capital account surplus is expected to narrow chiefly because of a reduction in net official inflows. Net private capital outflows will continue but at substantially lower levels than in 1982/83.

The foreign debt of Jamaica is high, and debt service continues to absorb more than a quarter of export revenues. The debt service ratio will increase to 26 percent in 1983/84 and is expected to reach 30 percent in 1984/85 before beginning to decline. However, my authorities believe that the Jamaican economy can attain a sustainable rate of growth once the world economy picks up and the basic structural changes in the economy have been made.

Jamaica has already taken a number of steps to make up for the slippages that occurred in the program last year. The program for 1983/84 requires a major adjustment on the fiscal side. In addition, significant changes have been made in the exchange and payments system, and a larger than originally envisaged improvement is looked for in the current account of the balance of payments. On this basis, the Government of

Jamaica seeks the Board's support for the proposed program for 1983/84 and requests a waiver of the performance criteria that were not met on March 31, 1983.

The Government will consult periodically with the Fund about progress under the program and, in any event, will do so before December 31, 1983 with respect to policies affecting demand management and the exchange system. Additional consultations will be held before March 31, 1984, on possible subsequent arrangements in support of the medium-term strategy underlying this program.

Extending his remarks, Mr. Joyce said that the additional measures described by the staff representative in his opening statement had been adopted on June 17, 1983. At that time, the Prime Minister had also announced that a reduction in imports of $150 million would be needed and that further reductions in government expenditure would have to be made to meet the fiscal requirements of the program. The staff had noted that, since that announcement, there had been further announcements of increases in the prices for, inter alia, gasoline, diesel oil, cooking oil, and detergents, and that there had been a substantial rise in bus fares. The purpose of the Prime Minister's speech, which had been broadcast on radio and television, was to advise the public of the seriousness of the situation and of the additional measures that were needed to make the adjustments required under the program before the Executive Board. The Prime Minister had made it clear that Jamaica faced a difficult situation in the immediate future, and that the measures were needed to close the foreign exchange gap. He had emphasized the importance of the revised exchange arrangements in encouraging additional investment, thereby improving the opportunities for further growth and employment. Finally, he had emphasized that the decisions had been reached only after lengthy Cabinet discussions during which the Cabinet members had concluded that there must be no wavering in the effort to restructure the Jamaican economy in order to make it self-reliant, more competitive, and better able to face adversity.

Mr. Erb said that both draft decisions were acceptable. The improvement in the adjustment effort to which the authorities had recently committed themselves was welcome. During the previous discussion on Jamaica, he had stated that further significant measures would be required, and the subsequent response of the authorities reflected their recognition of the need to make the necessary adjustments. The extremely difficult but necessary decisions that the authorities had made in the previous several weeks demonstrated their commitment to the adjustment effort and moved in the right direction.

The adjustment program for 1983/84, Mr. Erb noted, was critically dependent on a substantial recovery of bauxite and alumina exports in addition to cutbacks in capital and consumer goods imports. The projected levels of exports of bauxite and alumina and the official balance

of payments support seemed overoptimistic, however, and there was a high probability that additional adjustment measures would be needed to achieve the balance of payments objectives. It was unfortunate that most of the improvement in the current account deficit was expected in the second half of the program year; slippages would jeopardize the attainment of the goals in the program year. The authorities were to be commended for their decision to shift some transactions to the parallel market, and he agreed with the staff that the authorities should be prepared to shift further transactions to that market promptly if and when necessary.

Commenting on fiscal policy, Mr. Erb said that he was seriously concerned about two matters. First, the increase in revenues in the program year, which was to account for a reduction of 2.3 percent of GDP in the overall central government deficit, would be heavily dependent on two one-time-only transactions: the transfer of current and accumulated profits from public enterprises and the central bank, and revenue from special bauxite and alumina sales. Hence, the improvement in the structural deficit would not be particularly significant, and stronger measures would be needed in subsequent years if the medium-term goals were to be achieved. Second, the bulk of the fiscal adjustment was to result from a reduction in capital expenditures; current expenditures as a percentage of GDP were to rise sharply. It would be critically important for the authorities to develop policies that would permit them to reduce current expenditures to sustainable levels more quickly than was now expected. In that connection, it was important to note that wage settlements had continued to exceed the rate of inflation.

The Managing Director returned to the chair.

In the economic policy memorandum, Mr. Erb went on, a brief mention was made of deregulation, but it was not clear to him how the staff felt about recent developments in pricing policy. Was the present policy stance adequate in the light of the changes in the exchange rate policy?

The discussion in the staff report on the medium-term prospects for the Jamaican economy was welcome, Mr. Erb said. The scenario should provide a valuable framework within which the authorities could formulate and, if necesary, adjust their policy path over the three-year period 1985-86. In that period, export incentives, industrial rehabilitation, and structural adjustments supported by the World Bank and the Inter-American Development Bank, together with further increases in bauxite production, were expected to result in real GDP growth of 4 percent and in continued improvement in the fiscal balance. The projections for capital flows and exports for 1985/86 might prove to be excessively optimistic, and the structural adjustment measures and export incentives might have to be strengthened to a greater extent than the authorities expected. Continued deregulation of the economy and divestment of government-owned productive assets would also be necessary. In that connection, the recent approval by the World Bank of the second structural adjustment loan for Jamaica was welcome. The authorities should be encouraged to implement rigorously the measures to which they were committed, and they should be prepared to strengthen them if necessary.

Mr. Taylor said that he agreed with the staff appraisal and supported the proposed decisions. However, he was concerned about the additional failure, represented by the present case, to observe the four-week rule on the circulation of a staff paper on an important use of Fund resources. Failure to circulate such papers within a reasonable period made Executive Directors' task of reviewing the issues difficult. He understood the pressures under which the staff and the authorities often had to work. He certainly sympathized with the Jamaican authorities, who had to deal with difficult problems. Nevertheless, everything possible should be done to adhere strictly to the agreed procedures on the circulation of staff reports.

The main decision before the Executive Board concerned the proposed program for the third year of the extended arrangement, Mr. Taylor remarked. At the time of the adoption of the arrangement, in April 1981, a number of Executive Directors, including the Executive Director for the United Kingdom, had said that they were worried because a program for the second year of the arrangement had not been delineated, and because the improvement in the budgetary and external deficits in the first year of the program seemed relatively limited. Behind those fears was the suspicion that the assumptions about the scale of available external financing in the program period were overoptimistic. Official and private external financing had fallen well short of expectations, and there had been a serious slump in the bauxite market. Those factors were the main underlying causes of the nonobservance of the three performance criteria for which a waiver was being requested.

In retrospect, Mr. Taylor commented, it was clear that the thrust of adjustment had been weak, leaving Jamaica with a steep hill to climb in order to achieve the program objectives. Still, the authorities had accomplished a great deal in the first two years of the extended arrangement and had complied with all the performance criteria through end-March 1983. Moreover, the strict and constructive measures that the authorities intended to implement in the third year of the arrangement were impressive. For those reasons, he agreed with the staff that the waiver was justified.

On the domestic policy side, Mr. Taylor continued, the main weakness had been fiscal policy, and particularly the authorities' inability to reduce the public sector deficit in line with the program objectives. That inability was the fundamental cause of the country's excessive dependence on external finance, and it was therefore appropriate that the target for the overall central government deficit for 1983/84 was about the same as the original target--10 percent of GDP--despite the considerable slippage in the previous year. The additional measures that were being taken to bring the program back on track--particularly the tax measures and the cuts in capital spending--were courageous and welcome. The combined effect of that strong fiscal squeeze should be to reduce the central government deficit by as much as 5.5 percent of GDP. The authorities' intention of phasing out central government transfers to state enterprises was also welcome; achieving that objective would require great determination and would go a long way toward meeting one of the major goals of

the World Bank's second structural adjustment loan program for Jamaica, namely, to improve the financial position of public enterprises.

In the external policy field, Mr. Taylor said, the greatly increased emphasis on financing imports through the parallel market was welcome. The transfer of $530 million worth of payments for basic imports in the present fiscal year out of the official market was especially commendable. The new arrangement for Caribbean Community (CARICOM) trade, including the new special exchange rate, was appropriate. The arrangement was expected to be kept in place for at least six months, and Jamaica's Caribbean trading partners apparently were satisfied with it. However, the present exchange arrangements were still a second-best substitute for a more decisive adjustment. The authorities should be aware of the danger that the exchange rate regime could become an arbitrary set of multiple currency practices that tended to induce economic inefficiency and confusion. He fully agreed with the staff that "reunification of the exchange system at a realistic rate should be sought as soon as possible." A clear timetable for the unification of the exchange system should be established by the time of the next review. An increasingly competitive exchange rate, together with firm fiscal and monetary restraint, could be expected to reduce the external current account deficit in the present fiscal year by as much as 10 percentage points of GDP. That objective was ambitious, but it was the minimum necessary in view of the continuing heavy interest burden, the expected slowdown in the inflow of donor aid and other capital, and the important objective of rebuilding foreign exchange reserves. The current account target could be reduced if capital inflows were larger than the staff had projected, but the projection seemed realistic. The fact that private capital outflows were still taking place suggested that conditions for investment in Jamaica were less attractive than those in other countries.

The re-emergence of external payments arrears, albeit on a relatively minor scale, was particularly disappointing after the authorities' successful effort to eliminate arrears ahead of schedule by end-March 1982, Mr. Taylor commented. The timetable for eliminating the arrears was welcome. The objective of rebuilding gross foreign reserves was commendable, although the expectation of an increase of $200 million by end-March 1984 seemed overoptimistic.

The proposed decisions were acceptable, Mr. Taylor stated. Jamaica's present difficulties were a graphic illustration of the importance of planning from the start for a sustained adjustment effort in a multiyear program. The performance in the coming year would be crucial. The economy urgently needed to make further progress toward standing on its own feet, especially as the scope for further Fund assistance after the end of the present arrangement was likely to be relatively limited.

Mr. Ainley said that he agreed with the main points in the staff appraisal and accepted the proposed decisions. Jamaica's performance in the first year of the extended arrangement had been good, but in the second year had been mixed and, in some respects, disappointing, largely

because of a prolonged depression in the bauxite market and a sizable shortfall in capital inflows. As a result, the fiscal and external positions had deteriorated, new arrears had accumulated, and a number of the performance criteria for end-March 1983 had not been observed.

The authorities recognized, Mr. Ainley went on, that firm action was needed to preserve the gains that had been made and to restore the momentum of adjustment. The program for 1983/84 and the measures being introduced under the World Bank structural adjustment loan would go a long way toward meeting those objectives.

For the immediate future, Mr. Ainley remarked, the authorities' moves to strengthen government finances and to bring the budget deficit back into line with the original target were welcome. The recent improvements in tax administration, and the tax compliance program, had had encouraging results and should be continued. As the staff had noted, the proposed tax increases would have to be introduced promptly if the revenue target was to be met. In that connection, the special bauxite sales mentioned on page 17 (EBS/83/122) would also be important, and it would be useful to know whether they had been agreed or were still being negotiated. Either way, the authorities should be prepared to adopt additional revenue measures if there were a shortfall in expected receipts.

In a longer-term perspective, Mr. Ainley commented, it was disappointing that the main burden of expenditure cuts was to fall on capital spending. He agreed with the staff that the apparent inability to reduce current expenditure was a serious problem. It was of course necessary to attract and keep high-caliber civil servants, but it would be essential for the authorities to maintain strict control over the public sector wage bill and the number of government employees. He hoped that the zero-base budgeting exercise, due to be completed in the coming year, would provide an opportunity for a thorough review of current outlays.

The progress made in streamlining the operations of the public enterprises was commendable, Mr. Ainley said. The introduction of improved management and accounting practices, together with the recent increases in utility rates, should strengthen the financial position of the enterprises and contribute to a significant reduction in the overall budget deficit.

On the monetary side, Mr. Ainley remarked, the authorities' intention of financing a larger portion of the budget deficit from nonbank sources was welcome. It would be useful to know whether the authorities intended to act on their recent study of ways to improve the domestic capital markets.

In the external sector, Mr. Ainley continued, the authorities were making commendable efforts to eliminate arrears and reduce the current account deficit to a sustainable figure. The export targets for 1983/84 were ambitious, even if world trade recovered as expected; however, the restructuring of the sugar and banana industries, the new incentives for nontraditional exports, and the tourist promotion campaign were important

steps in the right direction. In addition, the dismantling of import restrictions and the broadening of the parallel exchange market were welcome. While he agreed with the staff that those measures were an improvement on previous policies, the system of three exchange rates appeared to be administratively burdensome and complicated for investors, businessmen, and tourists, and the authorities should be encouraged to unify the system as soon as possible.

It was clear from the helpful analysis in Section III of the staff paper, Mr. Ainley commented, that the program for 1983/84 was a first step in what would have to be a sustained, medium-term strategy to rebuild the economy. It was encouraging that the authorities were working closely on the strategy with the World Bank; and the recently adopted three-year public sector investment program provided a realistic framework for development planning.

The tasks facing the authorities in the coming months were extremely difficult, Mr. Ainley concluded. However, with good luck--in the form of a world recovery--and good management, the 1983/84 program should help to restore confidence and give the authorities room to press ahead with more far-reaching structural reforms.

Mr. Morrell said that he agreed with the staff appraisal and supported the proposed decisions. The waiver was justified on the basis of the substantial policy actions, which, if successful, would enable the authorities to achieve most of the original program objectives. The performance criteria for the period to the end of 1983 seemed appropriate, and he hoped that the authorities fully appreciated the importance of observing all the criteria. Their intention of eliminating the external commercial payments arrears by end-1983 was welcome.

External developments, Mr. Morrell went on, including a sharp drop in export earnings from bauxite and less favorable official and capital flows than expected, had played a significant role in the deterioration of the external position and in undermining the basic strategy of export-led growth. However, fiscal performance had also fallen short of the program targets for 1982/83, partly because of the shortfall in revenues from the bauxite levy. Although the target for current expenditure had been met, there were clearly longer-term difficulties in containing current outlays because of increases in both public sector wages and interest payments. Much of the burden of fiscal adjustment would be on capital expenditure, although it would involve cutting lower-priority domestically financed projects. Transfers to public enterprises were to be limited, and he wondered what implications that policy would have for the important structural adjustment objective of rehabilitating the public enterprises.

The revenue measures that had just been announced were welcome, Mr. Morrell continued. The emphasis on strong fiscal adjustment in 1983/84 was appropriate, although the fiscal targets appeared achievable only if the revenue performance were closely monitored and a tight rein were kept on the growth of current outlays, particularly through restraint in public sector wages.

Commenting on monetary policy, Mr. Morrell said that the aim of slowing the rate of monetary expansion and the emphasis on meeting private sector credit needs seemed appropriate. In the past, domestic borrowing by the Government had pre-empted credit for private sector investment.

The shifting of petroleum, basic foodstuffs, and other important items onto the parallel exchange market could be expected to have a significant inflationary impact, Mr. Morrell remarked. He wondered whether that move was consistent with the objective of keeping the rate of inflation within 8-10 percent. The staff had concluded that "reliance should continue to be placed on the parallel market as a means of allocating scarce foreign exchange, promoting exports, and improving the liquidity position of the Bank of Jamaica." Formalizing and strengthening the parallel market were merely a step toward unifying the exchange system. Achieving that objective promptly was an appropriate expectation under an extended arrangement.

A key element in the economic recovery, Mr. Morrell said, would be the maintenance of external and domestic confidence through prudent tax management, including the elimination of payments arrears, productive use of external resources, acceleration of the pace of structural adjustment--including the policy of privatization--and appropriate financial policies, particularly in the fiscal area.

Mr. Mtei said that he broadly agreed with the staff appraisal and accepted the proposed decisions. The basic objective of the medium-term plan adopted within the framework of the extended arrangement was to reverse the decline in the economy and to promote economic recovery; considerable progress toward those ends had been made in the first year of the arrangement. However, toward the end of the second year, economic performance had been less favorable than expected, basically because of the adverse effects of unfavorable international conditions. Net capital inflows--an essential ingredient for the successful implementation of the program--had fallen substantially short of the projected levels, which appeared to have been rather optimistic. Weak demand had caused a severe decline in the bauxite industry, thereby reducing export earnings by 17 percent. A rapid rate of increase in exports and a large inflow of net foreign capital had been expected, and their failure to materialize had caused many of the program targets to be missed.

The authorities had introduced a number of measures to deal with the present difficult situation, Mr. Mtei continued. Reform of the exchange and trade system in January 1983, resulting in the legalizing of the parallel market and the liberalizing of exchange controls and quantitative restrictions on imports, should improve the allocation of scarce foreign exchange and encourage exports. The measures taken to deregulate prices and to simplify and liberalize imports were expected to encourage the private sector to increase its role in the economy. In assessing the public enterprises, however, the staff should stress the need for rationalization and proper management rather than privatization. The recent

case of Hungary suggested that, in certain circumstances, public enterprises could be an effective vehicle of growth and development. Moreover, the continuing high level of unemployment in Jamaica was a cause for concern, and the authorities might have to adopt further measures to stimulate employment.

The financial program for 1983/84 reflected the authorities' commitment to reinforce the adjustment effort and to correct the slippages that had occurred in the second year of the extended arrangement, Mr. Mtei remarked. The new program was designed to keep inflation within a relatively low range of 8-10 percent, and to achieve a 3.5 percent rate of growth of real GDP. In the fiscal area, the program called for an overall deficit of 10.3 percent of GDP, in line with the original program target. It was to be achieved through an increase in revenue to 31 percent of GDP, mainly as a result of improved revenue collection and the adoption of new tax measures. Government expenditure was expected to be reduced to 41 percent of GDP. He agreed with the staff that placing the brunt of the expenditure adjustment in 1983/84 on capital outlays would adversely affect growth and employment. The authorities should be encouraged to implement their plan for restructuring the current budget with a view to curbing the growth of current outlays. The Government's effort to rationalize public enterprises was welcome.

As to monetary policy, Mr. Mtei went on, the projected decline in domestic bank lending to the public sector should reduce net credit to the public sector by 3 percent, leaving a considerable portion of bank credit for use by the private sector. The Government intended to rely on nonbank sources to finance its operations during 1983/84. The authorities' intention of continuing the present interest rate policy, sterilizing the liquidity impact of financial operations in the dual exchange market, and refraining from intervening in the parallel market was commendable.

Under the 1983/84 program, Mr. Mtei observed, the balance of payments was to record a surplus of $125 million. In addition, the level of official reserves was to be the equivalent of 13 weeks of nonbauxite imports, in line with the target in the original program.

In view of the 1983/84 program and the medium-term strategy of the authorities, Mr. Mtei remarked, the slippages from the original program targets during the second year of the extended arrangement were likely to be temporary. The recent and prospective policy measures should ensure that the program was viable. Jamaica was clearly implementing significant measures that were expected to reverse the slippages that had led to the nonobservance of the performance criteria for end-March 1983.

The Fund had to be somewhat flexible in applying performance criteria, especially when many of the elements on which a program was based were not under the complete control of the member country itself, Mr. Mtei considered. Such flexibility was especially desirable when deviations

from planned targets were temporary and the authorities were taking the necessary corrective steps. To enable Jamaica to make the structural adjustments needed to resume sustainable economic growth, the Fund should continue to provide financial assistance and, where appropriate, to give the Government's policies its stamp of approval. The fact that the proposed drawings would increase the Fund's holdings of Jamaican dollars to a rather high percentage of quota was in fact an argument in favor of maintaining the present access limits. After all, Jamaica was only one of a number of countries requiring the Fund's assistance in relatively high proportion in relation to quota.

Mr. Wang stated that he broadly agreed with the staff analysis and accepted the proposed decisions.

The staff representative from the Western Hemisphere Department remarked that the bauxite export projection depended on three special transactions that were expected to occur in the 1983/84 program year. Of those transactions, one--a stockpile arrangement with the United States--had been negotiated. The second involved an increase in production of the local alumina refinery and was dependent upon the successful negotiation of the bauxite levy arrangement after December 1983. It was too soon to know whether or not the increment in production would be secured. The third transaction involved an oil-barter arrangement with Mexico, which had not yet been finalized. A possible slippage in bauxite exports in 1983/84 underscored the importance of the mid-year review and the program's demand management focus.

The question had been raised, the staff representative recalled, whether the inflationary effect of the new exchange arrangements made the forecast of an inflation rate of 8-10 percent somewhat optimistic. A significant proportion of import transactions had already been made in the parallel exchange market before the January 1983 measures had been introduced. There had been little acceleration in the consumer price index in the first four months of 1983; the annualized rate for that period was 7.8 percent. On the other hand, the recent policy changes, involving increases in the domestic price of gasoline, would significantly boost the rate of inflation. As a result, the projected annual average rate of inflation of 8-10 percent could prove to be a little optimistic.

Direct price controls had been significantly reduced in the first two years of the extended arrangement, the staff representative noted. The World Bank staff, on whom the Fund staff had relied to some extent in assessing pricing policy in Jamaica, felt that the policy was no longer a major issue. The second structural adjustment loan did not highlight pricing as a policy issue.

The staff had made strong efforts to make sure that the projection of capital inflows in 1983/84 was realistic, the staff representative from the Western Hemisphere Department said. There had been two meetings of donor countries--one in Paris in April 1983 and the other during the 1983 annual meeting of the Caribbean Development Bank--during which

projected donor flows had been identified on a country-by-country basis. Although the figures on donor commitments were realistic, much would depend on the effort that the Jamaican authorities made to draw down lines of credit committed by donor countries. As for commercial bank loans, there had been three meetings with a steering committee of banks, and an agreement had been reached in principle on refinancing of maturities in the remaining three quarters of the current program and on refinancing of the maturities for the following year as well. Including a drawdown of the balance of payments loan that had been negotiated with certain banks, disbursements of some $25 million and a rollover of maturities of $55 million were expected. Nevertheless, a shortfall from the program could occur; much would depend on the success that the authorities had in their approach to European banks in the second half of 1983. As for projecting donor assistance over the next few years, the staff had approached major donors and had obtained indicative commitments. Mr. Ainley's question about reforms in the nonbank area could be taken up on a bilateral basis.

Mr. Joyce commented that Executive Directors clearly understood the problems facing Jamaica. Mr. Mtei had made useful comments on broader policy issues that went beyond the Jamaican case. He agreed with Mr. Mtei that the Fund should show some flexibility in its dealings with many developing countries, and particularly those whose programs had not been fully successful largely because of developments beyond their control. In such cases, which included the present case of Jamaica, ways should be found to bring the program back on track. As for the future, Mr. Ainley had appropriately noted that Jamaica needed both good luck and good management.

It was his understanding, Mr. Joyce said, that the contract for 500,000 tons of alumina was reasonably firm and was to be signed in the near future. The contract with the alumina refinery was tied to ongoing negotiations on the bauxite levy.

It was true, as Mr. Erb had suggested, that the transfer of profits from the public enterprises and the Bank of Jamaica was in effect a one-time-only transfer, Mr. Joyce commented. However, the important point was that the authorities were determined to bring the finances of the public enterprises under control and to proceed both with disinvestment and with the effort to improve operational efficiency, thereby enabling the authorities to eliminate subsidies and the enterprises possibly to become profitable.

The authorities were deeply concerned about the need to bring current expenditure under better control, Mr. Joyce said. They had chosen to emphasize a reduction in capital expenditure at the present stage because they could make the reduction quickly. The freeze on civil service employment was still in effect, and the wage increases that had been granted had been designed mainly to reduce the compression of salaries that had intensified in recent years, making it difficult for the authorities to hire and retain qualified senior and technical staff. A zero-base budget

exercise had been started, and a survey was being made to evaluate the services financed by public expenditure. The authorities hoped that the studies would help them in the effort to constrain the growth of public expenditure.

Executive Directors had recognized the magnitude of the effort that the authorities were making to shift import and export transactions to the parallel market, Mr. Joyce commented. That task clearly had not yet been completed, and the authorities wished to continue to keep a close eye on the exchange rate system, and to identify other goods that could be transferred to the parallel market. There had been some difficulties in the operation of the parallel market in the tourist sector, and the authorities would take whatever steps were necessary to ensure that the problems were solved. They did not want the exchange rate system to become excessively complex or confusing.

Some increase in the rate of inflation was likely to have occurred because of the large shift in transactions to the parallel market, Mr. Joyce went on. Some of the inflationary impact had already been reflected in transactions occurring on a no-funds license basis. It was possible that the rate of inflation for the program year as a whole, and particularly in the second half of the year, would exceed the projected 8-10 percent.

The effort to project a medium-term outlook, Mr. Joyce said, was a part of the attempt to construct a scenario that would provide an idea of future requirements. However, at the present stage, it was impossible to say precisely what steps would have to be taken in 1984/85 and 1985/86. That matter would be kept in mind for future discussions on Jamaica.

The Executive Board then turned to the proposed decisions, which were approved.

The decisions were:

Extended Arrangement

1. Jamaica has consulted with the Fund in accordance with paragraph 3(c) of the extended arrangement for Jamaica (EBS/81/79, Sup. 3, 4/15/81) and paragraph 4 of the letter of March 31, 1982 attached thereto in order to reach understandings with the Fund regarding policies and measures that Jamaica will pursue and to establish performance criteria, subject to which purchases may be made by Jamaica during the third year of the extended arrangement.

2. The letter from the Prime Minister and Minister of Finance and Planning, and the Governor of the Bank of Jamaica dated May 24, 1983 together with the Economic Policy Memorandum of Jamaica for FY 1983/84 and the Technical Memorandum of Understanding annexed to it, shall be attached to the extended arrangement for Jamaica (EBS/81/79, Sup. 3, 4/15/81) as amended, and the letter dated March 31, 1982 together with the annexed Economic Policy Memorandum of Jamaica and the Technical Memorandum of Understanding shall be read as supplemented and modified by the letter dated May 24, 1983 together with the Economic Policy Memorandum and Technical Memorandum of Understanding annexed to it.

3. Accordingly, Jamaica will not make purchases under this extended arrangement throughout the third year:

(a) during any period in which

(i) the limit on the net domestic credit to the public sector as specified in paragraph 2 of the Technical Memorandum of Understanding annexed to the letter dated May 24, 1983, or

(ii) the limit on the net domestic assets of the Bank of Jamaica as specified in paragraph 3 of the Technical Memorandum of Understanding annexed to the letter dated May 24, 1983, or

(iii) the target for the net international reserves of the Bank of Jamaica as specified in paragraph 4 of the Technical Memorandum of Understanding annexed to the letter dated May 24, 1983, is not observed; or

(b) if the limit on disbursements on account of new external debt as specified in paragraph 5 of the Technical Memorandum of Understanding annexed to the letter dated May 24, 1983, is not observed; or

(c) if the limit on commercial external payments arrears, on deferred replenishment obligations to the EDF, and deferred obligations for oil payments to Venezuela and Mexico, as specified in paragraph 4 of the Technical Memorandum of Understanding annexed to the letter dated May 24, 1983, is not observed; or

(d) during any period after December 31, 1983, until the mid-year consultation with the Fund described in paragraph 4 of the letter dated May 24, 1983, has been completed and any understandings deemed by the Fund to be necessary have been reached.

4. Purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 365.4 million until July 15, 1983; and the equivalent of SDR 402.8 million until October 15, 1983; and the equivalent of SDR 440.2 million until January 15, 1984.

5. In the light of the letter dated May 24, 1983, the Fund finds that no additional understandings are necessary concerning the nonobservance of the performance criteria as of end-March 1983 and that Jamaica may make purchases under the extended arrangement, notwithstanding the multiple currency practices and exchange restrictions introduced by Jamaica as described in EBS/83/122, and in respect of purchases of up to the equivalent of SDR 365.4 million under the arrangement through June 30, 1983, also notwithstanding the limits specified in paragraph 3, sections (a) and (c) above.

Decision No. 7447-(83/91), adopted
June 24, 1983

b. Exchange System

The multiple exchange rate system, and the 3 percent commission levied on foreign exchange payments (as described in EBS/83/122) constitute multiple currency practices. Jamaica also maintains restrictions on payments and transfers for current international transactions, including those arising from external payments arrears (as described in EBS/83/122). In view of the circumstances of Jamaica, the Fund grants approval of the multiple currency practices and the exchange restrictions (described in EBS/83/122) until December 31, 1983, or the completion of the mid-year review, whichever is earlier.

Decision No. 7448-(83/91), adopted
June 24, 1983

APPROVED: November 23, 1983

LEO VAN HOUTVEN
Secretary