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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/96

10:30 a.m., July 1, 1983

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

| Executive Directors | Alternate Executive Directors |
|---|---|
| A. Alfidja | W. B. Tshishimbi |
| | L. E. J. Coene, Temporary |
| | A. Le Lorier |
| A. Donoso | |
| | T. A. Connors, Temporary |
| | J. C. Williams, Temporary |
| M. Finaish | S. R. Abiad, Temporary |
| T. Hirao | T. Yamashita |
| J. E. Ismael | Jaafar A. |
| R. K. Joyce | |
| | C. Robalino |
| | G. Grosche |
| G. Lovato | |
| | C. J. Batliwalla, Temporary |
| | J. E. Suraisry |
| J. J. Polak | |
| | K. G. Morrell |
| G. Salehkhou | O. Kabbaj |
| F. Sangare | E. I. M. Mtei |
| M. A. Senior | |
| | A. Lindø |
| N. Wicks | C. Taylor |
| | Wang E. |

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

African Department: J. B. Zulu, Director; A. Basu J. P. Briffaux, A. B. Diao, C. J. Hoban, M. G. Kuhn. Asian Department: J. T. Boorman, X. Vongsathorn, M. Zavadjil. Central Banking Department: P. Ewenczyk, S. P. Leite. European Department: M. Z. Khan. Exchange and Trade Relations Department: D. K. Palmer, Associate Director, W. A. Beveridge, Deputy Director; K. M. Meesook. External Relations Department: H. P. Puentes. Fiscal Affairs Department: M. I. Blejer, M. Z. Yucelik. IMF Institute: A. Boureima, Participant. Legal Department: A. O. Liuksila, S. A. Silard. Research Department: K.-Y. Chu, L. U. Ecevit, N. M. Kaibni, M. S. Khan, A. Salehizadeh. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. Fajgenbaum, J. Ferrán, O. Gronlie, M. E. Hardy, J. E. Zeas. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: J. R. N. Almeida, S. E. Conrado, J. Delgadillo, L. K. Doe, L. Ionescu, P. Kohnert, H.-S. Lee, P. D. Péroz. Assistants to Executive Directors: H. Arias, L. Barbone, J. Bulloch, M. B. Chatah, M. K. Diallo, M. Eran, C. Flamant, I. Fridriksson, A. Halevi, M. Hull, H. Kobayashi, Y. Okubo, E. Portas, J. Reddy, Shao Z., D. I. S. Shaw, P. S. Tjokronegoro, N. Toe, M. Toro, A. Yasseri.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. J. E. Ismael as Executive Director.

2. NIGER - 1983 ARTICLE IV CONSULTATION; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1983 Article IV consultation with Niger (SM/83/98, 5/24/83; and Sup. 1, 6/13/83), together with a request by Niger for a purchase equivalent to SDR 12 million under the compensatory financing facility (EBS/83/120, 6/9/83; and Sup. 1, 6/29/83). They also had before them a report on recent economic developments in Niger (SM/83/66, 4/28/83).

Mr. Alfidja made the following statement:

> In recent years, the performance of the Nigerien economy has been dominated by developments in the uranium sector. Following a price boom and a sustained demand in the mid-1970s, uranium production expanded quite rapidly. During the period 1978-81, uranium sales represented 17 percent of GDP on average and contributed 17 percent of government revenue. Likewise, uranium export receipts accounted for 80 percent of export earnings. The sharp fall in uranium export prices by 35 percent in 1981 led to a substantial slowdown in uranium-related activities, hence creating financial pressures on the economy.
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> Overall economic activity contracted in 1982, for real GDP declined by about 1 percent, compared with an increase of 1 percent in the preceding year. This downturn resulted chiefly from the adverse developments in the uranium market and from a marked slowdown in government expenditure, especially capital outlays on public works and construction projects. Furthermore, inadequate rainfall has affected adversely agricultural production and livestock population. On the other hand, the consumer price index rose less rapidly in 1982 than in the preceding year, largely as a result of an improvement in supply and the implementation of a more restrained fiscal policy.
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> In 1979, the Government began to implement a five-year development plan (1979-83), centered around, inter alia, attaining self-sufficiency in food production, and improving basic infrastructure. Although actual investment exceeded target by about 48 percent during 1979-81, it was more concentrated in the socioeconomic and administrative infrastructure. In the light of these developments, the Government has decided to revise its investment program priorities for 1982-83 with the assistance of the World Bank. During 1982-83, the share of investment allocations for agriculture, livestock, and rural infrastructure will be more than doubled from the 10 percent

projected initially to 22 percent. Similarly, the share allocated to industry will be increased, while those of mining and energy will fall. The Nigerien authorities' decision to undertake a consolidation and reorientation of investment priorities is an indication of their flexible approach to the development effort. However, I share my authorities' view that it would be unrealistic to expect rapid results arising from this diversification effort given the formidable physical and financial constraints that stand in the way. They would like to stress, however, their firm intention to adopt policies geared toward the expansion of the production and export base of the country.

On the fiscal front, the overall deficit rose by about 5 percentage points to close to 11 per cent of GDP in 1980/81 owing to the decline in all major tax categories following the slowdown in uranium export earnings. The deterioration in the overall fiscal posture was also caused by the increase in foreign-financed projects in infrastructure, mining, and education, while, as a proportion of GDP, current outlays declined marginally. The worsening of the fiscal operations was arrested in 1981/82, when the overall deficit decreased by nearly 4 percentage points to 7 percent of GDP. This improvement, which arose entirely from a near 23 percent fall in real total spending, is an indication of my authorities' resolve to control expenditure growth in the face of declining revenue.

Monetary developments in 1982 were dominated by a more rapid growth in net credit to the Government from about 6 percent in 1981 to 20 percent, whereas private sector credit slowed during the same period. As a result, total domestic credit expansion accelerated from close to 22 percent in 1981 to 33 percent in 1982. The weakening in the Government's net creditor position reflected the need to accommodate the financing of a higher proportion of the fiscal deficit in 1981/82 due to a substantial shortfall in foreign drawings, while the slowdown in private sector credit resulted largely from lower borrowing needs due to mediocre harvests and the contraction of overall economic activity, especially in the mining sector.

In 1981, despite the aforementioned decline in uranium prices and a decrease in the net foreign assets of the central bank, the overall balance of payments registered a surplus of about SDR 31 million due largely to a 32 percent increase in net long-term capital inflows and a moderate decrease in imports. In view of a further fall in uranium export earnings in 1982 due mainly to a 23 percent decline in volume, imports were reduced again by 19 percent. As a consequence, the current account deficit decreased by 14 percent to some SDR 175 million in 1982. However, a large balance of payments deficit estimated at SDR 119 million emerged in 1982 due to a sharp 62 percent decrease in long-term capital inflows combined with a more-than-halving of the net foreign assets inflows of commercial banks. This fall in net capital inflows was largely attributable to considerably lower inflows of financing related to development projects.

My authorities have also shown flexibility in pricing policy. Indeed, in order to stimulate agricultural output, producer prices were increased substantially in 1980/81 and 1982/83 crop years for millet (100 percent), sorghum (43 percent), rice (nearly 55 percent), groundnuts (33 percent), cowpeas (89 percent), and cotton (about 94 percent). Concurrently, the sale prices of foodcrops were raised to levels commensurate with the opportunity cost of imports. The price of petroleum products was raised by 25 percent in 1982 in order to restrain consumption. Similarly, the tariffs for water and electricity were increased with a view to curtailing demand and reducing company losses. A further increase in electricity tariffs is under consideration.

In 1983, no recovery of overall economic activity is expected as real GDP is forecast to decline further by 1.5 percent, reflecting largely a contraction in uranium-related activities. This outturn, together with a projected small improvement in the export of livestock products, is expected to give rise to a marginal 2 percent increase of export earnings to about SDR 340 million in 1983. As a result largely of this export performance, and a further 15 percent decrease in imports, the current account deficit is forecast to fall by nearly 50 percent to about SDR 93 million in 1983. The combination of this amelioration with a moderate increase in net long-term capital inflows is to lead to a considerable 78 percent fall in the balance of payments deficit to SDR 26 million in 1983. Reflecting the continuous slump in uranium-related activities as well as the reduction in imports, only a marginal 3 percent growth in government revenue is envisaged in 1982/83. In order to limit the 1982/83 overall fiscal deficit to a sustainable level, the Government has undertaken to further curtail spending. To this end, nominal capital expenditure financed from domestic and foreign sources are to be reduced by 49 percent and 18 percent, respectively. As regards current expenditure, more than 60 percent of the CFAF 6 billion projected increase constitutes a provision for higher interest payments. In real terms, for the second consecutive year, total expenditure is expected to be 14 percent lower than in 1981/82. This fiscal redressment effort rests on some revenue-increasing and expenditure-restraining measures taken by the Government in 1982/83. These include the increase in tax rates on alcoholic beverages, petroleum products, the introduction of a new levy on cereal imports, the slowdown of recruitment, the withdrawal of all official cars formerly allocated to civil servants, and a reduction in the number of scholarships. Many of the aforementioned revenue measures are in line with the recommendations made by a Fund technical assistance expert. Other recommendations dealing with such areas as corporate and personal income taxes and real property tax are being implemented or are under active review. While remaining committed to the redressment of fiscal operations, it is the Government's view that revenue performance could be adversely affected by inadequate customs capabilities, especially at the Nigerien border, the insufficient number of trained tax personnel, and the effect of the continuous decline in overall activity.

Finally, in the monetary field, contrary to developments in 1982, private sector credit is forecast to expand more rapidly than credit to the Government. However, on the whole, total domestic credit is forecast to grow in 1983 at the same rate of about 33 percent as in 1982.

The Government of Niger is also concerned about the financial state of many public enterprises and has expressed at the highest level its intention to take steps to deal with the difficulties being experienced by these enterprises following the completion of studies under way. These measures may include further price adjustments, the selling of some enterprises to the private sector, and the closing of others.

Despite the serious financial difficulties that have beset the economy since 1981, the Government has remained current on its external obligations and is actively examining ways to reduce domestic arrears.

As indicated by the staff, Niger has experienced a shortfall of export earnings in 1982 estimated at some SDR 47 million due principally to the fall in the volume and price of uranium exports. This decline in uranium receipts was a reflection of the decrease in demand due to the growing resistance to the construction and operation of nuclear facilities as well as to the existence of large inventories in industrial countries. Little improvement in uranium receipts is expected in 1983. It is in this context that my authorities have introduced a request for compensatory financing for SDR 12 million. As stated by the staff, Niger has cooperated with the Fund, and my authorities intend to strengthen this cooperation in order to resolve the financial and economic difficulties being experienced by the country.

To end, I would like to reiterate my authorities' strong commitment to consolidating and furthering the gains achieved, especially in the fiscal field, despite the adverse developments in the uranium market. In support of their effort, they have requested a Fund mission to negotiate a stand-by arrangement.

Extending his statement, Mr. Alfidja commented that the authorities were committed to introducing the necessary fiscal measures, but they would need to discuss them thoroughly with the staff in order to ensure correct timing.

Mr. Sangare indicated his agreement with the staff appraisal. The difficulties experienced by Niger in the previous two years were typical of problems confronting exporters of primary products. Because their export sector was characterized by high commodity and market concentration, they were highly vulnerable to fluctuations in world demand for their commodities. That situation was compounded by the fact that Niger was both a landlocked and a Sahelian country, in which agricultural production had been considerably reduced by progressive desertification.

Niger's economy had prospered with the uranium boom, Mr. Sangare noted, but the downturn in the uranium market, combined with adverse climatic conditions, had caused GDP to decline at an annual rate of 1 percent in 1981/82, compared with a high growth rate of 9.3 percent in 1979/80. Consequently, national savings and investment had declined considerably. Furthermore, due to the Government's heavy dependence on uranium revenues, the budget deficit had widened to 10 percent of GDP. The shortfall in export proceeds had also led to a sharp deterioration in the balance of payments position and to an increase in the current account deficit. Those large fiscal and external imbalances had required heavy external borrowing, increasing sharply the country's external debt and debt service costs.

The authorities were aware of the problems and the need to reduce the external and internal deficits, while promoting the growth of real GDP, Mr. Sangare went on. The staff had projected a moderate recovery in the growth rate of GDP if the financial imbalances were reduced. However, with no signs of improvement in world demand for uranium, that assumption seemed optimistic.

The authorities' intention to reformulate the public investment program clearly indicated their recognition of the need to take adjustment measures, Mr. Sangare considered. In view of the depressed demand for uranium, considerable emphasis was being put on the rural sector in order to promote the growth of agricultural output. Furthermore, measures had been taken to increase producer prices and to implement various projects aimed at raising productivity, in particular, that of export crops such as cotton and groundnuts.

There was a clear need to improve the performance and rationalize the operations of the public enterprises, Mr. Sangare continued. The authorities' intention to study the problem of public enterprises with the help of the World Bank was therefore welcome. However, the systematic privatization of public enterprises should not be seen as the only solution, especially in areas where it was not economically viable for private enterprises to provide services.

Commenting on fiscal policy, Mr. Sangare remarked that it was the authorities' intention to reduce the fiscal deficit from 10 percent of GDP to 3.3 percent of GDP in 1982/83. The measures undertaken to increase revenues through the introduction of new taxes and a reform of the tax system in line with the recommendations of the Fiscal Affairs Department were welcome.

The external situation was difficult, Mr. Sangare commented, and with a public debt service ratio of 23 percent, a 40 percent reduction in the current account deficit would be difficult to achieve. Was the target realistic? Given the need for a reduction of domestic payments arrears, there would be a serious strain on the budget. The Fund could play a role in Niger's adjustment by helping the authorities to reschedule their debts and to adjust the maturity structure. He trusted that during forthcoming negotiations with the authorities regarding a stand-by arrangement, the staff would be flexible when formulating the program in order to facilitate debt rescheduling.

He had no major difficulties with respect to the request for a drawing under the compensatory financing facility, Mr. Sangare indicated. The export shortfall of SDR 47 million had been caused by a sharp decline in demand for uranium and the adverse impact of droughts. The proposed purchase was only one quarter of the total shortfall, and the projected increase in export earnings indicated that the shortfall was temporary. The authorities had cooperated with the Fund and had taken the necessary steps to correct their balance of payments difficulties.

Miss Le Lorier commented that Niger was a Sahelian country; its agricultural production was dependent on weather conditions and had suffered from the adverse effects of recurrent droughts. Despite those unfavorable conditions, agricultural output had regularly increased, an outcome that certainly indicated that, in contrast to many other countries, Niger had pursued sound agricultural policies for which it should be commended. Producer prices had been sizably increased in 1982, providing adequate incentives for farmers. Presumably, agricultural performance had been underestimated--at least in the public finance and balance of payments statistics--as the overvaluation of the naira had induced distorted and unrecorded trade flows with neighboring Nigeria.

Niger was also a landlocked country, and, therefore, transportation costs were high, making it difficult for the authorities to develop an export-oriented industrial or mining sector, Miss Le Lorier went on. Uranium, with a high value per unit of weight, had been an ideal candidate for diversifying the economy away from agricultural production. Uranium production had increased in the aftermath of the first oil shock, when ambitious programs for the development of nuclear production of electric power had been launched in industrialized countries. Owing to the high energy costs incurred by the uranium mines--which were initially relying on imported petroleum products--the construction of a thermal power plant exploiting local coal resources had been undertaken.

In the following years, the fiscal resources accruing from the uranium sector had been used appropriately to launch an investment program aimed at creating the necessary conditions for further economic development, Miss Le Lorier continued. The recent weakening demand for uranium and the associated substantial reduction in prices had hit Niger at the worst moment--at a time when repayments of principal on external borrowings contracted for the construction of the mines and thermal plant had begun to fall due. A heavy burden had been placed on the Government's financial operations, which were already under strain because of the reduction of uranium revenues. The authorities' practice of resorting to extrabudgetary outlays for public investment financing, and their overoptimistic appraisal of the availability of foreign financing had contributed to the sharp increase in the overall fiscal deficit in 1979/80 and 1981/82.

The authorities had already implemented a number of courageous measures--on both the revenue and expenditure sides--aimed at bringing the fiscal situation under control, Miss Le Lorier remarked. The beneficial effects of those measures would reduce the overall fiscal deficit substantially in 1983/84. She welcomed the authorities' recourse to Fund technical assistance in the fiscal area and their active cooperation with the Fund.

The development effort needed to be tailored to the new financial constraints, Miss Le Lorier considered. The authorities had undertaken a review of their investment priorities and would formulate their 1984 investment program with the assistance of the World Bank. She shared Mr. Alfidja's view that results from the ongoing diversification effort would not materialize rapidly; for that reason, it was all the more important that the main focus of the program should be on productive projects, particularly in the agricultural and livestock sectors. In addition, the financial problems of the parastatals would have to be tackled in line with the policy recommendations of the studies already completed.

The adjustment effort already under way was certainly painful, but there seemed to be no alternative, Miss Le Lorier said. Niger had thus far managed to avoid the accumulation of public payments arrears on the external side. However, debt service projections demonstrated that the situation would remain difficult in the years to come. Moreover, the "dette occulte" was sizable, and the related domestic arrears were estimated to have reached CFAF 33.6 billion. The reduction or elimination of those arrears at a pace consistent with available financing would be an essential condition for revitalizing domestic economic activity.

The assistance from the Fund appeared very much needed, especially in light of recent developments, Miss Le Lorier concluded. She supported the proposed decision regarding the compensatory financing facility and welcomed the request by the authorities for the negotiation of a one-year stand-by arrangement. She was confident that those negotiations would prove successful and would be completed soon, given the authorities' strong commitment to the adjustment effort.

Mr. Joyce stated that he was impressed by the steps that the Niger authorities were taking and by their recognition that their fate depended not only upon developments in world markets, but also upon actions taken to protect themselves. Uranium had served Niger well in the 1970s and had led to rapid economic growth and to increased public investment. More of that public investment should perhaps have been directed toward productive public investment rather than investment in infrastructure.

The fall in the price of uranium by 35 percent, Mr. Joyce commented, had led to an actual decline in GNP over the previous two years. Inevitably, uranium export revenues as well as earnings from uranium-related activities had dropped, resulting in financial pressures on the economy. Those problems had been apparent at the time of the 1981 Article IV consultation, when Executive Directors had discussed the need to scale down investment outlays, to curtail the growth in government expenditures, and to avoid further increases in debt.

Since 1981 some progress had been made, Mr. Joyce considered. There had been substantial increases in producer prices of major food and export crops, which undoubtedly had helped to sustain the economy and would contribute to both the expected reduction in imports and the slight improvement in exports.

It was unlikely that growth would reach the levels attained during the uranium boom, Mr. Joyce went on. The authorities had no option but to take further action on the investment front and to improve the fiscal and external balances. The authorities were to be commended for reducing the fiscal deficit from close to 11 percent of GDP in 1981 to an estimated 7 percent in 1982. The goal of reducing the deficit to 5.5 percent of GDP in 1983 was slightly higher than originally projected, but would represent a major achievement if it could be attained. The authorities had demonstrated their determination to make the necessary adjustment and to compensate for the deterioration on the external side.

He could support the request for a drawing under the compensatory financing facility, Mr. Joyce stated. He welcomed the authorities' request to open negotiations with the Fund for a one-year stand-by arrangement. Finally, he was most impressed that the authorities had moved quickly--even before the Executive Board had discussed the 1983 Article IV consultation with Niger--to implement some of the measures that the staff had called for.

Mr. Suraisry indicated his support for the proposed decisions. The economic and financial position of Niger had worsened considerably since the 1981 Article IV consultation. The prolonged depression in the uranium market and the succession of poor harvests had sharply reduced external and budgetary revenues. Real growth had been negative, and serious imbalances had emerged in the fiscal and external accounts. The increase in the debt service burden and the accumulation of sizable domestic arrears were of particular concern. However, it was encouraging that the authorities recognized the need for adjustment and were acting on the staff's recommendations.

The recent shift in policies provided a good base for a stand-by arrangement, which should be negotiated in the near future, Mr. Suraisry went on. The most urgent task was to reduce the overall budget deficit to a sustainable level, if the authorities were to meet their debt servicing obligation and repay domestic arrears. The present and prospective financing constraints underlined the need to reassess development priorities and to scale back the public investment program. He hoped the authorities would make a determined effort to formulate a revised program in cooperation with the World Bank and to bring investment spending within the budgetary framework.

More important, he welcomed the comprehensive package of tax measures outlined in Supplement 1 to the staff report, which fully reflected the advice of the Fund staff, Mr. Suraisry continued. The measures should lead to a significant strengthening of the revenue base over the next three fiscal years. The proposed cuts in current spending and the introduction of more effective monitoring procedures were also important steps in the right direction. Determined efforts would also be required to tackle the financial problems of the public sector. The recent studies of the two major corporations were useful, and similar studies would be made, with World Bank assistance, of the marketing agencies. It was essential that the authorities should implement the specific recommendations to cut costs, raise utility rates, and improve the management of those enterprises.

On the external side, the room for maneuver was limited by the relatively unfavorable prospects for uranium exports and by the need to service outstanding public and private debt, much of which had been acquired on commercial terms and at short maturities, Mr. Suraisry commented. He shared the staff view that priority should be given to export growth and diversification; the intention to expand production of export crops and develop the country's livestock resources was therefore welcome, although it would take time to bring about. He wondered whether the authorities were considering the staff suggestion of approaching the Paris Club for debt relief.

Mr. Abiad noted that Niger's economic position had deteriorated since the 1981 Article IV consultation; real GDP had recorded negative growth rates, while domestic and external imbalances had remained large, in spite of inital efforts to reduce them. Two interrelated factors had contributed to those disappointing results. First, and most important, exogenous developments in the uranium sector had adversely affected the revenue side of the budget, the balance of payments, and the debt service burden. Second, the authorities had found it difficult to reduce the high level of expenditure on public investment after 1981, when the favorable trend of uranium prices had started to turn around. The reduction in export revenues had significantly affected the financial constraints originally assumed in the framework of the 1979-83 Development Plan. Realizing the need to reduce the level of external borrowing and to contain the rate of increase in the debt service ratio, the authorities, in 1982, had reviewed the original investment targets of the Plan and had decided to focus efforts and resources on the completion of high-priority projects.

Those two factors, together with the financial operations of public enterprises had exerted considerable pressure on the central government deficit, Mr. Abiad went on. The fiscal deficit had remained relatively large in 1982, although the revised estimates were lower than the initial estimates, and its expected persistence in 1983 underlined the need for corrective action on both the expenditure and the revenue sides. It was encouraging that the authorities were actively seeking to rationalize development spending and to improve the profitability of public enterprises, although due regard needed to be paid to the important social services rendered by some of them. Furthermore, the authorities were fully aware of the need to reform the tax system by increasing its income elasticity and widening the revenue base.

Noting the authorities' determination to proceed further with adjustment, Mr. Abiad observed that the corrective measures already taken and those envisaged in the future appeared to provide the basic elements of what could eventually become a stabilization program deserving Fund support.

Some of the updated economic and financial indicators presented in Supplement 1 to the staff report differed significantly from earlier figures, Mr. Abiad said, and he wondered whether those modifications were due entirely to factors referred to in the supplement or whether they also indicated the possible existence of some difficulties relating to the data base.

In conclusion, the authorities' request for a purchase under the compensatory financing facility seemed to meet all the requirements, and he could support the proposed decision, Mr. Abiad remarked. However, the calculated export shortfall for 1982 represented about four times the amount of the proposed purchase. Could a larger porportion of the shortfall have been compensable, taking into account the possibility that Niger would soon be entering into a stand-by arrangement with the Fund?

Mr. Salehkhou stated that during the previous two years Niger's economy had been adversely affected by declining international demand for uranium. In addition, the volume of aid had been lower than anticipated; agricultural output had been poor; access to capital markets had become increasingly difficult; and the debt situation had deteriorated further. As a result, the economy had suffered both internal and external imbalances. The terms of trade had deteriorated sharply in 1981 and to a lesser extent in 1982; consumer prices had risen significantly, and exports had declined by 20 percent in 1982. The budget deficit remained at 10 percent of GDP, and the current account deficit had reached 14 percent of GDP, while the external debt equaled about 50 percent of GDP.

The Government had taken significant measures to address the problems, Mr. Salehkhou noted. New tax measures and measures to restrain expenditure had been adopted in order to improve the budget position. In the area of monetary policy, the authorities' aim was to limit the expansion of domestic bank credit. Public investment had been significantly reduced in order to keep within the existing budgetary framework.

Important measures had been adopted to consolidate the finances of public enterprises and to bring their pricing policies more in line with market conditions, Mr. Salehkhou went on. Several key prices had been raised recently. The technical assistance from the World Bank would be particularly helpful in studying the financial operations of public enterprises.

He particularly welcomed the authorities' decision to conclude a stand-by arrangement with the Fund, Mr. Salehkhou continued. Perhaps a longer-term arrangement covering three years would be more appropriate to lay the foundation of a lasting structural reform. He shared the staff view that there was a need to restrain public investment and to direct it to the productive sectors. He hoped that the authorities' plan to reduce domestic arrears would prove successful and that adequate foreign assistance would be forthcoming so that a meaningful structural adjustment program could be worked out.

Mr. Williams commented that Niger was a Sahelian country and faced particular difficulties. The authorities' commitment to improving the performance of the agricultural sector and the success they had achieved so far were commendable. They intended to work with the World Bank to prepare a new investment program that would emphasize futher development of Niger's agricultural and livestock resources.

With respect to an eventual Fund-supported adjustment program, Mr. Williams commented that it was critically important for the authorities to formulate a public sector budget for 1983/84, that realistically reflected the internal and external financial constraints confronting the country. Such a budget would necessarily entail a significant reduction in the overall deficit. In addition, he urged the authorities to devise a program for the reduction and eventual elimination of domestic payments arrears. He shared the authorities' concern about the effect of Niger's external debt service obligation on the budget. The possibility of seeking debt relief from the Paris Club deserved careful consideration, and in that respect, he would welcome further comments from the staff or Mr. Alfidja.

Commenting on the request for a drawing under the compensatory financing facility, Mr. Williams said that he supported the proposed decision. However, the shortfall was part of a larger and more serious balance of payments problem. He was therefore pleased with the steps already taken by the authorities and urged them to persevere in their efforts to formulate a comprehensive adjustment program that could be supported by a stand-by arrangement.

The staff representative from the African Department remarked that a number of Executive Directors had expressed doubts about the pace of recovery and the speed of adjustment, particularly with respect to the budget and the external current account deficits. The staff was also skeptical about a rapid recovery, and it was unlikely that the growth rate would be high in the following two years. The staff had emphasized to the authorities the importance of reducing financial imbalances so that investment and productive activities were not constrained in the long term. However, in the short term, lower levels of investment would be required. The authorities would have to shift investment priorities toward productive projects, particularly in the agricultural and livestock sectors, and if weather conditions were not as harsh as in the previous two years, it was possible that GDP could grow at a modest rate in the future.

With respect to the size of the reduction in the financial imbalances, there were three factors that would affect the level of imports, the staff representative said. First, if the level of foreign aid fell, there was a tendency for imports related to the aid-assisted projects to decline also. Second, the authorities had already considerably reduced expenditure on extrabudgetary outlays, which would therefore lead to a reduction of imported inputs in productive sectors. Third, the authorities would be increasing taxation, particularly of imports. Most adjustment would have to come on the import side, but it was reasonable and not excessively optimistic to expect an improvement in the budget and balance of payments position.

The operation of the banking system had contributed to the underlying financial imbalances, the staff representative went on. The commercial banks had relied on their substantial access to short-term borrowing abroad to help finance activity in Niger. A reduction in foreign borrowing by those banks would be associated with a reduction in expenditures and, therefore, in imports.

Debt service--both private and public--would be high in 1984, the staff representative continued. At least two thirds of the maturities falling due in 1983/84 would be owed to private creditors. A small proportion, about 20 percent, would be owed to the Paris Club official creditors. Although there was undoubtedly a need for debt relief, it was a question of whether the Paris Club or the private creditors should be approached. The terms of a new loan from private creditors would need to be considered, but it was likely that the terms of rescheduling offered by the Paris Club would not be as strenuous as those offered by the private creditors, primarily because both interest payments and amortization would be considered in rescheduling arrangements through the Paris Club.

The high level of private foreign debt had arisen as a result of the budgetary arrears of domestic enterprises, the staff representative explained. Budget and extrabudgetary expenditures for project outlays therefore had to be prefinanced through credits from head offices abroad and through loans from foreign banks. Any adjustment program would have to eliminate budgetary arrears to domestic enterprises, and those enterprises would then have to make overdue payments to external creditors to reduce the level of private debt. The main problem was that there was no clear estimate of the size of the foreign component in domestic debt.

A number of Directors had wondered whether a longer-term arrangement would perhaps be more appropriate, the staff representative from the African Department remarked. The authorities were reformulating the adjustment program and taking steps to reschedule debt, review the investment program, and to introduce a reform of the tax system. A stand-by arrangement would be suitable as a means of initiating the preliminary phase of the adjustment program, but the staff would consider the need for a longer-term arrangement once the policy strategies were formulated.

The Deputy Director of the Exchange and Trade Relations Department, commenting on whether a larger proportion of the export shortfall could have been met by the Fund, said that the staff mission to Niger in July 1983 would be discussing the general question of further use of resources. Drawings under the compensatory financing facility beyond 50 percent of quota depended on the merits of the case and should also be considered within the context of an appropriate adjustment program, which the authorities wished to negotiate.

Mr. Alfidja stated that his authorities would welcome the opportunity to discuss with the staff a further use of Fund resources under the compensatory financing facility. He agreed with the Deputy Director of the Exchange and Trade Relations Department that the request would have to be considered within the policy framework agreed upon by the Executive Board. The authorities were unfamiliar with Fund programs, Mr. Alfidja went on. Furthermore, there was a lack of skilled staff in Niger, and the collection of reliable data also presented a real problem. The authorities were therefore being cautious in formulating and implementing an adjustment program, and they were not excluding the possibility of entering into a longer-term program using Fund resources.

With respect to the debt problem, he could assure Directors that discussions concerning debt rescheduling were under way, Mr. Alfidja remarked. The structure of the debt in Niger was a problem, but the authorities were seeking advice and were considering the option of seeking debt relief through the Paris Club. A national committee had been established to examine the short-term foreign borrowings of the banking system and the various private contractors, and a number of recommendations had been made to settle part of that debt.

Finally, the authorities had begun to take measures to improve the operation of public enterprises and to reform the tax system, Mr. Alfidja said, but they were being implemented as part of a medium-term program.

The Chairman made the following summing up:

In concluding the 1983 Article IV consultation with Niger, Directors broadly agreed with the assessment of the economic situation and the policy recommendations contained in the staff appraisal. They noted that over the past two years real GDP had declined, the external terms of trade had deteriorated, and the imbalances in the public sector and in the external accounts had been large. Moreover, the Government's domestic arrears were sizable and the external debt service burden had increased markedly. In these circumstances, while supporting Niger's request for a drawing under the compensatory financing facility, they strongly urged the authorities to persevere with and to strengthen policies to reduce the country's large internal and external imbalances.

As high levels of public investment had contributed to the financial imbalances, Directors stressed the need to make the public investment program consistent with the country's financial constraints and the weak external demand for uranium, and to stress the development potential of agriculture and livestock. To improve the financial situation of the public enterprises, they suggested more flexible price policies and more efficient marketing operations, as well as the early implementation of the recommendations of the reviews of the financial operations of parastatals.

Noting the sharp reduction of national savings in 1981, Directors urged a sizable reduction in the overall fiscal deficit through increased taxation of the nonuranium sectors and cutbacks in nonessential outlays. They noted the steps already taken in that direction. The forecast reduction in the government deficit to 5.5 percent of GDP in 1983, from nearly 11 percent in 1981, was an encouraging development.

Directors indicated the need to reduce the Government's domestic arrears and avoid their recurrence by strictly monitoring and controlling all outlays within a budgetary framework. Directors advised a reduction in the rate of domestic credit expansion by appropriate restraints on bank financing of the fiscal deficit and on deposit money banks' recourse to foreign borrowing and central bank rediscounts.

To alleviate the prospective heavy burden of external debt service payments, Directors urged restraint on foreign borrowing and suggested that steps be taken to seek debt relief from foreign creditors in an appropriate way.

Directors warmly welcomed Niger's determination to pursue their stabilization policies in the framework of a stand-by arrangement with the Fund.

It was proposed that the next Article IV consultation with Niger be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding 1983 Article IV Consultation

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Niger, in the light of the 1983 Article IV consultation with Niger conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

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

Decision No. 7456-(83/96), adopted
July 1, 1983

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Niger for a purchase of SDR 12 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 Niger and approves the purchase in accordance with the request.

Decision No. 7457-(83/96), adopted
July 1, 1983

3. PAPUA NEW GUINEA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Papua New Guinea (SM/83/110, 5/31/83). They also had before them a report on recent economic developments in Papua New Guinea (SM/83/130, 6/17/83).

Mr. Morrell made the following statement:

My Papua New Guinea authorities found the staff report helpful and stimulating to internal policy discussions. They also gained a great deal from their exchange of views with the staff mission team.

Papua New Guinea is an island economy in the early stages of economic development, endowed with considerable natural resources, but hampered by some of the most difficult terrain in the world and relying for export income on a few primary products and raw materials. These factors underlie the economy's vulnerability to fluctuations in world commodity and mineral prices, explain the high cost of internal distribution and transportation, and indicate the direction of investment being undertaken.

Since 1982 the Papua New Guinea authorities have been undertaking progressively stronger adjustment measures in order to halt the deterioration in the balance of payments and in the domestic budgetary situation which resulted in part from higher oil prices, declining commodity prices, and a downward reassessment of the ore content of the Bougainville copper mine. Most of their effort has been directed at reducing government spending over the medium term, and a number of strong and courageous decisions have been taken. The most notable of these has been the decision to reduce the number of people employed in government service by some 9 percent over 1983. Real growth in GDP is projected to rise by about 6 percent following four years of virtually flat growth, primarily as a result of expenditure on the Ok Tedi mining project.

Wage determination has been a key factor influencing economic conditions in Papua New Guinea. Minimum wages are determined by the Minimum Wage Board (MWB), an independent tribunal consisting of representatives of the Government, employers, employees, and the community. Up until the most recent determination in March 1983, wages were almost fully indexed to the likely inflation rate. The new determination, which covers the period to March 1986, provides for indexation up to only 5 percent a year, with no indexation above that rate. Wages for public sector employees generally follow closely the MWB determinations. My authorities have informed me that negotiations with the public sector employees are nearly completed and that they do not expect any significant deviation from the MWB determination.

Since independence in 1975, exchange rate policy in Papua New Guinea has, for the most part, been assigned to controlling the general level of inflation, with the authorities holding the view that the real income and balance of payments effects would be minimal. The authorities have not used exchange rate policy to stimulate production of tradable goods, despite the deteriorating price performance, because of the nullifying effect of wage indexation. My authorities do not consider the staff gives quite enough acknowledgment to the fact that their preparedness to now use the exchange rate more flexibly derives in large measure from the much more limited wage indexation decision currently in effect. As the report points out, the extent of exchange rate adjustment will depend on the government's assessment of the tolerable level of general inflation that would ensue.

External debt, both public and private, has increased rapidly since 1980. Public overseas debt has increased both to cover the current account deficit and to fund the Government's contribution to the Ok Tedi project, while private external debt has expanded almost wholly on account of the Ok Tedi project and Bougainville Copper Ltd. It should be noted, however, that the Government has undertaken its program of fiscal adjustment so that it can eliminate further recourse to official external commercial borrowing by 1986, or even sooner if possible.

On fiscal policy, my authorities report that the 1983 budget appears to be broadly on target. Revenues could be slightly under budget, while concessional financing drawdowns are also lower than expected. This latter fact means that associated expenditures will also be lower.

There was a favorable outcome from the aid talks with Australia held in June. Under the previous agreement, aid was to decline by 5 percent a year in real terms. The decline will now be significantly lower, with aid in 1983 being close to budget at K 213 million, equal to some 34 percent of total receipts.

On monetary policy, the staff notes on page 13 of SM/83/110 that a new rediscount mechanism was to be established in order to serve as a routine source of liqudity to the banks. My authorities advise that this facility was introduced in May. In addition, in response to continued slow growth in bank lending, interest rates were reduced by 1 percentage point on June 1, bringing to 3 percentage points the reduction over the past nine months.

Despite no growth in the broad money supply in the five months to May, my authorities expect growth for 1983 toward the upper end of the target range of 7-10 percent, assuming continued improvement in the balance of payments.

Completion of stage one of the Ok Tedi project is now put at an earlier date of July (rather than November) 1984. In the sense that private capital inflows related to Ok Tedi exceed imports and services related to the project, it is already making a positive contribution to the overall balance of payments. It will not, however, contribute much to export earnings or government revenue until after 1985.

In conclusion, my authorities welcome the staff's recommendation that Papua New Guinea be placed on the standard 12-month cycle for Article IV consultations.

Mr. Taylor commented that Papua New Guinea had an unusual and fascinating economy; with 3 million people speaking 700 languages, a very sparse internal infrastructure, only 15 percent of the working population employed in the cash economy, and copper and gold providing more than 50 percent of the export revenue. It was a dual economy, and he shared the staff's caution against applying too orthodox economic analysis to a rather untypical and undeveloped economy.

Given the heavy dependence on copper and gold exports, the world recession had had a more severe impact on Papua New Guinea than on some of its neighbors, Mr. Taylor went on. The country had benefited from a full drawing under the compensatory financing facility, and strenuous efforts were being made to continue implementing the needed fiscal adjustment begun in 1982.

The policy of fiscal retrenchment had been appropriate, Mr. Taylor remarked. The authorities had intended to reduce civil service employment by about 9 percent by March 1983, but only a small fraction of that reduction had been made; the authorities however had assured the staff that they would continue with their objective. A contingency fund had been established in anticipation of a relatively slow implementation of that program, but the fund was almost depleted. Did there need to be either a tightening of policy or a new approach on the fiscal side? The authorities had aimed to reduce public expenditure on goods and services by at least 5 percent in real terms in 1983. Could the higher than expected expenditure on public sector wages still be accommodated within the original target, or would further cutbacks be necessary?

On the revenue side, Mr. Taylor said, he appreciated the difficulties inherent in broadening the domestic tax base in a country with a limited cash economy. He was surprised that the staff had suggested introducing higher export taxes as a possible way to extend the tax base. Despite the much improved prospects for copper prices, further taxation in that sector would reduce incentives and discourage private investment at a particularly critical time. There was a need to diversify the revenue base over the medium term, but were there not other potential sources of revenue?

On the supply side, the staff had shown convincingly that real wages were unsustainably high, given the levels of skill and productivity in the economy, Mr. Taylor went on. Consequently, the burden of adjustment had fallen heavily on sectors of the economy that were not protected by wage agreements, thereby causing a decline in rural incomes and an increase in urban unemployment. One solution would be to modify or restrict the method of indexation so as to give less weight to price increases of nonessential items. In fact, the authorities had decided to take more drastic action and to limit the indexation component in the minimum wage determination system to a maximum of 5 percent a year for the following three years, which was a courageous step. Lower wages would improve the performance of the export sector and would encourage export diversification. On a related point, considerable capital expenditure had been directed toward the export sector, which underlined the need for further fiscal restraint in other areas.

If the fiscal and wage policies were not to bear too large a share of the adjustment process, the exchange rate would need to play a greater role, Mr. Taylor considered. The staff had been in favor of adjusting the exchange rate to increase the relative producer prices of traded to nontraded goods. Some relative price movement would have to occur if employment was to be increased and the export base diversified. With indexation, it was difficult to achieve a reduction directly through action on wages, and since inflation rates abroad seemed to be continuing to decline there was no choice but to adjust the exchange rate. The March 1983 devaluation of the kina pari passu with the devaluation of the Australian dollar had been a step in the right direction, although it was questionable whether it had gone far enough.

A large proportion of the recent increase in debt service ratio was associated with the financing of the new mining investments and the refurbishing of the existing mining operation, Mr. Taylor observed. Export earnings from those operations should be forthcoming and would provide the resources necessary to finance the borrowing. However, there were risks in such a strategy; the production capacity of the mines was always questionable, and copper prices were notoriously difficult to project. The staff was therefore right to caution the authorities about their borrowing policy and to advise them to borrow only on concessional terms. In many countries, the mining industry had typically been a field in which equity financing had played a role because of the risks involved. Had the staff ever encouraged the authorities to consider direct investment participation in the mining ventures?

In conclusion, he was in broad agreement with the staff appraisal, particularly on fiscal and exchange rate policy, Mr. Taylor stated. He shared the staff view that successful implementation of the 1983 budget was critical. In 1982, although the authorities' intentions had been good, implementation had not been fully successful. There had been valuable technical assistance provided by the Fund, and he hoped that it would continue.

The staff representative from the Asian Department said that there had been some slippage in the Public Sector Retrenchment Program. Expenditure would likely be higher than expected since more people had been kept on the payroll, but on the other hand slower retrenchment would reduce expenditure on severance pay and benefits. Nevertheless, the net effect would be to increase wage expenditures beyond the targeted amount. However, the authorities had recently reaffirmed their commitment to reduce expenditure in other areas in order to maintain overall expenditure at the original projected level.

He agreed with the authorities on the need to change the tax base in the medium term in order to increase revenues substantially, the staff representative stated. There was some possibility of introducing taxes based on real estate at some future time. Furthermore, the application of retail sales taxes at the provincial level was being considered, and the authorities intended to give the provincial governments more autonomy in raising taxes. With respect to the export taxes, the staff had been concerned about the appropriateness of providing exemptions from export taxes in periods of low export prices. There were already stabilization funds in operation, which would stabilize the incomes of exporters.

Finally, on mining arrangements, the staff representative from the Asian Department explained that there was equity participation by the Government and by foreign participants in the Ok Tedi mine. There was a tendency for mining contracts to change and evolve over time as countries gained more experience in dealing with foreign contractors. Forthcoming mining contracts in Papua New Guinea might well hold the possibility of greater equity participation.

Mr. Morrell agreed with Mr. Taylor that the level of urban wages was too high. The limitation on the indexation of wages to 5 percent had been established by an independent committee set up by the Government. There was clearly an imbalance between the rural and urban sectors, but the Minimum Wages Board had not accepted the authorities' suggestion for changing the relative wages of those two sectors, and had instead supported a fairly low overall increase. The Wages Tribunal provided an important element of stability in Papua New Guinea's labor market, but it had resulted in an unsustainable wage situation.

The exchange rate was an instrument that had not been sufficiently used, Mr. Morrell considered. While Papua New Guinea had been enjoying the benefits of high gold and copper prices, the authorities had been able to maintain the kina at a high value, but they had not adjusted the exchange rate to the decline in commodity prices, and as a result there had been inadequate incentives for other export producers. Papua New Guinea relied heavily on imported foodstuffs; therefore, any exchange rate movement had an impact on some of the basics of life, not just the luxuries. However, the authorities had indicated greater willingness to use the exchange rate as a policy instrument in the future.

Finally, the authorities were determined not to rely on external borrowing in the future, Mr. Morrell concluded. Not many countries indicated a wish to cease the use of external financing, and he wondered whether the authorities' intention was commendable given the level of per capita income in Papua New Guinea. However, in light of the uncertainties of mining revenue, it was perhaps wise to be cautious.

The Chairman made the following summing up:

> Support was expressed for the views contained in the staff appraisal for the 1983 Article IV consultation with Papua New Guinea. In view of the deterioration in both the fiscal and external positions that had occurred in recent years--in particular, as a result of the economy's dependence on copper mining and exports--the demand management measures adopted during the course of 1982 were supported by the Board. The importance of successful implementation of the 1983 budget, including the

public employment retrenchment effort, was also stressed. The reduction in public expenditure, especially in current expenditure, was viewed as a critical element of the medium-term adjustment program.

In order to reduce the burden of the adjustment effort on public expenditure, especially capital spending, and given the constraints on the expansion of revenue and the prospects for a decline in foreign aid, Directors felt that there was need for a broad policy mix, which included action in the fields of tax, monetary, and exchange rate policies.

The Government's aim of reducing the unduly high level of real wages was strongly supported, and the authorities were encouraged to continue their efforts to reduce the wage differential between rural and urban areas so as to encourage agricultural output, slow down the rate of labor migration to towns, and reduce urban unemployment. The recent depreciation of the kina was welcomed, and more flexible use of the exchange rate as a means to restore the balance between wage rates and the price of tradable goods was advised. The authorities' efforts to reduce the direct link between increases in consumer prices and the adjustment of minimum wages were strongly supported. The authorities' cautious approach to external commercial borrowing, in view of the recent sharp rise in such borrowing and the possible strain on future debt service payments, was welcomed.

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

## 4. VENEZUELA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Venezuela (SM/83/119, 6/7/83; and Cor. 1, 6/29/83). They also had before them a report on recent economic developments in Venezuela (SM/83/127, 6/15/83; and Cor. 1, 6/29/83).

Mr. Senior made the following statement:

This consultation has been complemented by special visits of senior officials from Venezuela to the Fund, and a mission will be leaving for my country shortly for conversations on the possible use of Fund resources. This somewhat laborious process has been of much help in clarifying and understanding basic policy positions, not only on the part of my Venezuelan authorities but also on the part of the Fund. Clearly there are still differences of perception between my authorities and the staff. Such differences, however, are basically related to the magnitude and the speed of adjustment, rather than to the need for adjustment itself. Venezuela experienced a major overall balance of payments deficit in 1982 and is currently facing a serious financial situation. My authorities are aware of the need for redressment, and have adopted important measures to restore internal and external equilibrium. Let me indicate some of the efforts undertaken by the authorities.

The Venezuelan economy is relatively small, open, and extremely dependent on a basic export commodity, which makes it highly vulnerable to external developments, and specifically to developments in the world oil market. Since 1979, the main objective of economic policy in Venezuela has been to adjust the rate of growth of aggregate demand to that of productive capacity to break the inflationary trend of the economy and improve resource allocation. Over the whole period, the formulation of economic policies and the choice of policy instruments have basically reflected the high priority given by the authorities to the control of inflation as a necessary prerequisite to achieve stable growth. To this effect, conservative, even orthodox, demand management policies were implemented, at the same time that a major price liberalization program was initiated in 1979 in order to eliminate built-in rigidities on the supply side of the economy. As a result, inflation rose sharply again in 1980 to about 20 percent but fell considerably during 1981 and 1982 as real GDP stagnated. While the thrust of this prudent policy stance was severely questioned internally in Venezuela, and even in some international fora, in the final analysis and with the benefit of hindsight it served Venezuela well, at least up to a certain point. In effect, Venezuela was able to weather somewhat better than other developing countries the seriously adverse economic conditions of the world economy of the past three years, especially the shock related to uncertainties and the virtual closure of private financial markets. In the end, however, this policy stance was not sufficient to isolate Venezuela from the negative economic environment, as the value of exports dropped sharply in 1982 because of declines in both the price and the volume of petroleum exports, and as capital flight intensified owing to a loss of confidence related to the overvaluation of the bolívar and the weakness of the current account. This should not be interpreted to mean that all problems were related only to external factors. While recognizing that there were internal slippages in policy, such as perhaps a belated adjustment in interest rates and the allowance of an overvaluation of the bolívar, it was exogenous factors that mainly contributed to current account weaknesses in the balance of payments, and thus to a deterioration in the climate of confidence and a substantial deficit in the capital account.

Perhaps the most important slippage was the authorities' failure to correctly gauge the dimensions of the change in the international oil market at an early stage, which led to overreliance on financing rather than more immediate comprehensive adjustment. Thus, the measures adopted in 1982 were perhaps insufficient, although by no means insignificant. During 1982, the authorities made determined efforts to adjust the economy to the new external situation. In the fiscal area, central government expenditures at 1978 prices were reduced by 10.6 percent in 1982, after experiencing an increase of 23.1 percent in 1981, and transfers to the rest of the public sector decreased by 32 percent. The number and amount of subsidized products were gradually reduced. During 1981 and 1982, the subsidies on fertilizers, rice, edible oil, coffee, flour, and sugar were abolished, and in January 1983 the subsidy on concentrated animal feed was also eliminated. The only agricultural product still being subsidized is milk. Subsidies in general were thus reduced from about Bs 4 billion in 1981 to about Bs 1.5 billion in 1983.

As regards ordinary receipts, to compensate in part for the fall in petroleum taxes, the excise tax on liquor was increased by 50 percent, the price of cigarettes by 50 percent, and the travel tax by almost 90 percent. At the same time, tariffs and prices on public goods and services were also significantly increased, continuing the process of bringing them to gradually reflect current costs. Tariffs on electricity were raised by 50 percent on average; on water by 115 percent on average, on telephones service by 50 percent, and there were also increases in postage rates, airport taxes, and tariffs on domestic travel.

Complementary to the abovementioned measures, during 1982 the government investment plan was comprehensively reviewed so as to reduce or postpone investments not considered essential in current circumstances. Several administrative initiatives are being implemented to rationalize and control public sector financial management, especially as regards decentralized agencies. These administrative and legal improvements are being mostly directed toward the external debt and the budget, although they also include other important areas related to information systems and new management methods for public enterprises.

As the measures already adopted have not been sufficient to deal with current imbalances and the more long-lasting difficulties of the international oil markets, as well as those encountered in the process of external debt renegotiation and the loss of international reserves that has already taken place, the authorities are committed to intensifying the adjustment effort in 1983, within a framework that would tend to distribute the burden of adjustment on all classes. The objectives of economic policy for the current year have thus been established as follows:

(a) to safeguard as adequate level of international reserves. More specifically, the authorities intend to have liquid reserves not fall below a minimum of the equivalent of two months of imports;

(b) to ensure the correct servicing of external debt, within the context of current limitations. Thus, the rescheduling of external debt must reflect such limitations;

(c) to further arrest deterioration in economic activity, in order to maintain employment at socially tolerable levels;

(d) to maintain the production potential of the oil industry, despite reduced investments;

(e) to further decrease public expenditure so as to gradually bring it into balance with public revenues, as well as to increase fiscal revenues not related to oil taxes;

(f) to minimize inflationary pressures originating in the three-tier exchange system;

(g) to return gradually to a unified, free exchange system.

To attain such objectives, for the short term the authorities have adopted a three-tier exchange control system. They are actively negotiating the rescheduling of the Venezuelan external debt, and will reinitiate their access to multilateral financial institutions. They will also continue their efforts to reduce public sector expenditures in real terms, so as to compress aggregate demand and imports.

Aside from more fundamental structural problems that have to be tackled in the longer term, Venezuela is basically facing a *liquidity problem reflected in the capital account of the balance* of payments and further aggravated by an unfavorable external debt maturity structure. Clearly, there was a marked deterioration in confidence brought about by the large deficit in the current account of the balance of payments and the overvaluation of the bolívar, thus casting doubt on the feasibility of maintaining the exchange rate at the unified fixed rate in effect before February. The introduction of the three-tiered system and the still uncertain outcome of economic policies, at least in the minds of many important sectors, has further contributed to a weakening of confidence. In such circumstances, and after very significant levels of capital flight during the second half of 1981 and all of 1982, the authorities had no alternative but to impose exchange controls. The authorities firmly believe in a free exchange system but could not allow further speculative capital flight without taking action. At the same time, while firmly committed to a unified exchange rate, my authorities consider that a multiple exchange system is necessary in current circumstances to minimize the most adverse effects of a general devaluation, to safeguard basic import prices for the lower-income people, and to soften the effects that devaluation would have on private sector productive enterprises and overall output and employment. The current system must be viewed as temporary, while prudent demand management policies take hold and confidence is re-established. Such a system is clearly directed to increasing non-oil exports and promoting import substitution, while reducing nonessential imports and minimizing effects on productive enterprises.

A general devaluation, while normally acceptable, in the Venezuelan case would have been inappropriate. First, practically 95 percent of exports consist of one commodity, oil; the production of this commodity is government controlled and does not suffer from profitability problems, at least still in current circumstances. It is doubtful that a general devaluation would be required for production of this product to increase. Clearly, here we have the problem that has often been mentioned in the Board, about what should be the most appropriate exchange rate policy for oil exporting countries. Second, the current system allows for a free rate that would benefit nontraditional exports, and that would also serve as a valve to gauge market forces without letting speculative movements permeate the totality of imports. Third, as has been mentioned before, this is a temporary system, and the authorities are already making efforts to transfer more imports from the Bs 4.3 rate to the Bs 6 rate, and from there to the free rate. This system allows the authorities to be selective, while shielding certain sectors from the most negative effects of devaluation, thus helping to reduce pressures for increased subsidies and wages. As a result of this exchange rate policy and import controls, Venezuela's imports are expected to fall by 32 percent in real terms in 1983.

Regarding external debt, the staff paper makes clear the magnitude of the problem. More than an exaggerated level of external debt, Venezuela's problem is the debt's maturity structure, though care has to be taken not to rely further heavily on such debt. For some time now negotiations have been going on between Venezuela and its creditors for a substantial rescheduling of short-term debt that would not involve additional amounts of financing. A deferral of amortization was granted until July 1, 1983, and more recently another deferral is virtually assured for 90 days more. I should only mention that these negotiations, while protracted and arduous, should prove successful for the benefit of all concerned. As the staff indicates, even though discussions with creditors should lead to a restructuring of the external debt on relatively favorable maturity terms, amortization payments would still average some 30 percent of exports of goods and services, and total debt service payments would be some 50 percent of exports of goods and services. Obviously, Venezuela's external debt burden will be eased only as the country improves its own growth performance and reduces reliance on foreign borrowing; thus the need for a successful rescheduling exercise and to arrest further deterioration of economic activity.

In the fiscal area, the authorities will intensify their efforts to adjust expenditures to expected revenues. For 1983, it is expected that current revenue will decrease by 3.6 percent. For expenditures, however, it is contemplated that public consumption will be reduced in nominal terms from Bs 43.2 billion in 1982 to Bs 41.9 billion; public expenditures on salaries and wages will be virtually frozen. Transfers to the rest of the public sector will again decrease, by 22 percent in relation to 1982, and public investment will be maintained within the availability of resources, undergoing a reduction in 1983 to Bs 43.3 billion from Bs 48.7 billion in 1982. Projects that are already under way will, of course, be given priority.

During 1983 the authorities expect to continue the system of administered prices, with sufficient flexibility so that prices will reflect cost increases, especially those originating from exchange rate changes. It is intended, however, that unjustified speculative price movements will be minimized, so that wages can also be maintained within prudent limits. The authorities expect to have much more price flexibility in the future, and by 1984-85 the price system should be basically free.

The policy objectives and measures described above should serve, in the authorities' view, to achieve a stabilization program geared toward gradual adjustment. In this regard, it would seem that the differences with staff perceptions are basically related to the speed of adjustment, not to the need for adjustment. The Venezuelan authorities are in basic agreement with the staff regarding the need for comprehensive adjustment. In their view, however, this adjustment cannot be compressed into a very short period without creating social disturbances that would endanger the effort as a whole. Too rapid an adjustment would create undue pressures for wage increases that would easily defeat the benefits achieved and could entail unduly high costs in terms of forgone output and unemployment that could even endanger the social fabric of the country. At the same time, such speedy adjustment would go against the established democratic process that has so painstakingly been nurtured for 25 years in Venezuela. Let me illustrate: fiscal reform can effectively be brought about only through a multipartisan consensus that is the product of cautious studies and interchange of ideas. There is clearly no difference between the staff and the authorities on the need for fundamental fiscal reform. However, this reform cannot be approved or implemented immediately. As has been mentioned, a Presidential Commission including members from all political parties, with assistance from the Fund, has been working since 1980 on ways to strengthen the tax system by broadening the income tax base and increasing indirect taxation. It is expected that this Commission will present its conclusions by August of this year, and the Government intends to propose new tax legislation to the Congress when it reconvenes in January 1984.

At the same time, a task force set up by the Ministry of Energy and Mines, Petróleos de Venezuela and Universidad Simón Bolívar is considering a new structure of internal prices for energy, gasoline, and other petroleum derivatives. It is expected that their proposals will be adopted by the end of 1983 or the beginning of 1984.

The implementation of these measures would tend to bring the authorities' position very close to what the staff has indicated. The normal process that adoption of these measures would require in Venezuela must, of course, be respected. The mission that will shortly travel to Venezuela will, I am sure, find a receptive audience as to the need for adjustment within the specific context of the country's current circumstances.

Mr. Robalino stated that he did not fully agree with the general thrust of the staff appraisal on Venezuela, which seemed to be pessimistic. Nevertheless, the speed of adjustment should not be excessively slow, particularly in view of the size of the debt burden, which could remain a problem even after being restructured on relatively favorable maturity terms.

The Government had recently taken important, if rather unorthodox, measures to restrain the current account deficit, Mr. Robalino said. However, given the current situation, he could not blame the authorities for being unorthodox.

Although the Central Government's tax revenues had increased slightly from 6.2 percent of GDP in 1978 to 7 percent of GDP in 1982, they remained at a relatively low level, Mr. Robalino considered. There was still plenty of room for fiscal adjustment, and the recent measures taken by the authorities to raise the rates charged by public utilities demonstrated that they had the courage to pursue the required adjustment. He hoped that the authorities would also adopt a tight monetary policy.

The low level of subsidies in the Venezuelan economy was welcome, Mr. Robalino remarked. The ratio of direct subsidies to GDP had declined to only 1 percent of GDP in 1983, and a further reduction in subsidies was expected in the near future.

He shared the staff's view that a simplification of exchange arrangements was necessary, Mr. Robalino indicated. He could understand the authorities' worries that a premature unification of the exchange rate could have a high inflationary impact, with little effect on exports. Finally, the program of official aid to Central America and the Caribbean countries--at a total annual cost to Venezuela of about $200 million in 1983--was commendable.

Mr. Connors considered that it was important that the authorities should implement a strong comprehensive adjustment program without delay, so that domestic and international confidence could be restored as quickly as possible. The measures introduced thus far were insufficient and, in many cases, inappropriate to deal with the economic and financial problems. The authorities had to make fundamental changes in their policies if they wished to restore some degree of internal and external balance to the economy. The reliance on reserve drawdowns and foreign borrowings was not a feasible option since the reduction in oil export revenues could not be regarded as temporary.

Commenting on domestic policies, Mr. Connors agreed that the fiscal position of the Government had deteriorated markedly. Although some steps had been taken to correct the fiscal imbalance, further action was necessary and had to be broad based. Corrective price changes were needed for a number of goods with administered prices, especially petroleum products. Other revenue-raising methods would also be necessary, and special attention should be paid to diversifying the tax system. Furthermore, public expenditures should be restrained and monitored closely.

A prudent expansion of domestic credit was necessary in order to foster overall price stability while allowing for corrective changes in relative prices and to avoid the leakage of domestic credit growth into increased imports and capital outflows, Mr. Connors remarked. It was disturbing that the Central Bank's discount rate had been reduced to stimulate activity. Strict monetary restraint was required in order to reduce inflationary pressures.

Changes in exchange and trade policies should be implemented, Mr. Connors considered, together with the domestic policy adjustments referred to earlier. He strongly recommended the introduction of a unified exchange rate at a market-determined level. The multitiered rate was inefficient and unworkable for any length of time. With a market-determined unified exchange rate, import restrictions could be removed and the export base diversified.

In conclusion, Mr. Connors stated, the authorities had to take timely and comprehensive measures in order to restore domestic and external confidence. The confidence of external creditors would further erode if partial, inadequate adjustment policies were attempted.

Mr. Lovato said that Venezuela's balance of payments difficulties had developed, in part, as a result of exogenous factors. However, the authorities had not taken sufficient or appropriate measures to control the situation and restore the balance of payments equilibrium. In particular, the three-tier exchange system, the reduction of the rediscount rate of the Central Bank, and the import restrictions, had all been inappropriate.

According to Mr. Senior's statement, the Venezuelan authorities were aware of the need for adjustment, Mr. Lovato went on, but they should also recognize that a market-oriented policy was a more suitable and useful approach. Import restrictions could be useful over the short term for buying time in which to adopt other necessary policies. In the long term, however, import controls on their own would not restore a sound economic situation and would be useless, or even counterproductive, in terms of inflation and resource allocation. He therefore urged the authorities to eliminate the quantitative import restrictions and to introduce a more liberal trade policy that would be within the framework of the country's economic and development strategy. The authorities should unify the multitier exchange rates, which caused distortions, at a market-determined level. Furthermore, the rediscount rate should be brought to a level consistent with the authorities' objective. A restrictive monetary policy was advisable in order to avoid capital outflows.

The public finance and exchange rate policies were particularly worrying aspects of the Venezuelan economy, Mr. Lovato considered. The reduction in both price and volume of petroleum exports had had a negative impact on central government revenues and the current account of the balance of payments. The authorities had not reduced expenditures in line with the fall in price of international oil, and consequently the deficit had widened markedly. Although international reserves could be used to finance the fiscal and balance of payments deficits in the short term, in the long term it was necessary to cut expenditure.

The authorities' efforts to reduce domestic demand had been insufficient, and their exchange rate policies had been inappropriate, Mr. Lovato remarked. As a result, external debt had increased rapidly over recent years, and by December 1982 the level and structure of outstanding debt had been particularly worrying, especially since private sector debt had not been included.

The authorities had had only limited success in rescheduling their short-term external public debt, Mr. Lovato commented, which was not surprising since they had not taken any adjustment measures. In the short term, the authorities had no alternative but to adopt restrictive fiscal and monetary policies, which would be difficult immediately before the elections, but a delay would lead to further deterioration in the economic situation.

Mr. Joyce stated that he shared the staff's concerns about the potential for further deterioration of the Venezuelan economy unless stringent adjustment policies were adopted by the authorities. There was clearly a divergence of view between the staff and the authorities. The authorities seemed to believe that an ad hoc approach to adjustment would be sufficient to correct the imbalances or, at least, that adjustment could be delayed. However, such an approach could cause even more serious difficulties. Some important steps had already been taken, but they clearly fell short of what was needed to stabilize the economy.

The authorities' recognition that weaker oil markets were not likely to be a temporary phenomenon and that even Venezuela's large financial reserves were not limitless was welcome, Mr. Joyce continued. However, measures taken to date seemed to be directed more at the symptoms of the problem than at the underlying causes. Efforts to contain the public sector deficit were directed toward reducing capital expenditures and little attention had been paid to cutting current expenditures or increasing revenues. Strong efforts were needed to curb current expenditure, including greater wage restraint in the public sector and a more determined stance on public employment. The pricing policies of public enterprises also needed to be liberalized, and additional tax measures were required.

On the monetary front, the authorities had stated that they recognized the need for restraint, Mr. Joyce remarked. Even so, the central bank discount rate had been lowered, which could accelerate the already high level of capital flight. In addition, the three-tier exchange rate system was likely to drain the already low and rapidly declining reserve position.

Earlier steps to achieve greater liberalization of prices seemed to have been reversed, and price controls had been multiplying again, Mr. Joyce noted.

He shared the staff's view that if there was to be effective adjustment in Venezuela, the full effects of exchange rate changes should be allowed to flow through to domestic prices, and both explicit and implicit subsidies should be reduced or eliminated, Mr. Joyce said. There had to be effective restraint on wages and salaries, reflecting the fall in real incomes that had occurred and, as soon as adjustment permitted, there should be a dismantling of import controls, which clearly worked against Venezuela's long-term interests.

The staff report had not attempted to forecast the 1983 outlook for economic growth, Mr. Joyce observed; did the omission represent an implicit admission by the staff that the outturn for 1983 could not be projected given the ad hoc nature of the policies being pursued? He had seen some projections indicating that real GDP might decrease by 2-3 percent in 1983, after real growth of 0.6 percent in 1982. Could the staff or Mr. Senior comment on those figures?

In his statement, Mr. Senior had commented that much of the weakness in the current account of the balance of payments had been due to exogenous factors, Mr. Joyce noted. However, it was clear that there had been a serious loss of confidence in the Venezuelan economy by the staff and, even more seriously, by the international financial community. Confidence could be restored only through the implementation of viable and effective policies. He appreciated that the timing would be difficult for the authorities, given the political situation, but the sooner those adjustment measures could be taken, the better.

The staff should urge the authorities to negotiate an adjustment program with the Fund as soon as possible, Mr. Joyce considered. It was questionable whether scarce Fund resources should be made available to Venezuela unless the authorities were prepared to adopt a program that would result in a more sustainable position in both the domestic and external accounts, as had been a prerequisite for many other countries. Finally, he agreed with the staff recommendation that, in the absence of an effective adjustment program, the Executive Board should not approve the multiple currency practices adopted by Venezuela in February 1983.

Miss Le Lorier stated that the staff report provided a clear and unequivocal assessment of the deterioration that had occurred in the Venezuelan economy over the previous 12-18 months, and the report also brought to light two important considerations. The first consideration was the size and rapidity of the deterioration that had occurred since 1982. The deterioration was best illustrated by the swing in the current account balance, which had deteriorated from a surplus equivalent to 3.5 percent of GDP in 1981 to a deficit equivalent to 5 percent of GDP in 1982. The second consideration was that the present imbalances were not sustainable beyond the very short term.

She fully understood the reasons why the authorities believed that the introduction of harsh, and therefore unpopular, adjustment measures would not be appropriate at the present time, Miss Le Lorier continued. Nevertheless, it was extremely important to recognize that the present policy--which, in effect, was buying time--had already entailed extremely high costs. She shared the staff's view that any failure by the authorities to act boldly in dealing with the country's economic problems would lead to more severe consequences.

The approach being followed by the authorities would lead to a serious weakening of the external financial position and a severe depletion of stocks of financial assets, which would eventually have to be reconstituted, Miss Le Lorier went on. The economy had been able to function without any major disruptions by drawing down its most valuable holdings. Such an approach might have the undesirable effect of masking the seriousness of the situation to both the authorities and the general public. The consumption of external reserves--including foreign deposits of the National Petroleum Company and the Venezuelan Investment Fund--if continued at the present pace, could lead to their near exhaustion by the end of 1983 or shortly thereafter.

The depletion of oil and materials stocks could also be viewed as another form of exchange reserve consumption and would therefore lead to a further weakening of the external position, Miss Le Lorier considered. The large use of materials stocks had made it possible to economize on capital outlays in the budget. It was questionable, however, whether those cuts could truly be regarded as anything but a postponement of future expenditure.

Less adjustment had apparently been taking place than actually met the eye, especially with respect to public finance, and the exchange rate regime, Miss Le Lorier remarked. It could be argued that the introduction of a free exchange market in February 1983 had represented a strong adjustment in the exchange rate. However, the reality was significantly different, as the bulk of external transactions apparently continued to be made at the old, probably overvalued, rate of Bs 4.3 to the dollar, and at the new rate of Bs 6 to the dollar, which also apparently included a preferential element. It would have been useful if the staff had indicated what the average floating rate had been recently and whether it considered such an average to be a reliable indication of an equilibrium rate.

It was unclear at present to what extent the floating rate was appropriate, since the supply and demand factors influencing it did not appear to be in balance, Miss Le Lorier said. The supply of foreign exchange was to come from some traditional exports--which could only produce so much--and from inflows of private capital, tourism, and services, which were subject to severe fluctuations. Therefore, if nonessential imports were subsidized through the use of the two preferential rates--a possibility not excluded in the staff report--the imbalances in the free exchange market would be large, and the resulting exchange rate could probably not be considered a valid indicator of an equilibrium rate. In those circumstances, she shared the staff's view that both the distortions created by the present exchange rate policies and the insufficient action in the field of demand management were not consistent with the nature of the required adjustment.

She urged the authorities to work out a comprehensive program that addressed the major areas of weakness in the economy, Miss Le Lorier concluded. In that respect, the report was not entirely reassuring since it indicated that there was a lack of convergence of views on the relevance of particular imbalances to the present difficulties. Could the staff comment on that point, especially in the field of exchange rate policy and direct and indirect subsidies? Did the staff or Mr. Senior know whether the authorities were considering closer cooperation with the Fund?

Mr. Wicks indicated his agreement with the staff appraisal. Since he agreed with the broad thrust of statements by Mr. Connors, Mr. Joyce, and Mr. Lovato, his comments would be of a rather particular and technical nature.

He welcomed the determination of the Venezuelan authorities to undertake significant fiscal adjustment measures in 1983, Mr. Wicks went on. The measures taken to cut the subsidies in the nonfinancial public enterprises were particularly welcome, but further firm fiscal action was still required to reduce the deficit and to harness sufficient resources for renewed public sector investment needed in the traditional industries.

Further cuts in current expenditure and additional revenue-raising measures seemed necessary, Mr. Wicks continued. The staff had made several constructive suggestions for raising extra revenue; in particular, the suggestion of eliminating the indirect subsidy on petroleum products should have high priority since domestic prices were not covering the costs of crude petroleum. Efforts to diversify the tax system should be considered; some kind of value-added tax seemed to be necessary to improve the public sector finances. However, any consequent price increases should not be compensated for by wage increases. The authorities should be commended for their successful wage policy, and he hoped that similar determination would prevent future wage demands from eroding the benefits of any new revenue measures. A sustained reduction in real wages was the required response to lower foreign exchange earnings.

The authorities should continue to resist the pressure to relax monetary policy, Mr. Wicks considered. As long as the external financing constraints remained, a policy of strong monetary restraint would be required.

On the external side, it was not clear that the three-tier exchange rate system adopted in February 1983 would succeed in bringing about the improvement in the balance of payments position that the authorities expected by the end of the year, Mr. Wicks said. The authorities had forecast a reduction in the current account deficit from $3.5 billion to just under $1 billion, and a halving of the overall deficit to $4 billion by the end of 1983. A net outflow from the capital account of about $3 billion was expected. Furthermore, assuming debt maturities were rescheduled in 1983, projections suggested that immediately available reserves would fall to less than $3 billion. Could the staff or Mr. Senior indicate whether those forecasts were perhaps overoptimistic? Finally, what were the balance of payments prospects for 1984?

There had been delays in establishing the machinery to administer the new exchange system, Mr. Wicks observed, and the processing of import permits and payments had lagged behind schedule. The new arrangements seemed to be rather cumbersome. Did Mr. Senior or the staff view those arrangements as adequate? If the three-tier exchange system did not seem to be achieving the authorities' aim of a sharp reduction in imports, then he would share the staff's view that a major simplification of the system would be preferable to direct import controls.

Commenting on Venezuela's external debt, Mr. Wicks noted that its extent had only recently emerged, partly because of deficiencies in the data base. In that respect, the improved control over the external debt operations of public sector enterprises and the authorities' efforts to register private external debt were welcome. He hoped that those efforts would eventually lead to the removal of the current uncertainties over exchange rate treatment of private sector debt. Furthermore, he urged the authorities to eliminate the arrears that had accumulated.

It was right to raise questions about the appropriateness of present policies and the speed of adjustment that was required, Mr. Wicks remarked. It was not clear when the reduction in Venezuela's oil earnings would be reversed and it seemed that the country would have to adjust to a lower level of real income. He urged the authorities to give serious and urgent consideration to strengthening their policies in areas outlined by the staff. He also endorsed Mr. Joyce's comments about the prospects for a stand-by arrangement. Venezuela would undoubtedly benefit from a stand-by arrangement with the Fund associated with the necessary adjustment measures.

Mr. Finaish stated that before 1982 the Venezuelan authorities had focused on reducing inflationary pressures as a prerequisite for steady and sustainable growth. In 1979, price liberalization measures had been undertaken in an attempt to reduce supply-side rigidities and promote productive efficiency. While the anti-inflation effort had been successful, the structural weaknesses had persisted, and the rate of growth had remained low. In 1982, the situation had deteriorated rapidly as a result of a substantial drop in oil revenues at a time of high international interest rates, persistent worldwide recession, and unsettled conditions in international capital markets.

Early in 1982 the authorities had adopted a policy package designed, inter alia, to address the problem of reduced oil export revenues, Mr. Finaish went on. Serious problems had eventually developed as a result of the authorities' failure to recognize the dimensions of the change in the international oil situation. As the fall in oil earnings had been judged to be temporary, more emphasis had been placed on financing rather than on taking comprehensive measures. In 1982, it had been difficult to forecast the magnitude of the problems associated with the drop in oil prices. Indeed, at the time of the 1982 Article IV consultation, neither the staff nor the Executive Directors had shown great concern over the situation. The staff appraisal had stated that "given the comfortable level of international reserves, as well as the uncertainties for international oil markets, this mix of adjustment and financing would appear to be appropriate for the time being." The staff had also indicated that there were no difficulties with respect to the exchange rate policy and had concluded that "despite the real effective depreciation of the bolívar over the past two years, the present approach to exchange rate policy would appear to be appropriate, given the policy response planned by the authorities to this year's balance of payments deterioration." It was therefore not surprising that the authorities had not anticipated the sharp turn of events that had later confronted them.

It was clear, however, that measures taken in 1982 had not been sufficient to deal with the developing economic crisis, Mr. Finaish continued. The growing fiscal deficit, the deteriorating current and capital accounts, and the high foreign debt--reaching nearly 50 percent of GDP--illustrated the need for bolder and more comprehensive measures in the coming months. Given the outlook for world oil demand and prices, and the prevailing conditions in the capital markets, adjustment measures were unavoidable if current financing problems were to be eased and the economy set on a more viable course. On that basic issue there seemed to be no major conflict between the staff view and that of the authorities as indicated by Mr. Senior. Their views differed, however, with respect to the pace of adjustment. While the urgency of the situation was clear and the staff's preference for drastic and immediate measures was understandable, it should be kept in mind that the timing and pace of such measures could not be considered in complete isolation of the institutional, political, and social environment. Nevertheless, he shared the staff's view that careful consideration should be given to the composition of the public spending cuts; in the 1983 budget, only capital outlays had been reduced while current expenditures had been slightly increased.

Venezuela's external position had continued to deteriorate over recent months, and the authorities had reacted by introducing a three-tier exchange system and restrictions on imports, Mr. Finaish commented. The staff had been particularly critical of that approach, since it considered that a depreciation of the bolívar should have been central to the adjustment effort. However, the authorities were apprehensive that such a general devaluation might set off pressures to reintroduce domestic subsidies. Furthermore, the introduction of a three-tier system had involved a partial depreciation, and was considered by the authorities to be an interim measure taken in response to balance of payments difficulties.

In conclusion, Mr. Finaish considered that the authorities had made an attempt to adjust to the drop in oil revenues, but that the country had been faced by a combination of adverse developments. It was in such circumstances that the Fund should play a useful and helpful role, particularly in view of the authorities' recognition that fundamental and comprehensive adjustment measures were needed, and of their willingness to cooperate with the Fund. Finally, he hoped that the authorities would consider a stand-by arrangement.

Mr. Hirao commented that Venezuela was facing major problems; oil export earnings had declined sharply in 1982, and the authorities were still not certain that external public debt could be restructured. External debt service was likely to absorb a large portion of Venezuela's foreign exchange earnings. However, the authorities had introduced a series of measures to cope with the difficulties.

On the external front, the effectiveness of the three-tier exchange rate system was questionable, Mr. Hirao considered. Given the limited resources available to the authorities, the maintenance of such a system could increase the balance of payments pressures. It should be noted that the continued pegging of the currency to the U.S. dollar at the same rate for the previous seven years, had brought about a significant real appreciation of the bolívar. The authorities' efforts to stabilize the free market through official intervention could be costly in terms of reserve losses. He shared the staff's view that greater scope should be given to the free exchange market in order to promote efficient use of resources and encourage diversification of the economy. Although the authorities believed that import restrictions were necessary in the short run, they would undoubtedly lead to a misallocation of resources over the medium term. Their early removal was therefore necessary.

On the domestic front, action was particularly desirable in public finances, Mr. Hirao continued. The authorities' attempt to reduce capital expenditures in the 1983 budget was commendable, but he wondered whether there might not be scope for further containing current expenditures. Wage restraint and a strict attitude toward public employment would need to be pursued. On the revenue side, elimination of the large subsidy on domestic petroleum products was necessary. In addition, the authorities should consider seriously the desirability of diversifying the tax system, including the possibility of establishing a sales or value-added tax.

On wage and price policies, the authorities should be commended for resisting the growing pressures for a general wage increase, Mr. Hirao remarked. It was important that price increases, which were expected to occur as a result of a currency depreciation and the modification of public policies, should not be offset by wage increases.

Mr. Grosche stated that the authorities had delayed too long in adjusting their economic policies to the large drop in export revenues. The measures taken in 1983 were insufficient to deal with the country's difficulties, and the introduction of a three-tier exchange system and additional restrictions on imports were counterproductive.

Commenting on public finances, Mr. Grosche said that he was concerned that the authorities had attempted to reduce the deficit by slowing down the public sector investment program. Such an approach was not appropriate; instead, emphasis should be given to the curbing of current expenditures, particularly through wage restraint and a strict attitude toward public employment. Cutbacks in certain capital outlays were probably unavoidable, but the authorities should not reduce the capacity of the major producing sector.

Additional action to raise revenue appeared necessary, especially through the elimination of the subsidies for domestic consumption of petroleum products, Mr. Grosche went on. In addition, early consideration should be given to a change in the tax system, with a view to bolstering revenues from direct and indirect taxes. Such action might be difficult, given the political situation.

On the external side, the major problem facing the authorities was the need to reschedule external debt, more than half of which would fall due during 1983, Mr. Grosche continued. Venezuela's creditworthiness depended on the extent and effectiveness of its adjustment measures.

He fully supported the staff's view that Venezuela's exchange and trade policies did not address the economic problems, Mr. Grosche said. The effects of the overvalued exchange rate were multiplied by the introduction of a multi-tier exchange system, which had created distortions in the supply and demand and had induced capital flight. Given Venezuela's difficult situation, there was no reason for the authorities to subsidize foreign exchange. He shared the staff's view that import controls might be inevitable in the short run because of the urgent need to reduce the demand for foreign exchange. However, those measures were an inefficient substitute for approaches based on market price mechanisms. He urged the authorities to eliminate the import restrictions and to return to the trade liberalization policies that had been interrupted in 1982.

The new exchange arrangements introduced in February 1983 should be approved by the Executive Board only if the authorities made it clear that those restrictions were temporary, Mr. Grosche stated. The elimination of the multiple exchange system without the parallel implementation of effective adjustment measures would favor capital flight and would add to the existing problems. It was therefore essential that the authorities and the Fund should agree as early as possible on a strong adjustment program. Without such an agreement, he could not approve the exchange restrictions.

Mr. Wang remarked that Venezuela had experienced a large drop in export revenue since 1961, and was currently facing a serious liquidity problem. The difference of opinion between the authorities and the staff on the magnitude and speed of the necessary economic adjustment should in no way hinder the implementation of a program.

In the past, when Venezuela had a strong balance of payments position, the authorities had made valuable contributions to the Fund, Mr. Wang recalled. Now that they were facing a difficult financial situation, they deserved full and timely support--both technical and financial--from the Fund. He was pleased that the staff would be discussing with the authorities the possible use of Fund resources, and he was sure that an understanding could be reached and that the forthcoming consultation would be a fruitful one.

Mr. Donoso said that Venezuela was facing a difficult financial situation as a result of declining revenues from oil exports. During 1982 the authorities had found it possible to maintain domestic expenditure by making use of foreign borrowing and by drawing down international reserves. The maintenance of a high level of expenditure at a time when the economy was experiencing an income reduction had reduced confidence in the value of the currency. Consequently, there had been a large outflow of capital, with a total loss of international reserves of nearly $8 billion during 1982. In reaction to those developments, the authorities had adopted measures that they hoped would reduce the external current account deficit to $1 billion in 1983, from $3.5 billion in 1982.

The authorities had estimated a net outflow of capital of $3 billion for 1983, Mr. Donoso noted. Overall, a loss of reserves of $4 billion in 1983 was implied. Those estimates were based on the assumption that external debt payments, due in 1983, would be refinanced.

In assessing the external payments situation, the authorities had assumed that the public sector investment program and inventory holdings would be reduced in 1983, Mr. Donoso commented. Of the overall deficit of the public sector, $1 billion would be financed by drawing down on international reserves, and the remainder would be financed through resources from the private sector. However, he shared the staff's view that public investment could not be postponed without negative effects on growth and on the financial situation of the public sector itself, and that financing of the public sector could not be maintained over the long term.

He urged the authorities to give early consideration to the staff recommendation that they should raise the prices of gasoline, conduct a thorough reform of the tax structure, and reduce current expenditure in order to free resources for investment, Mr. Donoso said. The improvement of the external position would depend on the intensity and sustainability of the expenditure reduction. Since the whole program of external adjustment was based on the assumption that external debt could be refinanced, it was essential that the financial position of the public sector should be sound and should remain so in the future, in order to improve the negotiating position of Venezuela. In that context, it was necessary to ensure that central bank lending to the private sector did not offset the expenditure cuts in the public sector.

Commenting on the exchange system, Mr. Donoso stated that it was valuable that the authorities considered the multi-tier exchange system to be temporary, and that they were making some effort to move toward a free exchange rate. However, the present system contained an implicit tax on oil exports that could be used to subsidize many categories of imports. That same objective could be obtained by explicit tax and subsidies channeled through the budget, if there were a unified exchange rate; a clear advantage would be that the resources involved could be better identified. A unified exchange system would provide incentives for increased export production and for import substitution, and would minimize the need for import restrictions.

In comparative terms, the economic adjustment required by Venezuela did not seem to be very great, Mr. Donoso considered. Perhaps, in normal financial circumstances, the size of Venezuela's international reserves would have allowed a more gradual adjustment. Given the high concentration of external debt payments to be made in 1983 and the extreme caution with which commercial banks were operating, the authorities should not delay their implementation of an adjustment program. Some changes in the fiscal and exchange rate policies would be desirable, and from Mr. Senior's statement it was apparent that the authorities were aware of the need to make further adjustments. The major difference of views between the staff and the authorities was related to timing, and he was sure that the authorities would take prompt action if it appeared necessary from the macroeconomic indicators, which were being carefully monitored.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/83/95 (6/30/83) and EBM/83/96 (7/1/83).

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 83/17 and 83/18 are approved. (EBD/83/178, 6/24/83)

Adopted June 30, 1983

APPROVED: December 2, 1983

LEO VAN HOUTVEN
Secretary