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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/104

10:00 a.m., July 18, 1983

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

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	L. E. J. Coene, Temporary
	A. Le Lorier
A. Donoso	
R. D. Erb	T. A. Connors, Temporary
M. Finaish	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	G. W. K. Pickering, Temporary
	C. Robalino
G. Laske	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	
	E. I. M. Mtei
	J. L. Feito
J. Tvedt	
N. Wicks	C. Taylor
	Wang E.

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

Also Present

Asian Department: J. T. Boorman. European Department: B. Rose, Deputy Director; A. Arimo, R. P. Hicks, K. A. Swiderski, H. Ungerer. Exchange and Trade Relations Department: C. D. Finch, Director; D. K. Palmer, Associate Director; W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; K. B. Dillon, H. W. Gerhard, M. Guitian, J. Martelino. External Relations Department: D. Driscoll, H. P. Puentes. Fiscal Affairs Department: A. L. Antonaya. Legal Department: G. P. Nicoletopoulos, Director; Ph. Lachman, S. A. Silard. Middle Eastern Department: B. A. Karamali. Research Department: W. C. Hood, Economic Counsellor and Director; L. Alexander, H.-Y. Chu, L. U. Ecevit, E. C. Meldau-Womack, E. A. Milne, T. K. Morrison, A. Muttardy, B. E. Rourke, A. Salehizadeh, H. H. Zee. Treasurer's Department: D. Williams, Deputy Treasurer; A. J. Mathuran, O. Roncesvalles, T. M. Tran. Western Hemisphere Department: M. E. Bonangelino, L. A. Cardemil, C. Cha, R. A. Elson, J. Ferrán, T. F. Lehwing. Bureau of Statistics: A. K. M. Siddique. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, J. R. N. Almeida, C. J. Batliwalla, S. E. Conrado, S. El-Khouri, S. M. Hassan, P. Kohnert, H.-S. Lee, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, H. Arias, L. Barbone, R. Bernardo, M. Camara, M. B. Chatah, M. Eran, G. Ercel, I. Fridriksson, G. Gomel, N. U. Haque, M. Hull, H. Kobayashi, M. J. Kooymans, W. Moerke, V. K. S. Nair, Y. Okubo, E. Portas, M. Z. M. Qureshi, J. Reddy, C. A. Salinas, J. Schuijer, Shao Z., D. I. S. Shaw, P. S. Tjokronegoro, M. Toro, Wang C. Y.

1. COSTA RICA - 1983 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1983 Article IV consultation with Costa Rica and the review under the stand-by arrangement approved by the Fund on December 20, 1982 (EBS/83/127, 6/20/83; Sup. 1, 7/13/83; and Cor. 1, 7/14/83). They also had before them a report on recent economic developments in Costa Rica (SM/83/150, 7/5/83; and Cor. 1, 7/14/83) together with a paper on Costa Rica's exchange system (EBS/82/213, 11/29/82).

Mr. Feito made the following statement:

I would like to express the appreciation of my Costa Rican authorities for the work done by the recent Fund mission in connection with the 1983 Article IV consultation and the review under the stand-by arrangement. My authorities value the Fund's advice and have been in continuous consultations with this institution since before the adoption of the current stand-by arrangement. They are in broad agreement with the documents prepared by the staff.

After several rather disappointing experiences in the recent past, Costa Rica's performance under the current stand-by program has been very satisfactory. This is, indeed, underscored by the staff in its report. Moreover, not only has Costa Rica amply complied with all performance criteria but it also has made considerable progress toward achieving the program's overall objectives. Thus, it can reasonably be expected that Costa Rica will successfully attain, with a margin to spare, all of the program's objectives for the present year. Let me say that this is by no means an insignificant achievement in the current circumstances of Costa Rica and the Central American region as a whole; as we have lately seen in the Executive Board, many other examples indicate the difficulties involved in successfully reaching such an outcome.

As Executive Directors may recall, the program adopted by the authorities in connection with the stand-by arrangement approved by the Board in December 1982 (EBM/82/163, 12/20/82), is comprehensive and even ambitious. Several Directors even had serious doubts about the possibility of it being successful and about the authorities' determination to carry it out. Indeed, the program's implementation has been difficult, and it has demanded sacrifice from the Costa Rican people, underscoring the authorities' commitment and determination.

The program's overall objectives are to contain inflationary pressures, to promote an orderly development of the exchange rate, and to facilitate the resumption of foreign public debt service payments. For the whole of 1983 the main targets of the program are to reduce the overall nonfinancial public sector deficit to no more than 4.5 percent of GDP, to increase public sector savings by the equivalent of 5 percentage points of GDP, to reduce domestic bank financing of the nonfinancial public sector by the equivalent of 2 percentage points of GDP, and to slow down significantly the inflation rate, from about 95 per cent in 1982 to about 40 percent by the end of 1983, which would be equivalent to an average inflation rate of about 55 percent in that year.

Regarding inflation, as the staff has pointed out, it is now expected that by the end of the year the inflation rate will be less than 20 percent, or less than half the program's target. This improvement has not been easy, and it evidences a greater degree of confidence in the Costa Rican economy, as well as the forces of adjustment that have been brought about by the adopted stabilization measures. In this regard, I should reiterate that Costa Rica has more than amply complied with all the program's performance criteria, denoting an adjustment that goes beyond what was agreed with the Fund.

As Directors might recalll, in December 1982 Mr. Senior had expressed the authorities' views that interest rates should be adjusted on the basis of expected domestic inflation and interest rates abroad, and that it was not necessary to bring real interest rates to positive levels right from the beginning of the program. Indeed, such a measure was considered counterproductive. In the event, as a result of the lower than originally estimated reduction in the inflation rate, all interest rates have become positive in real terms. In keeping with their expressed intention to maintain a flexible approach to interest rate adjustment, the authorities have now decided to slightly lower domestic interest rates. Even with such a reduction, however, real interest rates will remain positive and well above the programmed levels. In the same area of monetary policy, the authorities have decided to increase the reserve requirements on shorter-term deposits, not only partly to absorb excess liquidity in the system, but also to stimulate the growth of more stable longer-term deposits with the banking system.

The centerpiece of the stabilization program is the adjustment to be implemented in the fiscal field. As was indicated in Mr. Senior's statement of last December, the main adjustment effort in the public sector was to be carried out in the decentralized public institutions, with major increases in contribution rates and in tariffs and prices charged by state enterprises. Even before the program was started, significant adjustments were decreed, and only a small portion of the increases was left for the program period. In this regard it might be worthwhile to reproduce the table of adjustments already taken, and those proposed for the program period, set out in Mr. Senior's December statement:

	Increases Since May 1982 to Date 1/	Increases in 1983	Total Increases
	(In percentage changes)		
Electricity	87	75	227
Telephone	55	--	55
Railroad transport	95	22	138
Water and sewerage	153	46	270
Oil derivatives	80	15	107

1/ December 1982.

As the staff indicates, electricity rates and oil prices have been reduced in the last two months, but we should bear in mind that such adjustment came only after major increases in the last few months, and that it will still leave prices and tariffs at levels well above those of last year. Furthermore, the authorities will make efforts to compensate for revenue losses, and performance up to now is well above the program's projections. Indeed, there is a sufficient margin to accommodate these latest measures in great part, as the estimated overall public sector deficit for 1983 is now ₡ 5.3 billion compared with ₡ 6.8 billion in the program. The revised projections made by the staff indicate an overall public sector deficit of 4.0 percent of GDP, against 4.4 percent of GDP estimated in the program. The authorities have also decided, however, to reduce by half the investment program of the electricity company (ICE).

Regarding incomes policy, as mentioned by the staff, the authorities intend to continue to adjust public sector salaries and minimum wages in absolute amounts on the basis of the changing cost of a basket of basic goods and services. This system of wage adjustments results in salary increases below the expected rate of inflation; and, being an across-the-board adjustment for all salary scales, it results in very low relative adjustments for the higher salaries. As can be seen in SM/83/150, a substantial share of the adjustment effort has been borne by real wages, which have dropped by 30 percent in the last three years. A further deterioration of real wages is anticipated for this year.

From the beginning, the authorities expressed their commitment to the unification of exchange rates within the framework of a flexible exchange rate system. The authorities have determinedly moved toward the achievement of an orderly market, and gains have indeed been substantial. As mentioned by the staff in the supplement to EBS/83/127, since the end of June 1983, the spread between the banking and the free market exchange rates has been reduced to less than 5 percent. The recent change in the surrender requirement of export proceeds, transferring 1 percent of such proceeds from the banking exchange rate to the free market, is in accordance with the program's objective of exchange rate unification. The Costa Rican authorities may well make additional transfers in the future.

An essential part of the stabilization program, and of the authorities' efforts, is the normalization of relations with foreign creditors. Significant progress has been made in this area. A rescheduling agreement with bilateral official creditors was concluded at the beginning of this year in the Paris Club. In April, a memorandum of understanding was signed with the chairman of the steering committee in regard to debt negotiations with foreign commercial banks. It is now expected that all legal documents for this rescheduling will be signed by the end of July, or August, well ahead of the original schedule of the end of 1983. The one issue that was still left to be resolved between the banks and Costa Rica, namely, the interest rate to be applied to certificates of deposit (CDs), has already been agreed in principle with the chairman of the steering committee. Such agreement calls for CDs held by banks to be paid the original interest rate, as proposed by Costa Rica.

The authorities are well aware that the substantial adjustment effort they have undertaken this year is only the beginning of a long road toward sustainable growth. They continue to be committed to this effort and they now wish to indicate their intention to request an extended arrangement with the Fund when the present stand-by arrangement is concluded.

Mr. Robalino stated that he fully supported the proposed decisions, and he commended the Costa Rican authorities for successfully meeting all the performance criteria under the stand-by arrangement. The staff had noted clearly the improvements brought about by the authorities: the substantial reduction in the level of inflation, the improvement in the exchange rate situation through progress toward unification, and the final agreement reached with the Paris Club creditors and with foreign commercial banks. In spite of those achievements, the financial implications of some measures taken by the authorities were a matter for concern. First, the reduction in the prices of oil derivatives and electricity would undoubtedly reduce the total revenues of the public sector. Compensating fiscal measures should be taken to keep the adjustment program on track. Second, the staff correctly expressed concern about wages. A cautious wage policy was needed in order to avoid an increase in inflation as well as additional pressure in the fiscal area and on Costa Rica's export competitiveness.

Mr. Taylor commented that progress under the stand-by arrangement had been remarkably good in a number of areas. There had been a dramatic improvement in inflation, testimony to the significant measures taken by the new Administration since May 1982. He hoped that the progress to date could be consolidated and built upon through a continuation of the resolute action taken by the authorities.

Some recent developments in the fiscal area were a little worrying, Mr. Taylor continued, such as the recent decision to reverse the final phase of the increase in electricity rates, the larger than anticipated wage increase granted to public sector employees in January 1983, and the slow progress in selling enterprises controlled by the state-owned development corporation (CODESA). Those developments would make it more difficult to achieve the target of a public sector deficit of 4.5 percent of GDP in 1983. He agreed with Mr. Robalino that further fiscal action could not be ruled out, although it was encouraging to note Mr. Feito's information that revenue performance to date appeared to be better than expected. He invited the staff or Mr. Feito to indicate what further fiscal measures might be available if the situation deteriorated. Pressure for a further salary increase for public sector employees in July 1983 should be resisted, given the reduced level of inflation. It would be interesting to know what measures the authorities were planning to promote the sale of the state-controlled enterprises in the immediate future so as to reduce the burden of CODESA on central bank financing. Were the enterprises in fact salable?

The authorities should resist pressures that might weaken the revenue base of the program, Mr. Taylor considered. He welcomed their intention to strengthen tax administration with technical assistance from the U.S. Agency for International Development (AID), a process that would take time. It would be useful to have an assurance that the additional revenue measures adopted in late 1982 would be continued through 1983, since congressional opposition had sometimes hindered the full implementation of revenue measures in the past.

Commenting on monetary policy, Mr. Taylor welcomed the improvement in the monetary situation achieved to date under the stand-by arrangement, particularly the recent increase in the private sector's deposits with banks and the decline in the net domestic assets of the Central Bank as the result of increases in bond placements and in commercial bank deposits. The recent fall in domestic interest rates, following the declines in inflation and in competing international rates, should not be allowed to result in pressure on the free market exchange rate and in a reduction in private domestic savings through the banking system. The authorities would have to monitor carefully the demand for domestic assets, and interest rates should not be allowed to diverge greatly from international trends.

As a result of favorable rescheduling agreements, Mr. Taylor noted, it would be possible to eliminate payments arrears by the end of 1983, an important objective of the program, as he had stressed in December 1982. The authorities should finalize the rescheduling agreements with commercial creditors as soon as possible. Agreement in that regard would unlock the major new revolving trade credit facility, and it would enable the payment of interest that was in arrears and that was currently falling due. He urged the authorities to take a flexible negotiating posture in the matter of resolving the outstanding question of the interest rate to be paid on central bank certificates of deposits (CDs) held by the creditor banks. Good progress had been made toward the normalization of the exchange system, despite continued foreign exchange shortages, and it would be desirable to achieve unification of the exchange rate before the end of the program, if possible. Given the progress that was being made toward the settlement of arrears, he could accept the further temporary approval of the multiple currency practices and payments restrictions.

The staff correctly emphasized that the ability of Costa Rica to repay its debts and to surmount its economic difficulties would depend crucially on the improvement of export performance, Mr. Taylor remarked. He welcomed the consideration being given to export promotion. The Ministry of Exports had announced that it was aiming at a substantial increase in export volume by concentrating on the production of commodities that could not be produced elsewhere. Had there been any recent developments in that regard? The authorities' intention to reduce the export tax might be premature, at least until the prospects for revenue from that source and others became clearer. Perhaps, instead, the banking exchange rate should be adjusted to improve export competitiveness, given the rather low level of imports estimated to be handled through the banking exchange market.

The authorities intended in due course to seek an extended arrangement with the Fund to follow the present stand-by arrangement, Mr. Taylor noted. A multiyear arrangement that built on the present stabilization efforts would be appropriate, but it would depend on successful completion of the present program and on the development by the authorities of a convincing package of structural measures to lead the country along a clearly delineated medium-term adjustment path. Such a follow-on arrangement should be based on continued sound fiscal policy, with emphasis on a broader revenue base and stronger tax administration, continued restraint on the creation of domestic credit, the maintenance of flexible and realistic interest and exchange rates, and macroeconomic measures to diversify and to extend the productive capacity of the economy, particularly in the export field.

Mr. Donoso emphasized the considerable progress that had already been achieved in Costa Rica, and the determination of the authorities to adopt additional measures in all areas where there remained room for further adjustment. In the fiscal area, he welcomed the enactment of measures affecting both expenditures and revenues, aimed at reducing the nonfinancial public sector deficit from almost 14 percent of GDP in 1981 to 4.5 percent of GDP in 1983. He also noted the authorities' efforts to sell some of the enterprises controlled by the state-owned development corporation in order to improve its financial situation and to avoid recourse to central bank financing. Even though progress in that area had been slow, the authorities had been moving in the appropriate direction; perhaps the difficulties impeding faster progress were directly linked to the general weakness of the economy.

With regard to incomes policy, Mr. Donoso observed, while the size of the most recent salary adjustment had been higher than appropriate, the authorities considered that the recent deceleration of inflation would allow the elimination of further salary adjustments in the remainder of 1983. That decision would have a positive impact on the expenditure side of public sector finances and it should also consolidate the success in the abatement of inflationary pressures.

Commenting on monetary policy, Mr. Donoso noted that considerable progress had been achieved in the first few months of 1983. In fact, the banking system's liabilities to the private sector had been growing at a strong pace and improving in real terms, while the expansion of net domestic assets had decelerated sharply; as a result, the net international reserve position of the Central Bank, including payments arrears, had improved considerably. The authorities had proposed to reduce domestic interest rates in order to encourage prompt economic recovery; he agreed with the staff that such a measure was acceptable in light of recent developments in domestic inflation and in interest rates abroad. But insofar as the reduction depended on those factors, the authorities would have to be prepared to raise rates again if inflation accelerated in the future, or if there were pressures on the free exchange rate.

Considerable progress had already been made toward the achievement of the main external objectives of the program, Mr. Donoso added. Exchange rate unification would be completed before the end of the program period, normal service payments on Costa Rica's external debt had been resumed, and a settlement had been reached on external payments arrears, which were expected to be eliminated by the end of 1983. He commended the Costa Rican authorities for the progress already made, and he wished them success in the remainder of the program.

Mr. Connors remarked that Costa Rica had made substantial progress during the previous six months in improving its financial situation, particularly in reducing inflation, stabilizing the foreign exchange market and moving toward unification of the exchange rate, improving the net international reserve position of the Central Bank, and normalizing relations with foreign creditors. To maintain the momentum of the improvement in recent months, the continued strong efforts of the Costa Rican authorities would be essential in a number of areas.

Continued tight control of public sector expenditures would be necessary in order to achieve the 1983 target for the public sector deficit, Mr. Connors considered. Given the reduction in nominal revenues and the lower than anticipated level of external financing to date, he strongly supported the authorities' intention to reduce nominal expenditures below programmed levels in order to meet the targets for the public sector deficit and for banking system credit to the public sector. He agreed with the staff that, in light of the lower inflation rate and the size of the January 1983 public sector wage increase, no further increase in public sector wages was warranted in 1983. More generally, the review of the wage structure scheduled for July 1983 should be conducted with a view to safeguarding the recent successes of the stabilization program.

Progress in eliminating the operating deficits of the public sector enterprises would have to be continued, Mr. Connors went on. To that end, resistance to needed changes in administered prices, particularly in the areas of fuel and electricity, would have to be overcome, or additional offsetting expenditure reductions would have to be implemented in addition to those currently contemplated. The authorities should also strengthen their efforts to sell enterprises owned by the development corporation.

He agreed with the staff that, while the reduction in domestic interest rates implemented in May was acceptable, it was important to maintain positive real interest rates, Mr. Connors said. He urged the authorities to keep interest rates under close review and to make adjustments promptly if they became necessary. He supported the authorities' intention to move quickly on measures designed to improve the competitiveness of exports. Prompt unification of the exchange rate at a realistic level would be helpful. Substantial growth in exports was an essential element in Costa Rica's medium-term recovery; there should be no delay in devising and implementing a strategy to nurture that growth.

Mr. Pickering observed that, after experiencing a sharp deterioration in its economic situation in the three-year period ended in 1982, Costa Rica had undertaken significant adjustment. Performance under the program had been satisfactory; all performance criteria had been met, and many of the main objectives of the program would be achieved. Recent progress included the decline in inflation, the improvement in public finances, and the regularization of external payments with official creditors and international banks.

With regard to government expenditures, Mr. Pickering said that despite the progress made in reducing the overall fiscal deficit of the nonfinancial public sector, the authorities should adjust downward the levels of expenditure with a view to limiting further the required financing of the public sector, particularly from external sources. He joined other Directors in noting with disappointment the information in the supplement to EBS/83/127 indicating that tariffs of some public enterprises, particularly for electricity, had been rolled back significantly. Those changes not only represented an added burden to the public sector, but they could undermine the public perception that the authorities were determined to undertake the required adjustments. He agreed with other Directors and the staff that the larger than planned increase in public sector wages in January 1983 and the recent deceleration in inflation would mean that no further adjustments should be made in 1983.

The staff had noted that the new guidelines initiated in late 1982 for the adjustment of minimum wages and public sector wages would probably result in a further decrease in real wages in 1983, Mr. Pickering continued. The current incomes policy appeared broadly appropriate since the authorities would have considerable flexibility in maintaining control over future wage increases as inflation decelerated from the extremely high levels experienced in 1982. He urged the authorities to continue their determined efforts to avoid significant wage increases. He also encouraged the authorities to reverse the recent increases in the number of basic consumer goods and imports that were controlled by the Government. The narrowing of the recent spread between the banking and the free market exchange rates, from 9 percent to less than 5 percent, was welcome as a development that brought the authorities closer to their objective of unification of the three exchange rates, a step that would be important for the much needed promotion of the export sector.

Turning to the medium-term outlook for the Costa Rican economy, Mr. Pickering suggested that it was clear that the servicing of external debt would be onerous for the rest of the decade. For that reason, he agreed with the Costa Rican authorities that a satisfactory rate of economic growth and a sustainable balance of payments position would require the diversification and growth of exports. Such an approach would involve, inter alia, a simplified exchange rate system, and an expansion of trade beyond the Central American region. It was also likely that Fund assistance would be required to achieve the needed structural adjustment. He noted Mr. Feito's statement that the authorities were requesting a follow-on extended arrangement, and he associated himself with Mr. Taylor's remarks in that regard. Any amounts involved in a further program should be chosen with due regard to the long-term profile of Costa Rica's debt service.

Mr. Morrell commented that Costa Rica's adjustment program was on track. There were ample margins with respect to the quantitative ceilings, the balance of payments test had been more than met, and inflation was only half the projected rate. There also appeared to be a return of confidence as indicated by the appreciation of the free market exchange rate. In June 1981, his chair, among others, had noted that the relatively sharp depreciation of about 130 percent had probably been excessive and that it had been traceable to strong speculative elements. The staff had said that no growth in real GDP was expected in the current year. If that statement indicated that no decline was expected, it represented a dramatic improvement over the GDP decline of 8.8 percent in 1982, and it would be further evidence of the success of the stand-by arrangement so far. Could the staff provide output indicators for 1983 to date?

He agreed with the staff that fiscal measures were at the heart of the program, Mr. Morrell continued, and he welcomed the authorities' determination to keep the overall deficit of the nonfinancial public sector to 4.5 percent of GDP, notwithstanding the lower revenues implied by the lower levels of inflation. It was encouraging that the authorities were reducing spending levels by 12 percent more than originally intended under the program. However, it was disappointing that they had not been able to resist completely the pressures for a lowering of electricity and oil prices. He hoped that they would be able to make the compensatory revenue adjustments that they had mentioned, and he noted Mr. Feito's remarks with respect to the very large increases in those prices that had already occurred. The staff encouraged the authorities to divest themselves of investment in a number of parastatal enterprises. The reasons for that suggestion were understandable, but during times of recession, low profitability, and a credit squeeze it would probably be unrealistic to expect many interested or able buyers at reasonable prices.

Progress had been made toward exchange rate unification, Mr. Morrell noted, as well as toward the making of normal service payments on external debt and the settlement of external arrears. The memorandum of understanding covering the terms of the rescheduling of commercial debt had been signed in April 1983. Notwithstanding that rescheduling, the debt service ratio was expected to be over 50 percent in 1985-88, even if export growth averaged 5-7 percent in real terms. Did that projection by the staff take into account future debt that might be contracted? In any case, it was clear that the situation would be difficult for the economy to sustain. There was, therefore, a need for structural reform to increase and to diversify exports; he welcomed the World Bank's involvement through structural adjustment lending.

Did the staff agree with the authorities' assessment that inflation could be held to less than 20 percent in 1983, about half that originally projected? Mr. Morrell inquired. If the answer was yes, would it not suggest the need to adjust the net domestic asset ceilings in order to make them consistent with other program elements? Furthermore, the authorities were at present considering lowering nominal interest rates at a time when real interest rates were only slightly positive. If inflation could be contained at less than 20 percent, however, some downward adjustment in interest rates appeared reasonable.

The staff representative from the Western Hemisphere Department noted that it had been suggested that the authorities might need to consider further measures in the fiscal area. It appeared that, at present, the authorities were hoping to lower the rate of growth of expenditures to less than had been originally intended. They were not considering a further revenue increase at the moment, but if it became necessary, they would consider that approach, including possible adjustment of electricity rates.

It was not easy to sell the enterprises held by CODESA at a time of recession, the staff representative remarked. In addition, many of the enterprises were not in good financial condition. The authorities had formed a committee consisting of private and public officials to deal with the problem, and they were also conducting a study of the financial situation of some of the enterprises with technical assistance from U.S. AID. Firm offers had already been received for two of the enterprises, and the proposal to sell them had been submitted to the Congress for ratification. In addition, recognizing that other measures had weakened the revenue base of the program, the authorities had postponed the possible reduction in the export tax until 1984. The electricity corporation had already taken a number of measures, in compensation for the loss of revenues resulting from the recent rollback of tariffs, to ensure that locally financed capital expenditures would be below the budgeted level by about ¢ 450 million, almost equal to the estimated revenue loss.

Commenting on the external situation, the staff representative stated that Costa Rican officials had met with the steering committee of foreign commercial banks a few days earlier and that the issue of the interest rate to be paid on certificates of deposit had been settled on acceptable terms. The authorities had also indicated to the staff that they were close to signing the final legal documents to complete the rescheduling agreements. With regard to the medium term, the staff had assumed that capital inflows to the public sector would continue, while decreasing as a proportion of GDP from about 8 percent in 1983 to about 4 percent in 1987. The staff had not revised the original estimate of GDP growth in 1983, but the authorities believed that, on the basis of available indicators for agricultural production and construction activity, there would be zero or marginally negative growth of GDP in 1983, a considerable improvement over the outcome for 1982.

The inflation rate in 1983 would probably be about half of what had been assumed in the program, the staff representative from the Western Hemisphere Department added. Much would depend on the success of incomes policy and on appropriate monetary and fiscal policies, but the progress in 1983 to date had been encouraging. The most recent data indicated that, in the first six months of the year, wholesale prices had increased at an annual rate of about 9 percent. The staff had not considered it necessary to adjust the credit ceilings, however, because the outcome still remained somewhat uncertain. The authorities were taking measures to keep the growth of credit to both the public and private sectors below the permitted amounts, for example, by increasing reserve requirements of the banks.

The staff representative from the Exchange and Trade Relations Department, commenting on the question of whether to adjust the credit ceilings downward, said that, in general, if the demand for liquid assets in an economy turned out to be higher than originally estimated, a downward adjustment in the credit ceilings could result in a larger balance of payments surplus or in lower inflation. A downward adjustment in the credit ceilings would be appropriate if the internal generation of domestic liquidity appeared to be greater than the economy's willingness to absorb it. However, in the case of Costa Rica, the restoration of confidence arising from the success of the program had apparently led to a decline in the velocity of circulation of money. Therefore, it did not seem necessary to adjust the credit ceilings.

Mr. Feito observed that the new Costa Rican Administration that had taken office in May 1982 had faced a difficult economic situation. The authorities had reacted promptly by taking appropriate measures and by agreeing on a policy package supported by the stand-by arrangement with the Fund. It was clear that performance to date had been extremely satisfactory in all areas of the program. The degree of demand restraint had been greater than originally envisaged; as a result, all the performance criteria had been met with ample margins to spare, and progress toward the achievement of the main objectives of the program had been faster than initially foreseen. The point deserved emphasis because it underlined the strong commitment of the authorities and the soundness and coherence of the program.

The main focus of the program was on the correction of fiscal maladjustment, Mr. Feito continued, which had been correctly judged to be the major element in the imbalance between nominal demand and aggregate supply leading to inflation and balance of payments disequilibrium. As the staff and many Directors had pointed out, the progress made to date in correcting the fiscal imbalance had been substantial. The overall nonfinancial public sector deficit had been reduced, public sector savings had increased, and the degree of monetary financing of the deficit had declined. Actions in those areas had been stronger than contemplated in the program and they were the main factors responsible for the lower rate of inflation, the improvement in the external balance, and the restoration of confidence in the economy. Given the circumstances of the world economy and the structure of the Costa Rican economy, the achievement was noteworthy.

In a small, open economy such as Costa Rica's, with a relatively narrow productive base, international trade provided the main source of fiscal revenue, Mr. Feito remarked. Taxes on international trade directly provided about 50 percent of total revenues, but their importance to the revenue side of the budget was much greater, given the weight of exports in domestic output. Imports and exports amounted to about 50 percent of GDP; fluctuations in international trade, therefore, profoundly affected the fiscal position. A world depression accompanied by a declining or stagnating volume of international trade usually led to a much greater decline in the ratio of fiscal receipts to GDP than in other economies. In an economy such as Costa Rica's, heavily dependent on the international business cycle, it was a very difficult undertaking to arrest major fiscal disequilibria. The task involved structural, rather than simply cyclical, adjustment, demanding a strong commitment on the part of the authorities and considerable sacrifice of the standard of living of the population. The Costa Rican authorities were aware of the importance of pursuing a fiscal policy consistent with the program, and, if recent changes in the prices of public services were to endanger the progress toward fiscal balance, they were prepared to reduce the growth of nominal expenditures accordingly. They would focus primarily on the reduction of expenditures; investment priorities were being reviewed, and the national electricity corporation would probably reduce capital expenditures to about half the level originally intended for 1983.

In the case of Costa Rica, and in other small, open economies in the region, it was important to distinguish between domestic and external adjustment, Mr. Feito considered. A balance of payments disequilibrium originating in cost and price differentials between an economy and the rest of the world should be distinguished from a balance of payments disequilibrium resulting from worldwide economic cyclical fluctuations. In the latter case, when the disequilibrium had its origins more in the international business cycle than in domestic factors, policies of demand restraint placed the burden of adjustment on import reduction rather than on efforts to increase exports significantly. In Costa Rica imports had been reduced considerably, but exports had not reacted as desired to the deflationary package that the authorities had implemented. Given the present international recession, if many countries like Costa Rica made simultaneous efforts to maintain or to increase their exports in the face of a shrinking or stagnating volume of international trade, the final result would merely be a further fall in prices and a reduction in export receipts. It should be emphasized, therefore, that, while such small economies were making strong efforts to adjust and to adopt appropriate domestic policies to correct disequilibria, the international economic cycle, the outlook for finance, and the medium-term prospects all had to be taken into account. Finally, the Costa Rican authorities intended to request an extended arrangement with the Fund upon conclusion of the stand-by arrangement so as to consolidate the gains achieved by their current stabilization program.

The Chairman made the following summing up:

> Executive Directors were in broad agreement with the staff appraisal in the report for the 1983 Article IV consultation with Costa Rica and the review under the stand-by arrangement. Noting the difficult economic and financial situation of Costa Rica and the difficult external conditions, Directors commended the substantial adjustment efforts initiated by the Government in 1982 in the context of the stand-by arrangement. Directors noted that Costa Rica had been in total compliance with the stand-by program and they praised the significant progress that had been made in the areas of inflation, exchange rate management, and rescheduling of external public debt.
>
> Directors recognized the importance of fiscal policy in the stabilization program and noted the major revenue measures and expenditure restraints that had been undertaken by the Government in the second half of 1982 to reduce the public sector deficit. Directors stressed the importance of holding the public sector deficit for 1983 to no more than 4.5 per cent of GDP. Directors expressed serious concern about the weakening of the public sector revenue base as a result of the recent reduction of electricity rates and oil prices. They stressed, therefore, the need for measures to reduce expenditures to a level consistent with the availability of financing so as to hold down inflationary and balance of payments pressures. Such efforts would be facilitated

by a strengthening of tax administration. Directors also urged the authorities to contain wage demands and to follow a very cautious wage policy in the public sector. Some Directors stressed the need to improve the financial position of the state-owned development corporation through the sale of some enterprises owned by the corporation.

Directors noted that important progress had been made toward the unification of the exchange rates and they welcomed the authorities' reaffirmation of their intention to unify the rates fully before the end of the program and to continue to pursue a flexible exchange rate policy. Some concern was expressed about the medium-term outlook for Costa Rica's balance of payments, particularly in view of the very high debt service ratio, and several Directors noted that the achievement of a viable balance of payments position would require a strong export performance and the continuation of prudent fiscal and monetary policies.

Directors welcomed the progress that had been made in the rescheduling of Costa Rica's external debt and they noted that, as the debt rescheduling agreement entered into effect, Costa Rica would be in a position to eliminate its external payment arrears by the end of 1983.

Some Directors commented positively on the possibility of a new multiyear arrangement with the Fund to succeed the present arrangement when it expires in mid-December, provided that such a new program included an appropriate set of structural adjustment policies that would lead to a viable external payments and debt position in the medium term.

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

The Executive Board took the following decisions:

<u>Exchange Measures Subject to Article VIII</u>

1. The Fund takes this decision relating to Costa Rica's exchange measures subject to Article VIII, Sections 2 and 3, in light of the 1983 Article IV consultation with Costa Rica conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance Over Exchange Rate Policies).

2. Costa Rica maintains multiple currency practices and restrictions on payments and transfers for current international transactions described in EBS/82/213, EBS/83/127, and EBS/83/127, Supplement 1. In light of the continuing implementation by Costa Rica of policies for balance of payments adjustment, which are supported by a stand-by arrangement, the Fund grants approval

for the retention of these multiple currency practices and restrictions until the termination of the stand-by arrangement on December 19, 1983.

Decision No. 7469-(83/104), adopted
July 18, 1983

Review Under the Stand-By Arrangement

1. The Fund and Costa Rica have concluded the review pursuant to paragraph 4(c) of the stand-by arrangement for Costa Rica (EBS/82/214, Supplement 1).

2. Subparagraph 4(d)(ii) of the stand-by arrangement shall read: "introduces any new multiple currency practices, or modifies the existing multiple currency practice other than as described in paragraph 13 of the attached letter and in EBS/83/127, Supplement 1; or"

3. The Fund finds that no further understandings are necessary.

Decision No. 7470-(83/104), adopted
July 18, 1983

2. MALTA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Malta together with a proposed decision concluding the 1983 Article XIV consultation (SM/83/140, 6/22/83). They also had before them a report on recent economic developments in Malta (SM/83/148, 7/1/83).

Mr. Lovato made the following statement:

My Maltese authorities broadly concur with the staff's appraisal of economic events in the country in the 1981-82 period. They would, nonetheless, like to place more emphasis on some specific traits of the Maltese economy, such as its small size and openness, and the consequences of these for the conduct of economic policy.

Until 1974 Malta's economy depended and thrived on the British military base, which was gradually dismantled and finally closed in 1979. Following the closure, Malta embarked on a process of diversifying and expanding its economic system and succeeded in rapidly reabsorbing into other industries the work force previously employed in the services typically connected with a formerly dependent economy. Over a short period of time it undertook valuable development projects, upgraded its productive and administrative apparatus, and improved considerably the standard of living of its population.

In 1981-82 Malta's economy was severely hit by the recession in world production and trade, particularly in the EEC area. Exports recorded a sizable decrease in real terms over the period, with contractionary effects on domestic output. As a consequence, the unemployment rate rose dramatically, more than doubling from 1980 to 1982. The adverse impact of the decline in aggregate demand on labor market dynamics was magnified by sectoral shifts, such as the promotion of more capital-intensive industries with a view to diversifying and restructuring the country's productive apparatus. Labor redundancies emerged in the process leading to a higher observed unemployment rate. The reabsorption of as many as possible unemployed workers in newly developing industries is therefore currently regarded by my Maltese authorities as their overriding priority in the design and conduct of medium-term economic policy. Economic outcomes to date and policy intentions for the near future are to be appraised, therefore, against this background.

On fiscal matters, some stimulus was imparted to a sluggish domestic economy as the budget deficit grew to almost 3 percent of GDP in 1982. Current revenues increased, albeit at a slower rate than current expenditures. Capital spending was given a strong impetus by the resumption of sizable outlays in productive and infrastructural projects. Some degree of budgetary support to domestic activity is implicit in the fiscal estimates for 1983: revenues will be unchanged, while current and capital spending is expected to rise. The larger anticipated budget deficit will be easily financed by foreign grants and loans and by drawing on the ample cash reserves of the Treasury.

Monetary control does not pose particular problems to the Maltese authorities. Selective schemes have been adopted to allocate low-cost credit to sectors that are singled out as prominent for development purposes, such as shipbuilding and ship servicing. As for textiles and tourism, the authorities aim at improving product quality rather than expanding capacity. Deposit rates were slightly modified in 1982 and the lending rate structure made more flexible. Interest rates are comparable in real terms to those prevailing in world financial markets.

Incomes policies were implemented in 1983 with a view to improving the competitive performance of the Maltese economy. The wage freeze, supplemented by price and profit controls, introduced in January of this year, was a radical departure from the historical trends that prevailed in the country during the 1970s. My authorities believe that maintaining and possibly extending it beyond 1983 is an effective way of improving competitiveness and, therefore, employment.

Trade and exchange rate matters are two areas where my authorities do not fully concur with the view and assessments offered by the staff in SM/83/140. As far as the "trade reciprocity" issue is concerned, my authorities recognize that, especially for a small open economy, free multilateral trade is the best policy course in most circumstances. They feel, however, as the staff accurately represents, that bilateral trading arrangements are necessary in the currently depressed economic juncture to sustain Malta's export drive. They see bilateral trade as a temporary "learning" scheme designed to assist Maltese small and "infant" enterprises in their efforts to explore and develop new export markets. They also feel that in a stagnant world economy, where instances of patent or latent protectionism have been emerging in growing numbers, actual access to international markets is often restricted, if not indeed impossible, for small-scale exporters lacking entrepreneurial and commercial expertise. They see, therefore, continued room for government actions in the trade arena to lead export marketing drives in their initial stage.

Concerning the conduct of exchange rate policy, my authorities have monitored carefully and continuously exchange rate developments, aiming at maintaining competitiveness vis-à-vis Malta's trading partners but also at curbing imported inflation. The appreciation of the lira since 1980 has been primarily inspired by the desire to insulate the Maltese economy from the propagation of world inflation to the domestic price level. This policy was instrumental in bringing about a quick deceleration in the inflation rate in 1981 and 1982.

My authorities also stress that the high import dependence of the economy and the high import content of its export goods would reduce, and possibly nullify, the positive effects of a depreciated exchange rate on the country's external accounts. They believe, however, that, given the recent decline in the current account surplus, it is imperative that competitiveness be maintained. While convinced that the supportive policies in place on the fiscal, monetary, and incomes fronts are appropriate for this purpose, they agree with the staff that a flexible conduct of exchange rate policy is desirable.

Mr. Coene commented that Malta's economic development had continued on a relatively satisfactory path despite the adverse effects of the world recession, to which Malta's small, open economy was especially vulnerable. The shocks inflicted by the world recession had been somewhat dampened by the adoption of a more expansionary fiscal policy aimed at accelerating the structural transformation of the Maltese economy from a low-wage economy to a more sophisticated stage. The world recession had frustrated the Maltese authorities' wish to accomplish the gradual transition of the economy, while highlighting the underlying weakness of that economy--rapid growth of wages in excess of the increase in productivity over the previous decade. It was difficult to avoid the impression that the deterioration of export earnings in 1981, and especially in 1982, had been more severe than could have resulted from the recession alone, and that some other factor, such as the loss of competitiveness, had also been at work. That loss of competitiveness had been caused by large wage increases in the previous year, aggravated by the appreciation of the Maltese lira.

The authorities seemed to have concluded that competitiveness had been deteriorating, Mr. Coene continued, and in January 1983 they had imposed a wage freeze supported by strict price and profit controls. Such measures could be effective on a temporary basis, but he agreed with the staff in cautioning the authorities against excessive reliance on such devices as a means of achieving any lasting improvement in Malta's external competitiveness. Considering the large role of the state in the economy, a more formal incomes policy might prove useful.

In view of the openness of the economy, the reluctance of the Maltese authorities to use exchange rate depreciation to improve Malta's competitive position was understandable, Mr. Coene remarked. However, they had made excessive use of the exchange rate as a means of countering inflation, and it might be more useful to maintain the rate at its present level for the time being. Keeping the exchange rate at a more appropriate level would help to avoid imposing or tightening import controls that would otherwise be necessary to protect Malta's domestic industry from foreign competition. The information in SM/83/148 suggested that those controls had been applied not only to nonessential goods, but that they were also being used as a means of halting import penetration.

The policy of "trade reciprocity" was also counterproductive as a means of gradually improving competitiveness, Mr. Coene considered, since it tended to shelter exports from external competition and it could lead in time to decreased efficiency and increased support to exports by artificial means. The most effective way to gain access to foreign markets was through competitiveness in terms of price and quality; the size of the enterprises and the economy was of marginal relevance in that regard. He urged the authorities to seek other ways of ensuring access to overseas markets for Malta's exports.

The preceding critical observations should not be allowed to obscure the fact that the overall policy stance of the Maltese authorities was satisfactory, Mr. Coene stated. Fiscal and monetary policies for 1983 were appropriate, in particular the flexibility that had been introduced into interest rate policy. The past and present record of prudent economic management by the authorities provided assurance that, if the present economic situation were to deteriorate substantially, the authorities would take timely adjustment measures. With those considerations in mind, there appeared to be no special need to hold the next Article IV consultation with Malta on the standard 12-month cycle. Malta was a good candidate for a longer consultation cycle. Finally, had further thought been given to a move by Malta from Article IV to Article VIII status, since Malta's exchange system appeared to be relatively free of restrictions?

Mr. Grosche noted that the previous Article IV consultation with Malta had been concluded more than two years earlier. Although Malta had performed well in the 1970s and it had shown remarkable resilience to the worldwide recession and inflation, consultations on a more frequent basis could, nevertheless, be beneficial for the economy.

With regard to the issue of trade reciprocity, Mr. Grosche continued, Mr. Lovato had put forward impressive arguments in favor of bilateral trading arrangements in Malta's particular case. The authorities believed that such arrangements were necessary to sustain Malta's export drive in the currently depressed economic environment. However, the staff had correctly pointed out that the authorities should be keenly aware of the potential harmful effects of such a policy, especially in the long run. Trading arrangements were usually fixed term, and export industries based upon such arrangements could rapidly become obsolete, especially when exporters had not faced competition before and had not learned to compete. He welcomed Mr. Lovato's statement that the Maltese authorities considered those arrangements to be temporary, designed to assist Maltese small enterprises to develop new export markets.

Commenting on exchange rate policy, Mr. Grosche observed that the views of the staff and of Mr. Lovato did not appear very different. The authorities agreed with the staff's main point that it was imperative to maintain competitiveness. While the present wage freeze and price controls could make an important contribution, he agreed with the staff that an extended use of such measures carried the risk of creating distortions in the economy. In any event, a further appreciation of the Maltese lira should be avoided. Cautious monetary and fiscal policies should continue to be pursued. It was encouraging that the authorities shared the staff's view that not only were supportive fiscal, monetary, and incomes policies needed to maintain competitiveness, but that a flexible exchange rate policy was also desirable.

Mr. Connors said that two points deserved emphasis. First, the distorting effects of the policy of trade reciprocity were a matter of concern. Malta was a small, open economy that could ill afford to pass up the potential gains from trade. In their own self-interest, the authorities would have to be cautious in implementing the policy of trade reciprocity because of its potential costs. He agreed with the staff that a policy of reciprocity was also undesirable from an international perspective. Second, the importance of maintaining competitiveness should be stressed. Increases in wages and prices should be contained through policies that did not lead to distortions, and the authorities should stand ready to adjust the exchange rate if that approach was necessary to improve competitiveness.

The staff representative from the European Department commented that, while the policy of trade reciprocity carried with it potentially harmful effects, the authorities believed that the policy was necessary for Malta, being a small country that found it difficult to establish a share of international markets. It was a way of "putting Malta on the map" as one Maltese official had suggested.

The staff had discussed the question of Article VIII status with the Maltese authorities, the staff representative continued, but the authorities had believed that it was not an appropriate time to move from Article XIV status, given the vulnerability of the economy, the problems that they continued to face, and the fact that a number of other European countries in a similar position were not yet ready to move to Article VIII status.

With regard to the question of the consultation cycle, the staff representative from the European Department remarked, developments could move rapidly in a small, open economy such as Malta's. The staff had been surprised at how much the situation had changed since the previous Article IV consultation two years earlier. When the staff had explained the Executive Board's general interest in more frequent consultations, the Maltese authorities had indicated that a further consultation in about a year's time would be acceptable.

Mr. Lovato said that the two areas in which there was a difference of emphasis between the staff and the authorities were trade policy and exchange rate policy. With regard to the latter, while it was true that the real effective appreciation of the rate had been about 21 percent in the three years ended in the fourth quarter of 1982, there had been an effective depreciation in earlier years. Therefore, it was difficult, as the staff pointed out, to determine a point of equilibrium. Since the early 1970s, the Maltese authorities had tried to manage the rate so as to shelter the economy from the damaging effects of imported inflation. They were well aware of the need to maintain competitiveness, but competitiveness was not simply a question of costs and prices. In evaluating the pros and cons of an exchange rate adjustment, the structure of the specific economy had to be borne in mind. In Malta's case, the value of merchandise imports had usually amounted to about twice the value of exports. The price elasticity of domestic demand for most imports was relatively low, but especially for raw materials, capital goods, and most food items. A devaluation of the Maltese lira would, therefore, have two negative effects--an immediate deterioration of the terms of trade and an inflationary spiral because the unions would eventually withdraw their acceptance of incomes policy as a result of the increase in the cost of living.

On the other hand, the benefits to the export sector would be limited and temporary, Mr. Lovato suggested, because the import component of the domestic manufacturing sector and exports amounted to about 50 percent of the value of industrial output; therefore, the immediate increase in the import component of output, compounded by the higher cost of labor, would lead to a substantial increase in domestic prices and, consequently, to a reduction in competitiveness. His Maltese authorities believed that a lasting improvement in competitiveness required an increase in productivity, improvement in the quality of local products, and restraint of inflation, particularly labor costs. In that regard, the measures already taken in the textiles and the tourist sectors not to increase capacity but to improve quality, as well as the price and wage freeze introduced in

1983, were steps in the right direction. The authorities believed that, while a devaluation would have been a relatively easy measure to take, the decision to freeze wages had been much more difficult but would have a much better effect in the long run.

Commenting on the question of bilateral trade agreements, Mr. Lovato considered that a number of factors had to be taken into account, including the size of the country, the inexperience of its enterprises in international markets, and the current international economic situation, which was characterized by weak demand and growing protectionism. The deteriorating external economic environment had sharply dampened Malta's prospects for export-led growth; given the small size of the domestic market and of the enterprises, and the country's lack of entrepreneurial management and marketing skills, Malta had no option but to rely on government support in developing overseas markets, at least temporarily.

With those considerations in mind, Malta had been making efforts to identify new trading partners, Mr. Lovato stated. The bilateral agreements were not one-for-one trade exchanges, but agreements that contained financing aspects as well as provisions for direct investment or joint ventures in order to support small enterprises in their export efforts and to create the basis for better future economic relationships with other countries. The Maltese authorities would prefer to enter into multilateral agreements, as they had done in the past; they had entered into a number of reciprocity agreements only because of the problems created by the weakness of world demand and by protectionist measures in other countries. They were well aware of the dangers implicit in maintaining those agreements as medium- or long-term solutions; they considered them only temporary.

The Chairman made the following summing up:

Executive Directors noted that, after many years of high growth, the Maltese economy had been adversely affected in 1981 and 1982 by the international recession. This had been reflected in declining industrial production, reduced tourist activity, and a marked increase in unemployment. The weakening in activity, together with the easing of inflation abroad, had led to a pronounced deceleration of the rate of increase in prices to less than 6 percent in 1982. The winding down of inflation was also a reflection of policy measures, including a sizable effective appreciation of the Maltese lira. Directors noted, however, that real wages continued to rise substantially, in line with the authorities' social objectives but well ahead of gains in productivity, and that such a development was likely to aggravate the unemployment problem.

Directors observed that the Maltese authorities were emphasizing acceleration of development projects that offered a prospect of generating employment opportunities. However, concern was expressed about the policy of "trade reciprocity," which formed part of the Government's economic strategy, because those arrangements, unsatisfactory from an international viewpoint, carried a considerable risk of distorting the efficient allocation of resources, particularly for the medium and longer term; in that regard they should be considered as essentially temporary mechanisms.

Directors believed that the authorities should be commended for their responsible handling of fiscal policy and for the greater flexibility in monetary policy, especially their willingness to adjust the pattern and the level of interest rates. The price and wage freeze effective at the beginning of 1983 was also seen as an immediate strong response to the authorities' growing concern about competitiveness. However, such a policy could not provide a lasting solution, and it required adequate supplementary measures. In this respect it was felt that further effective appreciation of the lira should be avoided.

It is expected that the next Article IV consultation with Malta will be held on an 18-month cycle.

The Executive Board then took the following decision:

Decision Concluding 1983 Article XIV Consultation

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

2. The Fund hopes that Malta will continue to maintain its present relatively liberal system of payments and transfers for current international transactions.

Decision No. 7471-(83/104), adopted
July 18, 1983

3. COMPENSATORY FINANCING FACILITY AND BUFFER STOCK FINANCING FACILITY - FINANCING OF FLUCTUATIONS IN COST OF CEREAL IMPORTS - REVIEW

The Executive Directors considered a staff paper on a review of experience with financing of fluctuations in the cost of cereal imports and selected policy issues related to the compensatory financing facility and the buffer stock financing facility (SM/83/131, 6/16/83; and Cor. 1, 6/20/83).

The Economic Counsellor noted that events had caused some of the data in the staff paper to become outdated. For example, the staff stated on page 10 that Tanzania was not current in its payments to the Fund; however, as reported to the Board on June 29, 1983, Tanzania was now current in its obligations.

Mr. Polak made the following statement:

The paper before us provides a good basis for the review of a number of aspects of the compensatory financing facility. I propose to discuss first the four topics that are dealt with in this paper--with which I am in general agreement--and I intend to follow this up by some observations on the character of the facility.

Review of the cereal decision

The cereal decision was adopted only two years ago after a period of discussion inside and outside the Fund that lasted many years and that was finally brought to a positive conclusion only by a major intervention on the part of the Chairman. Even after the principle was agreed there were difficult negotiations about the percentages of quota and about the degree of integration of the cereal facility with the compensatory export facility.

It is a pleasure to observe that after its stormy preparatory period the experience with the cereal facility has been rather quiet. This is a reflection of an easing in the supply and demand situation in the cereal markets, which reduced the use of the facility below what had been expected earlier. Nevertheless, six purchases, for a total of SDR 285 million, provided useful assistance to five different members, each of which had an important problem with its food supply. We should also note that the smooth operation of the rather complicated provisions of the facility reflects the high quality of its design. I agree with the staff's conclusion that there is every reason to continue the facility as it now stands.

Experience with overcompensation and undercompensation

We have had a thorough discussion on this subject as recently as last November (EBM/82/145, 11/8/82). At that time we considered various changes in the facility to remedy the less than satisfactory experience of the Fund with cases of overcompensation as a result of the use of partly estimated data. In the end it was decided to handle this issue not by any changes in the facility but by improved procedures. The admittedly brief experience since then has been more satisfactory. In the light of this experience, I see no need for further changes, and I hope that, with the diligent attention that this matter is receiving from the staff, the present procedures will prove broadly adequate for the future. In this connection I want to underline my fundamental agreement with the staff on the importance of the early drawing provision as a means of providing members with timely compensation for export shortfalls.

Quota limits under the compensatory financing facility

This major section of the paper presents an interesting exercise on the "cost" of the compensatory financing facility under a series of assumptions as regards the various access limits. I want to commend the staff for the ingenuity that it has applied to this problem. However, according to the data presented in Table 6, these statistical exercises are still subject to a considerable margin of uncertainty. Obviously, the cost of the facility increases as the quota limits are raised. But the estimates for the liquidity impact in 1984-88 are also crucially dependent on certain assumed ratios, derived from past experience; yet these ratios have shown considerable variability in past reference periods.

Therefore, the decision on the appropriate quota limits for the facility will have to be based, not so much on these calculations, as on the simple principle that it would be reasonable to retain the present relative place of the facility in the scala of members' access to the Fund's resources in general and to keep access to the facility broadly unchanged in absolute terms.

Buffer stock financing facility

I agree with the staff that we should continue the buffer stock financing facility in its present form. It has been useful, even though it has been used with limited frequency and usually for small amounts. Moreover, the existence of this facility shows the willingness of the Fund to help with the financing aspects of international commodity buffer stocks. Its limited use serves as a constant reminder--and a very useful reminder--that the most fundamental difficulties with regard to unstable prices for primary commodities do not lie in the field of financing.

I now want to make some observations on the conditionality of the compensatory financing facility. This essential characteristic cannot be ignored when we are in the process of reaching agreement on other aspects of the facility, in particular, the magnitude of access.

As the paper's very helpful annex on the evolution of the compensatory financing facility shows, the Fund has, since 1966, applied two separate degrees of conditionality under the facility: a less demanding degree of conditionality in the lower tranche of the facility and stricter conditionality in the upper tranche. We had an extensive discussion of the latter conditionality in April 1982 (EBM/82/42, 4/5/82); and although that discussion did not lead to a fully agreed view, I do not find it necessary to comment on the upper tranche conditionality at this stage. The focus of my remarks will be on the conditionality of the lower tranche of the compensatory financing facility--a subject on which there is a disconcerting lack of clarity.

On this subject we have, of course, first the provision in the compensatory financing facility decision, viz., that the Fund would have to be

> satisfied that...the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties.

We have, further, the staff's understanding of that provision, as contained in the paper for the April 1982 meeting (EBS/81/251, 12/30/81):

> The criterion applicable to requests in the lower tranche should be interpreted as implying a willingness to receive Fund missions and to discuss, in good faith, the appropriateness of the member's policies and whether changes in the member's policies are necessary to deal with its balance of payments difficulties. (page 15)

But we also have a more recent, very different, statement from the staff (in the most recent paper on access (EBS/83/132, 6/27/83)) to the effect that

> Under current circumstances, use of the compensatory financing facility cannot be considered as unconditional, as would have been the case had export shortfalls been the sole cause of payments difficulties. (page 4)

From this, the staff goes on to suggest that there is no difference in conditionality between the compensatory financing facility (the whole facility--no distinction is made between its two halves) and use in the upper credit tranches; the only remaining difference, it is pointed out, is that use of the compensatory financing facility, unlike use of the upper credit tranches, is not phased.

It is not a satisfactory situation for the Fund to have on record two such widely different interpretations about the conditionality of one of its facilities, or at least about part of one of its facilities. The inevitable consequences of such a situation are that the area departments lack guidance on how to operate the facility; that member governments do not know what rights they have under the facility; and that it is difficult to ensure the uniform treatment of members and impossible to ensure the perception of uniform treatment. I consider it essential, therefore, that in our discussions today and in the coming weeks we should set ourselves the task of agreeing on a clear and well-defined view on this subject, which can then guide the staff in its relations with individual members.

As a contribution to such an effort, I should like to list a number of elements that should be observed in any statement that reflects the policy conditions for access to the lower half of the compensatory financing facility.

1. The compensatory financing facility is intended to meet a special payments problem of members, viz., one caused by an export shortfall. That export shortfall must meet two tests: it must be "of a short-term character" and "largely attributable to circumstances beyond the control of the member." We have an extensive procedure to appraise whether these two tests are met; once a shortfall qualifies under these tests, the member should be able to receive the corresponding assistance from the Fund with a minimum of delay. I recall that the possibility of relying on estimated data was introduced to enhance the promptness of the Fund's compensatory financing facility assistance. Protracted negotiations on a program are not compatible with this basic feature of the compensatory financing facility.

2. Payments difficulties associated with export shortfalls are frequently associated with other payment problems. This is not a new discovery. It was one of the main points of concern when the compensatory financing facility was established in 1963:

> The provision of credit to deal with the balance of payments effects of export fluctuations provides immediate relief for a country's short-term difficulties. In many cases, however, it will also be necessary to introduce measures of a policy character in order to attain a satisfactory and lasting solution to a country's balance of payments problems. (Compensatory Financing of Export Fluctuations, A Report by the IMF, 1963, page 26)

For that reason, the provision on cooperation to seek "appropriate solutions" for a country's payments difficulties was incorporated from the start.

3. Since the First Amendment of the Articles of Agreement, the Fund has not been permitted to extend unconditional credit. All transactions, those in the credit tranches as well as those under special facilities, must meet the test that the Fund is satisfied that use of its resources will be temporary. The ultimate safeguard of this is the member's obligation to repurchase. With respect to policy measures required to correct the member's payments position, the Fund can apply a graduated policy. Its requirements for use of the first credit tranche are less stringent than those for use in the higher tranches, and with respect to lower tranche compensatory financing facility drawings the emphasis is put on setting in motion a process of serious discussion with the member rather than on some ex ante judgment on the degree of

adjustment. Such a graduated approach is acceptable--and indeed it may from some points of view be beneficial--provided that access subject to relatively light conditionality is kept to a modest proportion of total access available under the Fund's current policies. As far as the (lower tranche) compensatory financing facility is concerned, the proportion constituted one fifth 1/ of the total when the facility was introduced, and it constitutes one thirteenth of that total now. 2/

I would suggest that against the background of these three principles, and perhaps some other principles that my colleagues might want to add, we seek a clear formulation to guide access in the lower half of the compensatory financing facility. It would probably not be necessary for that purpose to change the decision; in any event, our experience shows that the kind of language that is appropriate for a decision does not provide the precision that is needed for its application. To my mind, the text that the staff provided to us last year still constitutes a good formulation. If others would like greater precision or some difference in emphasis, that text could provide a good starting point for such a formulation.

Mr. Ismael noted that, in reviewing the experience with the cereal decision, the staff concluded that the scale of operations under the decision had been limited and that it was a means of assisting developing countries that imported cereals for their food requirements. He agreed, therefore, with the staff's recommendations that the cereal decision should be maintained for the future. With regard to overcompensation and undercompensation, the staff concluded that the incidence of undercompensation and overcompensation had been rather limited, and it recommended that the present early drawing procedures should be maintained. He agreed with that recommendation. The staff observed that the experience with the reversal of overcompensation had not been entirely satisfactory. In his opinion, in most of the cases in which there had been delays in reversing the overcompensation, the problem had not been a lack of desire or willingness to repurchase, but a chronic shortage of foreign exchange. Many of the countries that experienced difficulty in reversing overcompensation also had difficulties in meeting their other debt obligations.

The third section of the staff paper dealt with some of the considerations relevant to a decision on access to the compensatory financing facility and other facilities of the Fund, Mr. Ismael continued. He fully agreed with the staff that the paper was designed for a fairly limited purpose. Several projections of the use of the compensatory financing

1/ 25 percent of quota for compensatory financing facility and 100 percent of quota in the credit tranches.

2/ 50 percent for compensatory financing facility and 600 percent in the credit tranches.

facility were presented in the paper based on different assumptions. There were many uncertainties regarding those projections, in particular, the sustainability of the current economic recovery and the prospects for the prices of primary commodities. Nonetheless, the background analysis would be useful when Directors discussed the question of overall access to Fund resources. Meanwhile, the developing countries placed a high value on the compensatory financing facility, and they would like to see the access limit continued at 100 percent of quota. He regretted the tendency in the Fund to make the upper 50 percent of the facility a conditional tranche. There was growing evidence of a more restrictive interpretation of the test of cooperation; it would be contrary to the spirit of the facility to require countries to adopt Fund programs or policy measures of the magnitude envisaged in stand-by arrangements before requests in the upper tranche of the facility were granted.

Commenting on the buffer stock financing facility, Mr. Ismael said that the present limit of 50 percent of quota should be retained after the Eighth Quota Review came into effect. Although drawings under the facility had never exceeded 40 percent of quota, it was, nevertheless, useful to make provision for contingencies that might arise in future. The facility should be improved through an extension of the maturity period in line with the duration of each approved commodity agreement and its stipulated stock liquidation.

Mr. Lovato stated that he supported the two staff recommendations to continue present practices with respect to the cereal decision and the treatment of overcompensation and undercompensation. The cereal decision, while providing badly needed relief in situations of extreme hardship for low-income developing countries, had a relatively minor impact on Fund liquidity, and it could, therefore, be considered well worthy of continuation. As far as overcompensation and undercompensation were concerned, the Executive Board's discussion in November 1982 (EBM/82/145, 11/8/82) had been exhaustive, and there was no need to modify the Fund's practice. Although the early drawing procedure could result in a burden for the country if final calculations showed that early repurchase was necessary, it remained a useful provision for many countries that would not otherwise be able to avail themselves of the facility. The continuation of present practices seemed appropriate.

The issue of access limits to the compensatory financing facility was much thornier, Mr. Lovato considered. The estimates provided by the staff were clearly subject to many uncertainties, but they provided some idea of the extent of the operation of the facility in the future under different hypotheses. The facility was appropriate and it should be maintained. In that sense, the question of how much access to grant members applying for compensation of a shortfall should probably be considered on its own merits, and it should not be mechanically linked to access to conditional facilities. On the other hand, Directors should bear in mind the tight liquidity position of the Fund, the fact that part of the shortfall was often the result of endogenous factors, the level of commitments already reached within the facility, and the need to increase the proportion of conditional financing in the future. At present it was difficult to indicate precisely the appropriate degree of access, since the policy on enlarged access was to be discussed shortly and the outcome of that discussion would be very relevant. His authorities favored some tightening of the facility, with regard to both access and conditionality.

In Table 10 of the paper, Mr. Lovato continued, the staff indicated that the savings in resources that would be achieved through a scaling down of the access limits would only become noticeable for marked reductions in access, a development that would change the scope of the facility in an undesirable way. On balance, therefore, a lowering of access limits, while desirable in order to ease the burden on Fund liquidity and to maintain an appropriate mix between conditional and unconditional resources, should not be excessive. The forthcoming discussion on enlarged access would provide a better opportunity to deal with the problem. It was worth noting that the staff did not adequately discuss how access should be apportioned between the lower and higher conditional tranches of the facility under new hypothetical limits.

The issues raised by Mr. Polak were interesting and important, Mr. Lovato remarked. The conceptual justification for the compensatory financing facility had been treated at length on many occasions. The problems for which it had originally been established continued to justify the existence of a special facility, although with a different type of conditionality attached. Along with the question of the permissible access limits under the facility, a thorough discussion of the requirement of cooperation had been conducted at the time of the April 1982 review (EBM/82/42, 4/5/82). Access to the first tranche of the facility should continue to be allowed under "easy terms," i.e., the semiautomatic and quick disbursement character should be preserved. To render all access to the facility conditional would amount to denying the existence of self-reversing balance of payments problems. However, his authorities favored some increase in the degree of conditionality in the upper 50 percent of the facility, although, as his chair had stressed in the course of the April 1982 review, the existence of a program should not be considered an absolute precondition. In that sense, the Executive Board discussion in 1982 had been exhaustive, and the Fund's practice should conform to the Executive Board's conclusions at that time.

Mr. Finaish said that he agreed with the staff's conclusions that operations under the May 1981 decision on the financing of fluctuations in the cost of cereal imports had not posed any major problems and that the decision should, therefore, be maintained. In coming to that conclusion, the staff had left open the possibility of an adjustment in the access limits on such financing as part of the current general review of access to Fund resources. He also agreed with the staff's recommendation, with regard to the early drawing provision of the compensatory financing facility that the present procedure should be maintained, since it had functioned in a broadly satisfactory manner.

On the other hand, Mr. Finaish continued, the staff did not put forward a suggestion or conclusion with regard to access limits under the compensatory financing facility. The discussion in that section of the paper focused on the probable effects of various assumed access limits on the capacity of the facility to meet members' future needs and on a comparison of the results with the levels prevailing in the past. The analysis, though useful, had not been further developed by the staff to arrive at a broad judgment as to what level of access would be appropriate for the period following the coming into effect of the Eighth Quota Review.

In the context of a review of access limits, two main considerations needed to be taken into account, Mr. Finaish considered. The first was the level of members' prospective need for balance of payments financing and the proportion of that need that should be met by the Fund. The second was the constraint imposed on the scale of Fund financing by its liquidity position. The former determined what could be called the appropriate or desirable level of access, and the latter determined the feasible or financeable level of access. It was an important distinction, and it would be helpful if the staff could provide guidance on both aspects in papers reviewing access limits.

It was also important to note that the determination of the desirable level of access was independent of considerations of the Fund's liquidity constraint, Mr. Finaish suggested. Such an approach had more or less been followed in EBS/83/79 (4/20/83), "Review of Enlarged Access Policy," which had been discussed in the Executive Board in May 1983 (EBM/83/71 and EBM/83/72, 5/18/83). In that paper, on the basis of its assessment of members' need for adjustment financing and of the conditions in the international financial markets, the staff had expressed the view that a reduction in the current potential absolute access under the policy on enlarged access, even for only part of the Fund's membership, would give wrong signals at present; in the same paper, the staff had gone on to address the question whether maintaining the present level of access would be possible, given the Fund's prospective liquidity position. It would have been useful if a similar approach had been followed in the present paper. Admittedly, the determination of the financeable access limits under the compensatory financing facility had been beyond the scope of the present paper since it would have required an examination of total access under all types of facilities in relation to the Fund's overall available resources. However, an indication could have been given in the present paper, based on the type of analysis employed in it, as to what might be regarded as the desirable access limits under the facility in the period ahead, before consideration of the Fund's liquidity constraint. For example, the staff could have indicated whether the Fund should attempt to maintain the service provided by the facility at levels close to those reached in the recent past.

While it was true that the availability of resources to the Fund would ultimately determine the level of access that could be financed, Mr. Finaish went on, it would still be useful, from both an analytical and a practical standpoint, to know the desirable level of access in the present circumstances. Awareness of the extent of the divergence between what was deemed desirable and what was feasible would make for a sharper appreciation of the seriousness of the Fund's liquidity constraint. It would also serve to make clearer the reason for lowering the access limits, i.e., whether it was mainly the liquidity constraint or the belief that present limits were excessive. The extent of that divergence would also provide an indication of the cost of the liquidity constraint in terms of the Fund's operations forgone and the implications of that factor for adjustment and growth in countries needing Fund assistance, as well as for the world economy as a whole and the openness of the international trade and payments system. It was noticeable that in discussions of a possible reduction in present access limits based on a shortage of Fund resources, little attention had been paid to such costs. The availability of resources to the Fund was not a datum but rather policy determined, i.e., determined by decisions of the membership to contribute resources to the Fund. The willingness of members to contribute would depend, among other things, on their perception of the Fund's real need for resources. The Fund's need for resources would, in turn, depend on what might be regarded as the appropriate or desirable level of the Fund's operations. Thus, a clearer understanding of the appropriate or desirable level of access could itself serve to influence the availability of resources to the Fund. In light of the above considerations, the concern for the Fund's liquidity constraint should not preclude an expression of views regarding the appropriate level of access.

Commenting on the calculations provided by the staff in Section III of SM/83/131, Mr. Finaish noted that the projections for drawings under the compensatory financing facility in the 1984-88 period were, by their nature, tentative and that they should therefore be interpreted with caution. The projected levels of drawings could be on the high side--for example, with regard to the projected drawings by the oil exporting countries. The assumed proportion of the maximum access that would be drawn by potential users in that group appeared to be higher, on average, than the corresponding drawings by users in the "core" group of countries. The export shortfall of the oil exporting group seemed to have been calculated on the assumption of an average rate of growth of oil export receipts of 9 percent a year in the period 1984-88. Of the various possible growth rates assumed in SM/83/87, "Compensatory Financing Facility--Requests for Drawings by Oil Exporters," that rate yielded the largest shortfall. Was it the same rate that had been used in the latest medium-term World Economic Outlook projections? The staff projections also seemed to have been based solely on the incidence of shortfalls and the possibility of a balance of payments need, whereas actual drawings would depend on the satisfaction of all the conditions attached to the facility. He did not wish to cast doubt on the probability that those countries would meet the other conditions in case of need, but rather to point to the inconsistency of the staff assumption with actual practice, and particularly to the special attitude that appeared to have been taken toward potential compensatory financing facility requests from those countries. He invited the staff to comment on those points.

Notwithstanding the preceding qualifications, Mr. Finaish continued, the staff's calculations and projections provided a broad indication of members' need for assistance under the compensatory financing facility over the relevant future period, and of the effects of different adjustments in access limits on the proportion of the prospective aggregate export shortfall that it would be possible to cover by drawings under the facility. The projections showed that the demand for drawings under the compensatory financing facility would continue to be large in the period ahead. Even under the maintenance of present access limits of 100 percent of quota, drawings would cover a significantly smaller proportion of the total export shortfall over the 1984-88 period than had been the case in recent years, according to the staff calculations. In conjunction with the increasing financial stringency being faced by many potential users of Fund resources on account of recent developments in international financial markets, that prospect would argue against any lowering of the access limits under the facility at present for any part of the Fund's membership. Indeed, the case for that approach was broadly similar to the case made by the staff in EBS/83/79 for not reducing the present absolute access under the enlarged access policy for any part of the membership.

With regard to the constraint imposed on access by the Fund's liquidity position, Mr. Finaish remarked, the matter had to be assessed by looking at the potential use of resources under all the facilities under different access limits in relation to the expected availability of resources to the Fund over the relevant period. An attempt to undertake such an analysis was contained in EBS/83/133 (6/28/83) scheduled for discussion in the following week (EBM/83/110 and EBM/83/111, 7/25/83). At the present meeting, a few general points on the question of the liquidity constraint could be made. First, while, in the end, the amount of available resources would determine the level of access that could be supported, the first approach should be to attempt, through judiciously exploring all feasible avenues, to raise the amount of resources to what might be considered the desired level of access in the present circumstances of the world economy.

What the actual liquidity constraint would turn out to be could not be judged merely by the amount of additional resources needed under different access limits, some information on which was provided in EBS/83/133, Mr. Finaish considered, but on Directors' expectations as to the proportion of the indicated additional resources that it would be possible to raise. To date there had been little information available on that question.

Second, as noted in EBS/83/133, the Fund's liquidity position could begin to improve substantially after 1986 as the large drawings of recent years fell due for repurchase, Mr. Finaish added. The Fund's requirement for more borrowed resources until 1986 could be looked at as a temporary injection of additional liquidity into the Fund to enable it to help members to tide over an exceptionally difficult period. The Fund had done a useful job in raising access to its resources and in arranging for the necessary financing as members' needs for balance of payments assistance mounted in recent years. A premature and abrupt departure from that approach could undermine the sustainability of policies in member countries supported by the increased Fund assistance, just when those policies were beginning to bear fruit.

Finally, in addition to the question of the liquidity constraint, EBS/83/133 raised other issues bearing on access limits under the compensatory financing facility, Mr. Finaish stated, including "conditionality" of drawings under the facility and the question of "balance" between conditional and special facilities. He would reserve his remarks on those issues until the Board meeting of July 25, 1983.

Mr. Laske stated that he agreed with the recommendation by the staff that the cereal decision should be maintained essentially unchanged. The only exception was the limit on access under that decision, a question to which he would return. In his authorities' view, the cereal decision did not really conform to the purposes and objectives of the Fund, since it dealt with a rather narrow and exceptional aspect of a country's balance of payments problem. Nevertheless, he could support the continuation of the decision for the humanitarian reasons upon which it was based and because it was not likely to lead to significant calls on the Fund's resources in the foreseeable future. He also agreed with the proposal to conduct the next review of the decision in about two years' time, rather than when the forthcoming quota increase took effect, as had originally been intended.

The problems connected with overcompensation and undercompensation in cases in which the export shortfall had been calculated on the basis of partially estimated export data had been discussed on several occasions, Mr. Laske recalled. Those discussions had shown that overcompensation was not a problem that had led to excessive and unjustified use of the compensatory financing facility. Nevertheless, as a matter of principle, overcompensation should be prevented as much as possible. To that end, the staff should be extremely cautious when estimating export data for the undocumented part of the shortfall year. In a previous discussion, the possibility had been mentioned of deducting a precautionary discount from export shortfalls that were based on estimated data. For valid reasons, the Board had not adopted that proposal in its previous review, but if cases of overcompensation were to occur in the future more frequently than they had occurred to date, the possibility of a precautionary discount might have to be looked at again.

The Fund's experience with the reversal of overcompensation had not been entirely positive, Mr. Laske considered. He welcomed the procedure by which members who requested early drawings were reminded of the possibility of overcompensation as well as of the importance that Directors attached to a speedy supply of the final export data. When more experience had been gained with the procedure, perhaps in 12-18 months, it would be helpful if the staff provided a report for the information of Directors. In sum, he endorsed the staff's recommendation to continue for the time being with the early drawing procedures as they stood. He attached great importance to the statement by the staff that it would bring to the attention of the Board any cases of special difficulty that might arise.

The most important aspect of the present discussion was the question of future access limits, Mr. Laske said. Use of the compensatory financing facility had increased considerably since it had been liberalized by raising the access limits to as much as 100 percent of the member's quota. Chart 1 in SM/83/131 was most informative in that regard. In 1982, drawings under the facility had accounted for 35 percent of total Fund credit, and, at the end of 1982, for almost 30 percent of all outstanding Fund credit. Because drawings under the facility were of relatively low conditionality and because the Fund's financial assistance in the present difficult times should primarily serve to further adjustment, the Fund could not continue to provide resources to such an extraordinarily large extent on such easy conditions.

The projections provided in Tables 6 through 10 demonstrated that compensatory drawings would reach a considerable volume if the present access limits for drawings under the facility and under the cereal decision were to be applied to the new increased quotas arising from the Eighth Quota Review, Mr. Laske considered. The updated information presented in EBS/83/137 showed that the Fund's liquidity situation was likely to remain very tight, even under the optimistic assumptions adopted. It would be imprudent, therefore, to establish access limits for the new quotas that would allow compensatory drawings to assume a larger aggregate volume than resulted from the present limits and the present quotas. Furthermore, the possibility of drawings under the compensatory financing facility by oil producing countries would add significantly to the potential demands on the Fund's resources. The projections for drawings from those countries would have to be added to the projections for "core" drawings when the new access limits were determined.

His views on the permissible future access limits were based on the information in Table 10, in which all the simulations and projections were drawn together, Mr. Laske went on. The new access limits for drawings based on export shortfalls as well as drawings under the cereal decision should, ideally, not exceed 66.6 percent of the new quotas. That percentage would leave absolute access unchanged for the core group of countries, if each of them had a quota increase of 50 percent. If it was thought desirable to have a rounded percentage, he could accept, albeit reluctantly, a 70 percent access limit, but that percentage would be the absolute maximum acceptable to his authorities. Table 2 of EBS/83/133, to be discussed in the forthcoming Board meeting on enlarged access policy, showed projections of $4-6 billion for drawings under the compensatory and buffer stock financing facilities in the 1984-86 period. That range was said to reflect access limits of 50-70 percent of the new quota. He had to conclude that access limits in excess of 70 percent would push such drawings beyond $6 billion, exposing the Fund's supply of ordinary resources to even more severe strain. Such a possibility ought to be avoided.

The combined access limit for drawings under the compensatory facility and drawings under the cereal decision had been set at 25 percent above the individual limits for the two types of drawings, Mr. Laske noted. If the individual access limits were to be set at 70 percent, the combined limit could be established at 90 percent. In view of the experience with the simultaneous use of drawings under the compensatory financing facility and under the cereal decision, such a combined access limit ought to suffice to accommodate even exceptional cases of need. It could be argued that a safety margin should be incorporated into the combined limit and that the limit should, therefore, be set at 100 percent. However, he could not recognize a real need for such a combined limit; a limit of 90 percent would be more acceptable.

One of the less attractive features of the compensatory financing facility was its rather modest conditionality requirement, Mr. Laske considered. In the present circumstances of the world economy, adjustment of external imbalances had to be the primary requirement. Therefore, it was not appropriate practically to disregard, at least in the lower 50 percent of the facility, the question of whether a country was making adequate efforts to adjust when it used compensatory resources. He strongly supported the suggestion that cooperation with the Fund should be required for all drawings under the compensatory financing facility. If the drawings went beyond 40 percent of quota, an arrangement with the Fund in the upper credit tranches should normally be required, or should already be in place.

Commenting on the possibility of drawings by the oil exporting countries, Mr. Laske recalled that the subject had been extensively discussed at EBM/83/79 and EBM/83/80 (6/2/83). He fully agreed with the conclusions reached at that meeting, namely, to treat requests for drawings under the compensatory fanancing facility by oil exporting countries on a case-by-case basis. However, he wished to reiterate that his authorities were still not fully convinced by the arguments that the staff had used in the relevant paper (SM/83/87) to justify the case-by-case approach. Given the particular nature of petroleum as a commodity, his authorities attached great importance to the careful scrutiny of requests for drawings based on the temporary character of oil export shortfalls. The present weakness in the oil markets was not only caused by cyclical factors, but also reflected important structural changes in oil consuming countries, changes that were likely to have a lasting impact on the overall demand for oil. Such structural factors would have to be carefully assessed when projections were made for the postshortfall year. The requirements of a balance of payments need and of cooperation with the Fund also had to be met.

The formula used for the calculation of a shortfall had been reviewed several times, Mr. Laske observed, one important change being the switch from the use of an arithmetic average to a geometric average. Notwithstanding that change, the formula did not always produce convincing results. It was somewhat illogical that the formula could produce a shortfall even in cases in which the value of exports increased in the shortfall year. On the occasion of the Executive Board's discussion of Panama's request for a drawing under the compensatory financing facility (EBM/83/91, 6/24/83), he had asked the staff to produce a paper analyzing situations in which the calculated export shortfall under the present procedures was not adjusted for a simultaneous decrease in imports directly related to the export shortfall. He looked forward to that paper.

The level of drawings under the buffer stock financing facility had not been large, Mr. Laske noted, and it was not likely to become large in the foreseeable future. He agreed in principle with the staff that no changes were necessary. However, the access limits should be adjusted to roughly the same extent as those for drawings under the compensatory financing facility and the cereal decision. The adjusted limit should be set at 40 percent of the new quota. He understood that such a limit was unlikely to be a constraint on members' actual use of the buffer stock financing facility.

Mr. Erb made the following statement:

Introduction

I will make some general observations and then comment on the three major sections of the staff paper:

1. Review of the cereal decision

2. Experience with overcompensation and undercompensation

3. Quota limits under the compensatory and buffer stock financing facilities.

Finally, I will give an indication of the access limits that my authorities believe appropriate for the compensatory and the buffer stock financing facilities when the Eighth Quota Review comes into effect.

General Comments

As with any use of Fund resources, the provisions of the Articles of Agreement must be satisfied, including the provision that the Fund must safeguard the use of its resources. This means that when committing any resources, no matter what percentage of quota or facility, the Fund must assure itself that it will be repaid within the required period without putting the country under severe balance of payments pressures that might lead it to actions detrimental to itself or the international community. This safeguard provision is at the heart of Fund conditionality. I will only touch briefly on Fund conditionality and the compensatory financing facility in today's discussion, but I intend to discuss it more extensively in the Board discussion of enlarged access, scheduled for July 25, 1983.

Another general comment I would like to make is that the compensatory financing facility is not designed per se to finance a country's entire shortfall or even a significant portion of a shortfall. In addition to other criteria that must be satisfied, the balance of payments need test means that the question of whether a country has access to the facility and the question of the extent of its access up to the specified quota based limit for compensatory drawings depends importantly on the strength of its external financial position.

This brings me to a third set of general observations I would like to make:

Although governments continue to yearn and search for greater economic stability, we live in fact in a world of economic fluctuations, including fluctuations in exports. If a country is to achieve strong economic growth over time and avoid periodic external financing crises, common sense and experience suggest that it should manage its policies in a manner that takes account of the likelihood of fluctuations in its exports as well as fluctuations in other domestic and external economic factors. In words that are more specific to this discussion: each country should manage its policies--and in particular its policies concerning official foreign borrowing and official holdings of foreign assets--in a manner that takes into account the possibility or likelihood of a temporary export shortfall. The expected frequency and expected magnitude of a shortfall will of course vary from country to country. Ideally, a country that manages itself in such a manner is not likely to be a candidate for the compensatory financing facility since it is not likely to be confronted with a balance of payments financing problem at the time of a temporary export shortfall. However, export shortfalls may turn out to be much worse than expected or a shortfall may occur when other problems face a country, thus exacerbating its external financial problem. In such circumstances the compensatory financing facility provides temporary financing in a useful and timely manner.

The experience of the past decade or so indicates that many countries have a tendency to assume that one or two years of extraordinary export growth will continue indefinitely and thus set their domestic policies accordingly. Not only do they fail to use the good years to build their net foreign asset position to a level that is adequate to respond to a possible shortfall in the future, but their domestic economy becomes accustomed to an import growth that cannot be sustained. Even worse, some countries use the good years to embark on ambitious foreign borrowing programs resulting in an even higher import growth rate and a decline in their foreign borrowing potential. Such countries face adjustment problems when export growth returns to more normal levels and more serious adjustment problems when an export shortfall occurs. In my judgment this is an important reason why a number of countries have had to seek a general Fund program to deal with balance of payments problems that were larger than the underlying export shortfall. It is also a reason why the test of cooperation under the compensatory financing facility must be implemented rigorously in order for the Fund to safeguard its resources.

I make these general observations in part because I believe that the existence of the compensatory financing facility should not inadvertently contribute to a perception in governments that it is less necessary to manage their policies in a manner that takes into account the likelihood of temporary export shortfalls. This risk would perhaps not be so great if the compensatory financing facility were made more symmetric by requiring countries that elect to use the facility to build up a special reserve position in the Fund when they experience export excesses. Given the current structure of the compensatory financing facility, however, it would seem that frequent users of the facility should pay especially close attention to the policy advice provided by the Fund staff during regular consultations in years of strong export growth.

I also have made these general observations because they influence the thinking of my authorities not only with respect to the specific role which should be played by the compensatory financing facility but also their thinking with respect to access and to implementation under the facility.

I. Review of the cereal decision

Given the limited experience with the cereal decision to date, it is difficult to make judgments at this time about whether changes need to be made in the decision or in the practices affecting its implementation. Although my authorities also have doubts about whether the cereal decision fits into the Fund's overall mandate, I agree with the staff that major changes in the decision--except for access limits--are not necessary in this review.

In light of the possibility that more requests will be made in the near future I would like to reiterate a point that we have made in the past concerning the implementation of the "beyond the control" requirement. Given that exchange rate policies, producer pricing policies, and consumer pricing policies all have an important influence on cereal supply and demand developments within a country, these policies will require close scrutiny when we evaluate whether a cereal import excess is beyond the control of a government.

II. Experience with overcompensation and undercompensation

The early drawing provision provides an additional degree of flexibility to the Fund when responding to requests by countries with a temporary shortfall and a balance of payments financing problem.

On the whole, the staff has implemented this feature of the decision with its usual care and prudence.

If there is any asymmetry, it appears to be marginally in the direction of overcompensation:

- According to the paper, the total amount of undercompensation represents 4 percent of the total amount of early drawings--excluding Argentina it amounts to less than 1 percent.

- The total amount of overcompensation is more evenly distributed and represents about 5 percent of the total amount of early drawings.

- Although not computed in the staff paper, I would like to note that for the 16 countries, overcompensation amounted to 50 percent of the total early drawings of those countries.

- For the 6 countries that were undercompensated, the undercompensation amounted to 26 percent of the early drawings by those countries--excluding Argentina, undercompensation amounted to only 8 percent of the early drawings.

Table 3 in Annex III (SM/83/131) indicates that in many countries the lag in data was much shorter at the time of request than at the time of the calculation of the actual shortfall. I would like to ask the staff why this occurs, since we attach great importance to the timely provision of actual data for the whole shortfall year. I would also like to ask the staff for its suggestions on how the time lags could be reduced.

On another matter, this chair has attached great importance to the requirement that there be a prompt repurchase when there is overcompensation.

- In this regard, I am pleased to note that, of the 16 cases of overcompensation, repurchases were completed within 30 days for 8 countries.

- It is disturbing to note, however, that 8 countries did not complete the transaction within 30 days and that 4 of these took as long as 4 to 9 months.

- The case of Tanzania is particularly enlightening since Tanzania ended up having an export excess of SDR 24 million instead of an export shortfall of SDR 15.9 million. And yet, Tanzania was not able to make a prompt repurchase as required. This example illustrates the importance of the Fund assuring itself when committing its resources that a country is dealing with its underlying balance of payments problems.

Because of the prompt repurchase requirement when the early access provision is used by a country, it is our view that the overall payments position of the country and the steps it is taking to deal with its overall problem need careful analysis by the staff and a firm conclusion that the country is in fact dealing with its underlying balance of payments problem.

III. <u>Quota limits under the compensatory and buffer stock financing facilities</u>

Our position on the limits will be shaped by:

1. the view of the roles and objectives served by the compensatory and buffer stock financing facilities relative to the roles and objectives served by IMF balance of payments adjustment financing under the credit tranches;

2. the need for the Fund to live within the resource base that is available to it.

Use of resource simulations under the facilities made by the Fund staff are helpful but must be treated with caution:

1. longer experience with core countries provides one with more confidence in the simulations for this group;

2. experience with the cereal decision is limited, thus staff simulations must be treated as highly uncertain;

3. the Fund has not yet had any experience with regard to requests under the compensatory financing facility by oil producers.

   - In this regard, I also believe that the estimates of future use provided by the staff are subject to a high degree of uncertainty because of the lack of experience.

- Regarding the U.S. approach to requests under the compensatory financing facility by oil producers, I stand on my statement made during the Board's previous discussion of this subject.

Regarding the limits which should be set when the Eighth Quota Review comes into effect, my authorities consider the following limits appropriate:

Compensatory financing facility (exports) limit:	65-70 percent
Compensatory financing facility (cereal) limit:	65-70 percent
Compensatory financing facility (exports) + (cereal) combined limit:	85 percent
Buffer stock financing facility limit:	30-35 percent

Mr. Tvedt commented that the staff had provided a thorough review of the compensatory financing facility and related issues. His authorities supported the proposed cereal decision and the early drawing procedure. With regard to the latter, he recalled his statement during the Board's discussion of early drawings in November 1982 (EBM/82/145, 11/8/82), and the great importance that his authorities attached to the updating and improvement in the availability of trade statistics.

Turning to the financing of export shortfalls, Mr. Tvedt considered that the compensatory financing facility had amply demonstrated its usefulness. The modifications that had been undertaken over the years had all served to make the Fund better equipped to aid members in weathering sudden balance of payments difficulties stemming from exogenous factors. As some previous speakers had emphasized, access to the compensatory financing facility had generally been easier than to other Fund facilities, largely due to the self-correcting character and temporary nature of the difficulties that the facility was meant to alleviate. The only stipulation, besides the usual provisions relating to the use of Fund resources, had been the requirement of cooperation with the Fund in finding solutions to the member's balance of payments problems.

In the present circumstances it was hard to give a precise explanation of what constituted cooperation with the Fund for the purposes of drawings under the facility both below and above 50 percent of quota, Mr. Tvedt continued. However, there appeared to be a widespread belief that a member could not draw beyond 50 percent of quota under the compensatory financing facility unless it had an upper credit tranche arrangement in place or unless it negotiated such an arrangement concurrently with the compensatory drawing. If that view was correct, he was not convinced that present policy was congruent with the most recent guidelines given by the Board. Admittedly, those guidelines had not been very explicit, but they had, nevertheless, called for continued application of judgments on cooperation in a flexible manner on a case-by-case basis. For that reason, it would have been useful if the question of cooperation had been addressed in the paper before the Board. He was not sure that the conclusions of the Board discussion in 1982 continued to serve their purpose. Consequently, he was inclined to support those Directors who called for further consideration of the question of cooperation in order to establish clear guidelines. At the present meeting, he would not take a position on the quota limits that were to govern access to the compensatory financing facility. The issue would need to be taken up in the Board's forthcoming discussion of overall access to Fund resources.

Mr. Tshishimbi said that he agreed with the staff appraisal and recommendations regarding the issues of compensatory financing of fluctuations in the cost of cereal imports and the issue of overcompensation and undercompensation arising from early drawing procedures. The cereal decision appeared to have worked well. Six countries had made purchases under the decision, and it had achieved its intended purpose. However, the staff indicated that two of the six countries in question might have been able to purchase larger amounts if a separate cereal facility had been established. For example, one of those countries would have been in a position to purchase about 50 percent more if the amount had been available under a separate facility. Despite the limited number of participating countries in the cereal decision, that particular point brought to mind a question in which his constituency was particularly interested, namely, why had the staff not explored the possibility of a separate cereal facility outside the framework of the compensatory financing facility based on export shortfalls? Admittedly, the question had been amply discussed when the cereal decision had been approved, but it was now two years later, and the Fund was benefiting from the very smooth functioning of the cereal decision. Perhaps a new look at a separate cereal facility would be warranted.

Commenting on the question of access to the compensatory and buffer stock financing facilities, Mr. Tshishimbi noted that the staff did not make a specific recommendation. A number of alternatives based on various access limits were presented in order to simulate potential demand on Fund resources within those facilities. The simulations were based on the prospective demands of the core countries, suggesting that somehow an overall limit on special facilities and on all the other conditional facilities could be envisaged without a negative impact on the overall availability of resources to countries encountering difficulties in their balance of payments. That approach to the question had been inappropriate, and he would comment further on the question of access at the forthcoming discussion of enlarged access policy.

The compensatory and buffer stock financing facilities were, in their own right, designed to assist members, particularly those members that were mainly exporters of primary products, Mr. Tshishimbi remarked.

As with any use of Fund resources, the use of those facilities was contingent upon the member encountering balance of payments difficulties of a temporary nature. For the compensatory financing facility in particular, the difficulties had to be attributable to circumstances beyond the member's control and the member had to undertake to cooperate with the Fund to find an appropriate solution to its balance of payments difficulties. Those conditions ensured that the revolving character of the Fund's resources was preserved. The Fund ought not to add more conditions to the use of those facilities. In particular, he did not agree that an overall ceiling should be imposed encompassing the compensatory financing facility, the buffer stock financing facility, and the other conditional facilities. The special facilities were self-limiting: in the case of the compensatory financing facility, drawings were related to the export shortfall, and in the case of the buffer stock financing facility, to the country's need to share in the financing of the relevant buffer stock.

He shared the concerns expressed by Mr. Polak about the conflict that had developed between the initial decision on the compensatory financing facility and the special facilities in general and the new concept that appeared to be emerging in the staff's working methodology, in which the Fund appeared to be imposing more conditionality on the special facilities without clear guidance from the Directors, Mr. Tshishimbi added. He would return to the question when the Board discussed enlarged access policy, but he wished to express the strongest support of his chair for the unconditional character of the compensatory and buffer stock financing facilities. It was disturbing to hear suggestions that access to those special facilities should be reduced at a time when the economies of smaller members were becoming increasingly open to outside influences and subject to large fluctuations, mainly as a result of the volatility of the economic policies followed in the larger industrial countries. The Board should conclude its discussion by giving the staff clear guidance on the operations of the special facilities. As to the proposals by Mr. Polak to differentiate between lower and upper tranche conditionality, he would like to study them further before commenting.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/103 (7/13/83) and EBM/83/104 (7/18/83).

4. AUDIT REPORT, 1983 - TRANSMITTAL TO BOARD OF GOVERNORS

The Executive Board approves the recommendation set forth in EBAP/83/179 (7/12/83).

Adopted July 15, 1983

5. ANNUAL MEETINGS - OFFICE ARRANGEMENTS

The Executive Board approves (i) the guideline, set out in paragraph 3 of EBAP/83/177 (7/6/83), for providing regional groupings with office and meeting room space at Annual Meetings without charge; and (ii) the recommendations contained in paragraph 4 of EBAP/83/177 (7/6/83), for providing offices for Executive Directors at Annual Meetings and for providing local secretarial help for Executive Directors at Annual Meetings abroad.

Adopted July 13, 1983

6. DAY CARE

The Executive Board approves the proposal set forth in EBAP/83/181 (7/8/83).

Adopted July 15, 1983

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 83/26 and 83/27 are approved. (EBD/83/186, 7/8/83)

Adopted July 14, 1983

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/187 (7/13/83) and EBAP/83/188 (7/14/83) and by Advisors to Executive Directors as set forth in EBAP/83/187 (7/13/83) is approved.

APPROVED: January 18, 1984

LEO VAN HOUTVEN
Secretary