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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/112

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

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

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
J. de Groote	
B. de Maulde	
A. Donoso	
R. D. Erb	T. A. Connors, Temporary
	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
	M. Casey
A. Kafka	C. Robalino
G. Laske	G. Grosche
	C. P. Caranicas
	G. Gomel, Temporary
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	O. Kabbaj
	A. Camara, Temporary
	J. L. Feito
	A. Lindå
	M. Hull, Temporary
	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

A. M. Negm, Deputy Governor, Central Bank of Egypt. African Department: A. B. Diao. Asian Department: Tun Thin, Director; J. T. Boorman, H. C. Kim, J.-S. Kim, R. J. Niebuhr, A. O. Roden, G. Szapary. Exchange and Trade Relations Department: D. K. Palmer, Associate Director; S. Mookerjee, Deputy Director; R. K. Abrams, M. Guitian, A. Pena. External Relations Department: A. F. Mohammed, Director; A. M. Abushadi. Fiscal Affairs Department: D. C. McDonald, A. M. Abdel-Rahman, M. A. Wattleworth, M. Z. Yucelik. IMF Institute: O. H. Lobo, A. Tith. Legal Department: G. P. Nicoletopoulos, Director; H. Elizalde, Ph. Lachman, J. V. Surr. Middle Eastern Department: A. S. Shaalan, Director; A. K. El Selehdar, Deputy Director; M. Arif, J. G. Borpujari, R. H. Floyd, S. H. Hitti, B. A. Karamali, K. Nashashibi, D. B. Noursi, M. Shadman, B. K. Short, L. A. Wolfe, E. J. Zervoudakis. Research Department: W. C. Hood, Economic Counsellor and Director; R. R. Rhomberg, Deputy Director; K.-Y. Chu, E. A. Milne, T. K. Morrisson, B. E. Rourke, A. Salehizadeh. Treasurer's Department: I. A. H. Diogo. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. O. Bonvicini, P. D. Brenner, J. E. Leimone, J. F. van Houten. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, J. R. N. Almeida, C. J. Batliwalla, S. E. Conrado, J. Delgadillo, S. El-Khouri, L. Ionescu, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, H. Arias, R. Bernardo, M. B. Chatah, M. Eran, G. Ercel, N. U. Haque, H. Kobayashi, P. Leeahtam, W. Moerke, V. K. S. Nair, Y. Okubo, J. K. Orleans-Lindsay, G. W. K. Pickering, J. Reddy, J. Schuijer, M. Toro, J. C. Williams, A. Yasseri.

1. ARAB REPUBLIC OF EGYPT - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with the Arab Republic of Egypt (SM/83/103, 5/26/83). They also had before them a report on recent economic developments in the Arab Republic of Egypt (SM/83/116, 6/7/83).

Present for the discussion was Mr. Aly M. Negm, Deputy Governor, Central Bank of Egypt.

The Director of the Middle Eastern Department remarked that the staff had not yet reviewed the FY 1983/84 budget, which had been announced only after the staff papers had been circulated. However, the authorities were projecting an overall deficit of LE 5.12 billion. To put that figure in perspective, the budget for the previous year, ended June 30, 1983, had provisionally projected a deficit of LE 4.1 billion, somewhat below the staff's estimate of LE 4.7 billion. In the event, the deficit had turned out to be about LE 4.825 billion, and the ratio of the overall budget deficit to GDP had remained at about 20 percent.

Mr. Negm observed that, since the previous Article IV consultation discussion, there had been a number of noteworthy developments in the Egyptian economy. The deficit in the current account of the balance of payments had dropped sharply to $800 million from $2.1 billion in 1981/82, despite a decrease in the value of petroleum exports. That improvement in the current account had been due mainly to a 50 percent increase in workers' remittances through official channels and a 7 percent decrease in imports, mostly public sector imports.

Over the course of 1982/83, the commercial banks had been allowed to expand the amount of their foreign exchange transactions at free market exchange rates, which had discouraged imports and stimulated inflows of workers' remittances through banking channels, Mr. Negm remarked. As a result, the commercial banks had been able to increase their net foreign assets. In March 1983, as part of a continuing effort to liberalize the exchange system, the Egyptian authorities had removed virtually all exchange surrender requirements imposed on exporters. Hence, with the exception of some agricultural products, exporters were currently able to hold their earnings in retention accounts that could be freely used to finance their own imports or could be transferred to other free currency accounts. The Egyptian Government had agreed in principle with the recommendations in the report of the recent Fund technical assistance mission on the exchange rate. Some technical details remained to be worked out, but the authorities would be taking the necessary measures to introduce a unified exchange system in the near future.

During 1982/83, Mr. Negm continued, the growth rate of the budget deficit had been cut sharply to 9 percent--from a rate of 73 percent in 1981/82--so that domestic bank financing of the deficit had declined from 28 percent to 16 percent. The deceleration in the growth of the budget deficit had been achieved largely through greater administrative

effort in tax collection and expenditure control, as well as through lower prices for imported essential foodstuffs. The 1983/84 budget contained several measures designed to slow the growth of the budget deficit. The amount of subsidies was to be reduced from LE 2.7 billion in 1981/82 to LE 1.6 billion in 1983/84, and consumer subsidies were to be cut by LE 420 million by reducing the subsidy on bread. In addition, the Egyptian Government was issuing new ration cards in order to restrict access to rationed goods by well-to-do families, and it was reducing the number of subsidized commodities from 12 to 5. Some LE 400 million would be saved through a tightening of customs exemptions; LE 200 million would be obtained from new tax rates on incomes and profits; and an additional LE 335 million would be produced from several other measures. The total package would be equivalent to LE 1.3 billion.

During 1982/83, monetary growth had been slowed to 21 percent from 44 per cent in 1981/82, partly through a smaller percentage increase in credit to the Government and partly through more rigorous enforcement of the loan-to-deposit ratio and partial credit ceilings on public sector companies and the private sector, Mr. Negm remarked. Action had also been taken to restrict bank lending to households to finance consumer durables. Differential interest rates had been introduced for different borrowing sectors, encouraging the industrial and agricultural sectors, and tightening credit to trade and services. During 1983/84, continued enforcement of the loan-to-deposit ratio and partial credit ceilings, combined with a further percentage decrease in government borrowing, should help to maintain a deceleration of money growth.

To improve economic efficiency and encourage private investment, the Government had taken a more serious view of required price adjustments, Mr. Negm commented. In the agricultural sector, price controls had recently been discontinued on all crops except cotton, wheat, and rice. The prices of those three commodities had been raised at the same time that controls had been lifted on other crops, and further adjustments would be made according to the results of studies currently under way. The Egyptian Government firmly believed that decontrolling agricultural prices was a prerequisite both for achieving food security and for reducing dependence on food imports.

The Government also wished to improve energy conservation, Mr. Negm noted. Hence, two increases in electricity rates had been made in 1982/83; in addition, natural gas, which could be sold for significantly more, was being substituted for butane in household consumption. Natural gas from newly developed fuels was also being transmitted to electricity generating stations and fertilizer plants as a substitute for fuel oil in order to augment the volume of petroleum products available for export.

His Government was also determined to improve the finances of the public sector industrial companies, Mr. Negm observed. One way of achieving that aim was through greater use of product differentiation by adding a somewhat improved model to the product line at a significantly higher price. It was estimated that such product differentiation would

reduce the Government's producer subsidies by LE 100 million in 1983/84. Finally, a thorough financial reform of the public sector companies--which would extend greater authority to company managers to determine prices and control costs--was under discussion.

Mr. Erb stated that he was concerned about the serious structural imbalances in the Egyptian economy, which had produced high and growing deficits in the public sector budget and continued weakness in the external accounts. For a number of years, economic policy in Egypt had been favoring consumption at the expense of savings and investment, a strategy that, if continued, could have negative effects on future economic growth.

The economic goals outlined in Egypt's current Five-Year Development Plan seemed sound, Mr. Erb continued. Unfortunately, thus far inadequate policy changes had been undertaken to achieve the goals of the plan. There were several areas in which policy action was needed. First, the fiscal budget was expected to widen substantially as food subsidy costs increased and commodity prices firmed up as part of the world economic recovery. Second, energy was heavily subsidized, with domestic prices at only 17 percent of world prices, which resulted in a budget and foreign exchange opportunity cost of LE 3 billion annually. Two further consequences of low domestic energy prices were the wasting of valuable oil resources and the bias toward inefficient energy-intensive projects. Third, agricultural producer prices remained far too low to provide appropriate incentives for increased production. Fourth, the exchange rate remained overvalued, thus hampering both non-oil exports and worker remittances. Finally, the prevailing negative real interest rates encouraged consumption and speculation at the expense of savings and capital formation. He was in broad agreement with the staff appraisal and endorsed the policy recommendations contained therein. It was regrettable that so little progress had been made since the previous Article IV consultation discussion, and he again urged the authorities to act without further delay to take the reform measures required to correct the many distortions in the economy. In that regard, it was vital that any policy actions adopted by the authorities should be consistent with, and supportive of, a comprehensive and well-thought-out adjustment effort.

It was imperative for the fiscal deficits to be significantly reduced and the underlying structure of the budget to be improved, Mr. Erb said. The measures recommended by the staff as initial steps toward those goals seemed broadly appropriate, and he urged their adoption as soon as possible. On the monetary side, considerable improvement would be possible if the fiscal deficits were reduced. Current rates of liquidity growth seemed excessive, and he therefore joined the staff in supporting the authorities in their intention to maintain an anti-inflationary monetary stance.

Serious resource misallocations occurred because import prices continued to be out of line, Mr. Erb observed. A consequence of existing price distortions had been to favor consumption and to reduce the

incentive for savings and investment; hence, there was a need for increased reliance on market adjustments to allocate resources in an environment in which artificial controls on both consumer and producer prices had been eliminated. In that context, low domestic energy prices were of particular concern, and it was unfortunate that the period in which it had been intended to raise domestic prices of petroleum products to world levels had been extended from five to ten years. He fully agreed with the staff that a substantial increase in prices was needed, with a full pass through to final consumers.

Another concern was that public sector enterprises continued to price their output below the cost of production, thus creating a need for budget subsidies, Mr. Erb commented. Appropriate pricing policies would help to rectify the situation and would, moreover, help to reduce the fiscal deficits. As for external sector policies, greater reliance needed to be placed on pricing and exchange rate actions as instruments for improving the structure of production and trade in Egypt's external accounts. An active exchange rate policy--which had as its goal the unification of rates at an appropriate level--was clearly required.

In sum, Mr. Erb said, it was of the utmost importance for the Egyptian authorities to act quickly to reverse the ever growing imbalances in the economy. The longer that the necessary measures were delayed, the more difficult the inevitable adjustment would be. Egypt should not base its future on a narrow and inefficient economic base and increasing dependence on foreign assistance; internal and external balances must be rapidly restored, and economic efficiency should be a priority goal.

Mr. Grosche noted that, while Egypt's overall external position had moved from deficit into surplus during the previous year, the economic situation had continued to be extremely difficult. Indeed, the turnaround in the external position had been due to exceptional factors rather than to any underlying improvements in Egypt's external position. For 1982/83, it was expected that the trade balance would once again show an unsatisfactory performance, with exports covering only about 40 percent of imports.

Another area of concern, Mr. Grosche continued, was the large fiscal deficit--about 20 percent of GDP--that had been financed to a considerable extent by government borrowing from the banking system. In FY 1981/82, revenues had increased by only 5 percent, while expenditures had risen by 23 percent. Subsidies formed a large part of expenditures, and centralized controls on production and prices in agriculture and industry had impeded growth in those two sectors, while an open-door policy and a relatively controlled free environment had stimulated growth in the services and administration sectors. Consumption growth had been higher than the growth of capital formation, giving cause for serious concern about Egypt's future.

Clearly the economic policy stance needed to be changed fundamentally to place less emphasis on consumption and more on productive investment, Mr. Grosche considered. The immediate task ahead should be a marked

reduction in the fiscal deficit, and he agreed with the staff that significant measures toward that end should be put into effect early in the coming year. Among the measures that should be envisaged on the expenditure side were reductions in consumption subsidies and control of the growth of other current spending, particularly wages and benefits. On the revenue side, it was important to adjust domestic retail prices of petroleum products, which averaged only 17 percent of comparable world prices. More generally, pricing policies should permit public sector companies to earn a reasonable return on investment.

Monetary policy should be directed toward assisting the reform of the financial system, and further cuts in the current rate of liquidity growth, which still seemed to be in excess of the needs of the economy, would be helpful in that respect, Mr. Grosche said. On the external side, the favorable balance of payments outcome during the current year should by no means be considered grounds for complacency. Numerous uncertainties persisted, particularly with respect to future oil price developments, the level of workers' remittances, and service receipts from the Suez Canal and tourism. In the circumstances, the authorities should aim at strengthening the external position. The growth of imports had to be controlled through appropriate demand management and pricing, and improved exchange rate policy was a prerequisite for better export performance.

Some measures to improve the efficiency of the exchange rate system had been taken recently, Mr. Grosche noted, with the effect of abolishing most of the exchange surrender requirements. Since they were likely to increase the volume of exchange in the free market further, an early reunification of the rates should not be difficult. Exchange rate arrangements had for some time been quite complex in Egypt, involving multiple currency practices. In that regard, he welcomed the indication by Mr. Negm that the Egyptian Government would be taking the necessary measures to introduce a unified exchange system in the near future.

Mr. Taylor agreed with others that there were serious imbalances and maladjustments in the Egyptian economy that were urgently in need of correction. The excesses in financial policy and the existence of widespread relative price distortions were among the main problems; in particular, the domestic retail price for petroleum was only 17 percent of the world market price when converted at a realistic exchange rate. It was difficult to see how Egypt could realize its objective of becoming a net oil exporter if such major price distortions were allowed to continue. In the circumstances, he was in favor of the Fund seriously exercising its surveillance role in the Egyptian case and welcomed the staff recommendation that the next Article IV consultation should be held on the standard 12-month cycle. Of course, he strongly supported the virtue of consulting with the Fund at an early date, and it seemed unfortunate that so much time had passed without any clear indication that the authorities were taking adequate steps to resolve their economic difficulties. While a comparatively gradual approach to adjustment might have been taken two years previously, more drastic policy action

would now be necessary. In that regard, he had been pleased to hear from Mr. Negm that the authorities had begun to take firmer action in the fiscal, credit, and pricing fields.

The most important priority for action was in the area of fiscal policy, Mr. Taylor continued. Public expenditure was about 60 percent of GDP, and the fiscal deficit--which had reached 20 percent of GDP in 1982--was projected to rise further in 1983, in the absence of appropriate corrective measures. He welcomed the reduction in subsidies envisaged for 1983/84, although he had noted that much of the reduction was attributable to a decline in international prices of several imported commodities rather than to specific governmental action. On a related matter, he wondered whether the new ration card system--designed to restrict subsidies to those truly in need--had become fully operational. Also, he was disappointed to note that the former timetable for phasing out the system of consumer subsidies had been extended from five to ten years. A clear timetable for the elimination of subsidies should perhaps be an early priority.

There was little doubt that the surge in current expenditure was diverting scarce resources away from potentially more productive areas of the economy, Mr. Taylor observed. Hence, he agreed with the staff on the need to strengthen the underlying structure of the budget. Did the staff have any more information on the authorities' reaction to the five specific fiscal proposals set out on page 7 of the report?

Some progress had been made on the monetary side during the past year, Mr. Taylor noted; nonetheless, current liquidity growth was still quite rapid. The interest rate structure would need to be carefully reassessed, and some modifications should be introduced, particularly if industrial and agricultural investment failed to pick up as much as the authorities hoped. In general, an effort should be made to ensure that interest rates were reasonably competitive with those elsewhere. A commitment to that effect could be another early priority.

Commenting on the exchange rate, Mr. Taylor welcomed the recent abolition of foreign exchange surrender requirements, a positive step toward simplification of the exchange rate system that was likely to increase the importance of the free market rate. Although a complete unification of all the exchange rates might not be feasible in the very near future, progress toward that end should be an essential element of corrective action, and unification should remain a priority goal. Also, an appropriate pricing policy centering on a realistic exchange rate would be essential if there was to be any improvement in Egypt's external position. On a related matter, he welcomed the formal elimination of the two bilateral payments arrangements with Fund members in April 1983, and he urged the authorities to work toward terminating the outstanding bilateral agreements with China and with Sudan as soon as possible. He could endorse the staff's recommendation for nonapproval of exchange restrictions and multiple currency practices.

The staff report referred to deep-rooted structural problems in the Egyptian economy, Mr. Taylor recalled, and he had detected some doubts on the part of the staff that the Five-Year Development Plan provided a convincing response by itself to Egypt's domestic problems. The overall objective of increasing the levels of domestic savings and investment and reducing the economy's reliance on external resources seemed to be appropriate, but it would be difficult to achieve that objective without determined efforts to reduce consumer subsidies and public sector consumption. The authorities had noted that the plan was intended primarily to be a broad statement of objectives, supplemented by more detailed annual programs. In that regard, he recognized that the need at present was to concentrate on bringing forward the detailed and specific programs within the framework laid down in the development plan. However, some parts of the plan seemed to be overoptimistic. For example, petroleum exports had been projected by the authorities to grow at a rate of 12 percent annually through the next few years. The staff had perhaps been more realistic in stating that "total export receipts will decline in 1983." If they did, Egypt's ability to service its external debt would be adversely affected despite its relatively favorable maturity mix. In conclusion, he could support the thrust of the staff appraisal and the proposed decision, and he would encourage the authorities and the staff to consult closely in the near future on a comprehensive adjustment program.

Mr. Casey observed that the Egyptian economy had performed well in many respects, but the fiscal situation remained worrying. The overall fiscal deficit in 1982/83 had been more than 20 percent of GDP, and he therefore wondered how the staff had been able to describe the situation of the Egyptian economy as one of "relative stability." The staff had rightly pointed to the low elasticity of the tax base and the system of open-ended commitments on the expenditure side as reasons for the fiscal problem. The fiscal position was also quite vulnerable to external factors such as fees from the Suez Canal, oil prices, and commodity prices. Indeed, over half of central government revenue was obtained from the Petroleum Authority, the Suez Canal Authority, and customs duties. It was worrying that fiscal deficits of the magnitude experienced in Egypt had occurred even without any real rationale; in a sense, the fiscal deficits seemed simply to "happen."

It was also a matter of concern that subsidies continued to account for almost one fourth of total current government expenditure, Mr. Casey said. He recognized that the matter of subsidies was a sensitive and controversial issue, but he wondered whether the authorities might be able to achieve their social objectives by some form of income support--which would lead to less resource misallocation--than through subsidies. Furthermore, if producer prices were increased, farmers would not need subsidies or even income support, since their profits would be increased.

He could support the staff recommendations regarding the 1983/84 budget, Mr. Casey remarked, although he had doubts whether the authorities would be able fully to implement the recommended measures. His

own preliminary reaction to the 1983/84 budget was that, despite some good measures, little overall adjustment seemed to be envisaged. Very few of the recommendations made by the technical assistance mission from the Fiscal Affairs Department had ever been implemented. As the adjustment on the fiscal side might not be adequate, any stabilization program agreed with the Fund should perhaps be "backloaded." On a related matter, he wondered whether fiscal performance tests should not be considered in any program in addition to more normal credit ceilings. Such tests should apply to the consolidated public sector so as to minimize loopholes, such as interagency transfers. He recognized that there might be a problem in monitoring fiscal performance tests, although the Fund had managed to do so in some of the smaller islands in the Caribbean.

With regard to monetary policy, Mr. Casey considered, the growth in money and quasi-money--36 percent in 1982/83--was excessive. Admittedly, the growth rate had fallen from 1981/82, but he found it difficult to classify monetary policy in Egypt as having "an anti-inflationary stance." Of course, given all the price subsidies, it was difficult to know the true rate of inflation, although it could not be much above 20-25 percent. In any event, there was little that monetary policy could do until the fiscal situation was brought under control, and he could support Mr. Erb's comments in that regard. On balance, he agreed with the staff that some of the credit guidelines should be converted to ceilings; in principle, however, a more market-oriented approach might be desirable, although the capital markets might not be sufficiently developed for such an approach. Another matter worth noting in the area of monetary policy was the counterproductive effect of subsidizing interest rates for selected sectors such as industry and agriculture. The banks tended to offer less credit to those "preferred" sectors, a practice that provided a good illustration of the perverse effects of subsidization.

On the external side, despite recent improvements in the balance of payments, a number of structural problems remained, Mr. Casey said. Diversification of export receipts was essential, and, in that regard, he welcomed the provision of technical assistance by the World Bank. He assumed that the suggestion by the staff that exportable volumes of oil were being eroded meant that domestic consumption of oil had outstripped production, no doubt because of the extremely low domestic price of oil. The subsidy seemed to hit not only the public finances but also the balance of payments.

Like others, he believed that the unification of the commercial bank exchange rate and the free market exchange rate should be accomplished as soon as possible, Mr. Casey commented. The recent abolition of foreign exchange surrender requirements had already closed the gap somewhat; however, the unification of the rates at an appropriate effective level might usefully be a prior condition of any program. As a minimum, the Fund should require a timetable for reunification. A case could also be made for bringing the central bank exchange rate into the unification scheme or at least for reducing the number of transactions at the central bank rate. He noted from SM/83/116 that cotton and rice were exported at

the overvalued central bank exchange rate. The staff had implied that a devaluation of the rate would make little or no difference because of existing pricing policies; the logical approach, therefore, was to change existing pricing policies and to move exports of cotton and rice to the depreciated free-market rate. In passing, he wondered whether it was intended to include Egypt in the promised study of multiple exchange rate systems.

Turning to the matter of external debt, Mr. Casey noted that short-term bank debt had grown by 105 percent since 1977 and that the debt service ratio currently stood at 26 percent, which was worrying. Moreover, he had not found in the staff report any forward-looking debt analysis.

Finally, on a general matter, Mr. Casey observed that, when economies like that of Egypt had medium-term development plans, it was often difficult for the Fund to design programs for a shorter period that were consistent with both Fund principles and the medium-term objectives that the member had set for itself. In many cases, the medium-term plans of countries were overoptimistic, probably for psychological reasons; however, Fund programs needed to be realistic. He hoped that that inconsistency would not be a problem in Egypt.

Mr. de Groote remarked that any examination of the Egyptian economy should take into account the fact that Egypt had succeeded in achieving high rates of growth during the second half of the 1970s and into the 1980s. Unfortunately, since 1982, poor external performance--due mainly to developments in the world oil market--had exposed the underlying weaknesses of the Egyptian economy, which were likely to produce unsustainably large internal and external imbalances. There had been serious delays in the adoption of a policy to correct the difficult fiscal situation; as a result, the financial situation had continued to deteriorate rapidly. It was particularly worrying in a country with Egypt's population and resources problems that the growth rate had substantially declined, that the total budget deficit had grown to 21 percent of GDP, that the officially recorded inflation rate had risen even faster, and that the current account deficit had widened by more than 50 percent.

One of the more important adverse trends in aggregate economic activity in Egypt had been the declining share of agriculture in the economy, Mr. de Groote observed. In 1977, agriculture had been the largest sector of the economy, but its share had since dropped below the share of the commercial, financial, and insurance sectors, mainly because of artifically low producer prices and the asymmetry between rural and urban wages. The result had been an adverse effect on the allocation of resources and pressure on the balance of payments. Moreover, Egypt's consumption of agricultural commodities had exceeded domestic production, thus requiring an increase in the importation of foodstuffs and widening the gap between exports and imports of those commodities. It was to be hoped that greater flexibility in pricing policy would be exercised in

future and that structural adjustments in the agricultural sector would be adopted to help eliminate the imbalances. In that connection, he had been surprised to note from the recently published Five-Year Development Plan that the growth rate for agricultural production was projected at 3.7 percent, the lowest of any sector of the economy.

It was expected that the fiscal deficit would remain high for 1982/83, despite the best efforts of the authorities, Mr. de Groote noted. Hence, he agreed with the staff that there was an urgent need for meaningful reform of the fiscal system and improvement of the financial position of many industrial companies in the public sector, which were greatly affected by budgetary operations. In view of the likely continued decline in oil revenues, there could be no doubt that structural and other corrective action must be undertaken as soon as possible.

Recent monetary growth in the Egyptian economy had been excessive, Mr. de Groote considered. The size of the budget deficit, the structure of interest rates, and the present exchange rate policy all served to limit the authorities' room for maneuver in lowering the growth rate of the money supply. The expected continued deterioration in the current account and overall balance of payments position over the next few years would put even greater pressure on monetary aggregates. As the true inflation rate might be somewhat higher than the officially recorded one, the interest rates on loans and deposits were still quite negative. The staff had pointed out that existing interest rate policy must be kept under review to ensure that domestic rates were maintained at levels consistent with comparable rates in international financial markets. He would appreciate hearing from the staff the policy intentions of the authorities with regard to domestic interest rates, and he would welcome further clarification about the effectiveness of those rates in encouraging private savings and implementing more effective demand management.

Like others, he was troubled by the lack of information in the staff papers on Egypt's medium-term balance of payments situation, Mr. de Groote said. More data and analysis on that matter would have been welcome, especially in view of the trends in the oil market; moreover, it would be difficult without such information to develop a meaningful program for the medium term.

He had been happy to hear from Mr. Negm that the Egyptian authorities intended to introduce a unified exchange rate system, significantly to reduce subsidies on bread, and to cut the number of subsidized commodities, Mr. de Groote remarked. However, he had doubts about the usefulness of maintaining or reinforcing consumer goods rationing, especially for essential goods, since it was an easy matter to repurchase rations from lower-income beneficiaries. Devices such as rationing were poor substitutes for changes in the price mechanism and could lead to social inequities. The other measures announced by Mr. Negm seemed to go in the direction of additional price adjustments, incentives to investment, and increases in income and savings; however, they were only first steps toward the

fundamental requirement of a restoration of a realistic exchange rate and price system. Egypt remained the obvious example of an economy that had deprived itself of its development opportunities by adhering to an excessively rigid price and exchange rate system.

Finally, Mr. de Groote said, it was useful that the Article IV consultation discussion was taking place before the staff mission to Egypt discussed a possible agreement. The Article IV discussion should give the staff a clear idea of the framework within which a program could be developed.

Mr. de Maulde agreed that the Egyptian economy had performed well over the previous decade. More recently, however, its capacity for growth had weakened, partly because of changes in the world economy. While few countries had remained fully protected from the current recession, the negative consequences of the international situation appeared to have been more severe in Egypt than elsewhere. As a net exporter, it had suffered from a weakening in the oil market; as the operator of the Suez Canal, it had suffered from the reduction in maritime traffic because of reduced world trade; and, as an exporter of labor and tourism, it had suffered from a slowdown in development projects in neighboring countries and from an unprecedented cutback in leisure and travel expenditures in industrial countries. If it was true for those reasons that Egypt had suffered more than other countries from the world recession, it should also be true that Egypt would benefit more than others from a turnaround in the world economy. However, it was by no means certain that the ecomomy would be able to enjoy the high rates of growth of the previous decade for any reasonable period of time unless the authorities focused more seriously on the areas of weakness.

To some extent, Mr. de Maulde continued, many of the weaknesses in the Egyptian economy were the byproduct of reasonable decisions and policies, such as the decision to encourage the opening up of the economy and to promote inflows of foreign capital. Because profits in agriculture and industry had been kept artificially low, foreign investors had generally followed the path of least resistance and had concentrated on services and distribution activities, thus causing the shares in the economy of both industry and agriculture to drop sharply. Action to correct those developments was clearly in order.

He could support the priorities and objectives of the Five-Year Development Plan for the Egyptian economy, Mr. de Maulde said. However, there was a long way to go before those goals could be attained; indeed, the staff report seemed to indicate that progress in the desired direction might have been slower than expected, at least for the first year of the Plan. If the authorities were to move with determination toward a rapid correction of the structural imbalances, it would be necessary first to attain a more satisfactory rate of growth in the commodity-producing sector. Such an improvement was desirable not only from a domestic point of view, because Egypt had a large and growing population with many needs, but also as a means of strengthening the balance of payments, which was

vulnerable to fluctuations in international activity. In that regard, he welcomed the indications by Mr. Negm of the policy intentions of the authorities.

Two other areas of weakness also required greater attention, Mr. de Maulde considered. The first was the need to increase and promote savings. That consumption should represent about 90 percent of GNP was quite inappropriate for an economy like that of Egypt, especially in the context of a fiscal deficit equivalent to about 20 percent of GDP. As noted by others, it would be important to make large cuts in expenditure, since the structural characteristics of the tax system and the complexity of accounting procedures made it unlikely that additional revenue would be produced at all quickly. The monetization of the deficit that had been experienced recently seemed to reinforce the case for a more aggressive policy to encourage savings. A rise in interest rates would probably have a positive effect on workers' remittances. He had understood that bringing real interest rates in line with Eurodollar rates could be expected to result in a significant increase in potential remittances. He would appreciate hearing comments from the staff or Mr. Negm on that matter. Finally, while he could commend the authorities for the clever way in which the adjustment of the exchange rate had been managed, he believed that the system remained unduly complex. Like others, he felt that the time was ripe for a unification of the various rates.

Mr. Polak remarked that it was difficult to assess Egypt's performance in the past year because what economic data were available were either preliminary or limited, and some of the figures--for example, those relating to the balance of payments--were highly problematic. He could accept the staff's view that the financial outcome during the coming year would show improvement in certain areas, but he noted that some of the improvement would be due to external factors rather than to government policy and, for that reason, might not be sustainable. Still, he could generally support the staff's appraisal, particularly the indication that the immediate task of economic policy in Egypt must be the achievement of a significant reduction in the fiscal deficit together with reforms that would lay the foundation for a more viable budgetary structure and have more salutary effects on domestic resource mobilization and on resource allocation in general.

The Five-Year Development Plan should be the main vehicle for the needed change in resource allocation, Mr. Polak continued. However, the projections provided by the staff in SM/83/116 showed that little progress toward that goal had yet been accomplished. In spite of the planned change of course in industry, oil, and electricity, the only major changes expected by the end of the five-year period were for the share of the oil industry in GDP to rise from 15 percent to 18 percent and for the share of agriculture to drop from 20 percent to 16 percent. The relative importance of other sectors of industry was expected to remain about the same. Moreover, the staff had expressed doubts whether, in the prevailing circumstances of rigid prices and heavy reliance on controls, even those

limited objectives could be achieved. It was clear that, unless intervention were dramatically reduced and market forces were given more room to operate, appropriate structural change would simply not take place.

On the matter of subsidies, Mr. Polak observed that, in 1981/82, 36 percent of the employed labor force had worked in agriculture but had produced only 20 percent of GDP. He wondered in the circumstances whether the policy of restraining prices of agricultural commodities for the purpose of subsidizing urban consumers was the best path to follow. Freer prices, coupled if necessary with direct subsidies to the needy, might be a better option; and he agreed with Mr. Casey that income supports might more efficiently accomplish the authorities' social goals than artificially low prices. In that connection, he was happy to note that some steps were being taken toward decontrolling agricultural prices and reducing subsidies on agricultural commodities.

With regard to monetary policy, Mr. Polak noted that the Egyptian authorities had had some success in restricting credit. However, interest rate policy had, in his view, been inappropriate. According to the tables in SM/83/116, interest rates remained far below the rate of inflation, which had to be at least 20-25 percent. To stimulate activity in agriculture and industry, the maximum rate for loans to those sectors had been set at 13 percent; unfortunately, that preferred rate had simply discouraged banks from lending the necessary amounts to those sectors. In addition to the domestic impact of unduly low interest rates, he was also concerned about the international impact of the risk of pressures on the balance of payments through capital outflows or even the discouragement of capital inflows and remittances. Finally, he could agree with the staff's recommendation not to approve the exchange rate system. Recently, more and more transactions were being diverted to the free exchange market and, while that move was a step in the right direction, the budget and the economy would benefit more from a unified realistic rate of exchange.

Mr. Caranicas recalled that, on the occasion of the previous Article IV consultation discussion, a number of Executive Directors had expressed concerns about the Egyptian economy. In his summing up, the Chairman had indicated the hope of Directors that precise and strong corrective measures would be implemented in the 1982/83 budget year, beginning July 1, 1982. The opening statement by Mr. Negm at the present meeting had thus come as a pleasant surprise. While the situation in Egypt remained worrying, much improvement had taken place since the previous consultation. The deficit on current account had dropped sharply, the commercial banks had increased their foreign assets, and there had been an increase in workers' remittances. Moreover, there had been some improvement in the exchange rate, and the authorities had cooperated with the technical assistance mission in looking toward a reform of the exchange system.

While some of the concerns of previous speakers--such as structural weaknesses, rising public consumption, and high consumer subsidies--remained valid, it was apparent that the Egyptian economy was at a crossroads and that fiscal policy, in particular, was being given greater attention by the authorities, Mr. Caranicas remarked. There was also a deceleration in the growth of the budget deficit. His only question concerned the remark made by the staff at the previous consultation discussion that income tax in Egypt was mainly a tax of government employees and that the authorities would be attempting to revise the income tax law to overcome the problem. What progress had been made toward that end? Finally, he recalled the suggestion made by Mr. de Maulde at the previous Article IV consultation discussion that any delays in adjustment of the Egyptian economy could reduce the effectiveness of a Fund-supported program. Mr. Negm's initial comments seemed to show that Egypt had not waited too long for closer cooperation with the Fund. Moreover, since Egypt was a pivotal country in the Arab world, it was crucial that its economy should be economically stable and financially sound. In that respect, Fund assistance to Egypt might have more beneficial effects for the Middle East than would assistance to other countries in the region.

Mr. Prowse stated that, like others, he could support the staff appraisal and the suggestion that Egypt should be on a 12-month cycle for consultations. Turning to the staff report, he noted that government spending was almost 60 percent of GDP, while the deficit was about 20 percent of GDP. In fact, the deficit was larger than the value of agricultural output in the economy. Hence, strong structural adjustment was needed in agriculture, and the staff had rightly emphasized the importance of pricing and decontrol in that adjustment.

Like others, he had been disappointed in the treatment of external debt in the staff report, Mr. Prowse continued. Staff reports should provide a medium-term analysis of the debt situation; in the Egyptian case, where the debt service ratio was at 26 percent of GDP, the matter was certainly deserving of more than a brief paragraph. Finally, he could support the staff's recommendation that the existing multiple currency practice should not be approved.

Mr. Malhotra remarked that he was broadly in agreement with the staff report. He welcomed the indication by Mr. Negm of the actions already taken or intended by the Egyptian authorities, who had apparently fully recognized the need to pursue corrective action in the recommended areas. He hoped that the forthcoming discussions with the Egyptian authorities on a possible Fund program would be successfully completed at an early date.

The Director of the Middle Eastern Department, responding to criticism about the lack of any medium-term external debt analysis in the staff paper, observed that the Executive Board had made its request to include such data in consultation reports only after the consultations with Egypt had been concluded. The staff would certainly provide the requested analysis in the next consultation report.

With respect to the suggestion by Mr. Taylor that there were deep-rooted structural problems in Egypt, the Director noted that policy in recent years had by and large been directed toward increasing consumption, to the detriment of savings and investment. That policy touched upon a number of crucial areas in the Egyptian economy. For example, there was a reluctance to move toward a realistic exchange rate, because doing so would increase prices and have an adverse effect on consumption. In addition, attempts to improve the fiscal structure were hampered by efforts to alleviate the prime effects of incomplete reforms. Customs duties were still being collected on the basis of an exchange rate that was no longer used for any meaningful transactions.

Over the past four or five years, private consumption had increased from about 60 percent of GDP to 70 percent of GDP, a feature that was quite worrying, the Director said. While the Five-Year Development Plan called for a reduction in private consumption to a level of 60 percent of GDP, the staff felt that it would be impossible to achieve that target without drastic action. Unfortunately, no meaningful action toward that end had taken place thus far. The most recent measures referred to by Mr. Negm were certainly steps in the right direction, but they were not sufficient to address the problem.

The development plan had also projected an increase of 12 percent in petroleum exports, the Director recalled. It was difficult to judge whether such a target would be attainable unless, for example, additional petroleum reserves were discovered; the staff at present had no solid information that would help to justify the target. The energy sector was particularly important in the Egyptian economy. Energy consumption had been increasing over the past few years by 12 percent a year, the increase no doubt being closely related to the relatively low domestic prices. When the program for the electrification of rural areas in Egypt had been put into effect, it had been estimated that consumption per family would reach 4 kilowatts per month. Recent evidence showed that consumption was currently at about 70 kilowatts per month in rural areas; unfortunately, it was being used mainly to run consumption items like color televisions, vacuum cleaners, and similar appliances. Unless the bias toward consumption could be reversed--which would require more realistic pricing policies--it would be difficult to implement meaningful reform in the energy sector.

On subsidies, the Director observed that the authorities were planning to introduce changes, one of which--if successful--would have the effect of significantly reducing the subsidy on bread. The intention was to produce more of the type of bread that cost two piastres per loaf and less of the type that cost one piastre per loaf. Still, many direct subsidies remained, despite the advice of the staff that income support would be preferable. Of course, the authorities had been increasing income; the wage bill in the budget over a three-year period, for example, had increased by 150 percent, part of which was an increase in wages. Unfortunately, while the wage bill had been increasing, subsidies had

not been declining at the same rate. With respect to Mr. Taylor's inquiry about the new ration card system, the staff had no indications that the system had yet come into effect.

A question had been asked by Mr. Casey on whether, in Egypt's case, a one-year stand-by arrangement could be consistent with the medium-term strategy of the authorities, the Director recalled. The staff saw no inconsistency so long as the Egyptian authorities were in a position to discuss with the staff their medium-term strategy. It would be difficult to have a more extended arrangement based on ad hoc policy measures that were not comprehensive in scope or phased as part of the medium-term approach. The staff would be discussing those matters when the mission visited Egypt in the near future.

In the late 1970s and early 1980s, the Fiscal Affairs Department had conducted a technical assistance study on a sales tax on manufactures, the Director noted. That tax was supposed to be part of a financial program and had eventually been reviewed by all concerned political and legislative bodies in Egypt. However, the program had not been approved by Parliament. Instead, the authorities had modified the program and placed some heavy excise duties on a number of luxury commodities.

With respect to interest rates and remittances, the Director said, it would be difficult to argue against the proposition that there was a close correlation between the level of interest rates and the amount of workers' remittances. However, the two factors generally affecting the inflow of remittances through the banking system were the level of the exchange rate and interest rates. It was to be hoped that, when unification of the rates took place, a realistic and flexible exchange rate would be possible together with high interest rates. On a related matter, the staff was indeed looking toward unification of the exchange rate as a prior condition to any program.

In response to a question by Mr. Caranicas, the Director of the Middle Eastern Department remarked that it was certainly true that only government employees were unable to escape income taxes. However, in recent years, the collection of taxes from other than government employees had accelerated remarkably as the administrative machinery for collection had improved. Finally, it was clear that the objectives of the ambitious Five-Year Development Plan would not be realized unless there were supporting measures aimed at reducing private consumption from 70 percent of GDP to 60 percent of GDP. That goal could be accomplished only through a reduction in the standard of living of the Egyptian people. The important issue was to devise policies that would not further reduce the standard of living of the lowest income groups, leaving the brunt of the decline to fall on the relatively well-to-do segments of the population.

The Deputy Director of the Exchange and Trade Relations Department, responding to a question by Mr. Casey on the possibility of a performance test covering public sector operations, said that it would be possible to have a credit ceiling covering both the government budget and the rest of the public sector. In fact, such a ceiling had been used in stand-by

arrangements with Egypt in the past. However, it would not be possible to have a test on the overall deficit of the public sector, because of the difficulty of obtaining timely and reliable data on the rest of the public sector. For similar reasons, it would not be possible to monitor any particular component of public sector operations, such as total public sector expenditure. The best that the staff could do was to extend the ceiling to cover the entire public sector.

With regard to the potential for unification of the exchange system, the Deputy Director agreed with Mr. Casey that the objective should be a complete unification of all rates, including the central banking rate at which government transactions and certain exports currently took place. Some of those transactions, like the Suez Canal duties, were not sensitive to the exchange rate, while others were mainly related to pricing policy. The adjustments that would be called for in moving those transactions from the central banking rate would be difficult to undertake in the immediate future. In the circumstances, the Egyptian authorities were envisaging reform as a two-stage process, the initial stage of which would be to merge the commercial bank market and the free market. Such a move would be feasible at the present time and would greatly improve the efficiency of the exchange system. The central bank rate would be merged at a later stage. Of course, as Mr. Casey had noted, there was scope for moving some of the transactions at the central banking rate to the free market rate. For example, cotton and rice could be moved to the free rate; however, if such a move were to take place, there should perhaps be a temporary export tax on cotton and rice, because those commodities were not particularly unremunerative at the current exchange rate.

Mr. Negm remarked that the matter of energy sector reform in Egypt was a sensitive one. It had been discussed at all levels of Government, including the President of the Republic and on a number of occasions with staff from both the Fund and the World Bank. In 1983, some measures had been taken to increase rates on electricity and to substitute natural gas for butane in households and some industries. Subsidies in areas other than energy had also been reduced. Further price increases, particularly in energy, would be considered at a later stage, perhaps with controlled pricing limited to the poorer classes of the community. The ration card system was likely to be introduced during the 1983/84 fiscal year, as all preparations for its introduction had been completed.

With regard to the termination of bilateral agreements, Mr. Negm noted that the bilateral payments agreement with China would be terminated at the end of the agreement year, 1983. After 1983, payments would take place in convertible currencies.

On the relationship between increases in interest rates and improved savings, Mr. Negm recalled that the interest rate had played no role in the Egyptian economy up through 1976 but had tripled in real terms since then. Deposits in Egyptian pounds currently enjoyed a 13.25 percent interest rate, and the figures showed that savings had been increasing. Moreover, the withholding tax on interest--which had been 40 percent--had been eliminated.

As for the possibility of achieving a 12 percent increase in oil exports, Mr. Negm observed that two new oil deposits had been discovered--one offshore, north of Port Said, and the other in the Western Desert--and production should come on line in the near future. Finally, while it might be true that the provision of electricity to the rural areas had served initially to increase consumption, he had no doubt that, at a later stage, it would help to increase production as well.

The Chairman made the following summing up:

In discussing the report for the 1983 Article IV consultation with Egypt, Directors generally agreed with the views expressed in the staff appraisal. While noting that there had been some improvement during 1982/83 in the balance of payments, Directors were seriously concerned about the gravity of the remaining underlying economic imbalances. They welcomed the policy intentions of the Egyptian authorities but expressed some disappointment that more timely and vigorous measures had not been taken to redress the structural weaknesses of the economy. Observing that pervasive cost/price distortions had led to severe misallocation of resources and interfered with efficiency in production and trade, Directors urged that progress soon be made in adjusting the price structures in agriculture and public sector industry to take adequate account of costs. They also considered that the authorities should set a medium-term objective of allowing market forces to determine operations of public sector enterprises. Particular attention was drawn to the low level of domestic energy prices--equivalent to only 17 percent of world market prices--and to the enormous loss in government revenue occasioned thereby.

Directors noted with regret that the time span over which the authorities intended to raise energy prices to world levels had been extended from five years to ten years, and they strongly urged the Egyptian authorities to accelerate the planned increases in domestic prices of energy. More generally, they observed that, in order to achieve sound and sustained growth over the longer term, the authorities needed to take significant and comprehensive action to transform the economy from a highly consumer-oriented society to one with significantly greater emphasis on productive investment.

Directors took note of the revised budget outcome projected for 1982/83 and the initial budget data for 1983/84, which implied that the public sector deficit was expected to continue at the unsustainable level of about 20 percent of GDP. They expressed concern that such a development reflected no basic reform of the structure of government finances. Government revenues continued to be relatively inelastic with respect to domestic economic activity and highly vulnerable to external factors such as Suez Canal traffic and petroleum market

conditions. Similarly, government expenditures continued to be sensitive to fluctuations in international prices for foodstuffs. Directors stressed the urgency of substantial and prompt measures to strengthen government finances as well as to generate the resources necessary to achieve the objectives set forth in the Development Plan. It was noted that direct subsidies continued to account for a relatively large share of government expenditure; while Directors welcomed the steps planned by the authorities in the 1983/84 budget to curtail the budgetary costs of consumer subsidies, they felt that more action should be taken in that field.

Noting that the more favorable outcome of the balance of payments projected in 1982/83 was largely due to external circumstances that could not be expected to persist indefinitely, Executive Directors considered certain developments to be particularly worrisome: first, non-oil exports had been stagnant for several years; second, stimulated by the low level of domestic energy prices, consumption of petroleum products was beginning to reduce the volume of crude oil available for export at the same time that foreign markets for oil were soft; finally, import demand was continuing to increase despite some steps taken to restrain import growth.

Directors welcomed the recent actions taken to liberalize regulations on surrender of export proceeds but emphasized that a thorough reform of the exchange system was required to promote traditional as well as new exports. Directors agreed with the staff that greater reliance needed to be placed urgently on pricing and exchange rate actions to improve the structure of production, trade, and the balance of payments. Hope was expressed that a timetable would soon be set to unify the commercial bank pool and own exchange markets.

Directors noted that public sector borrowing from the banking system continued to be very expansionary and that overall monetary expansion was excessive. In order to decrease inflationary pressures, they said, more comprehensive credit ceilings on both public sector industry and the private sector would be helpful in further reducing money growth toward a level commensurate with the real growth rate envisaged in the Development Plan. Noting the existence of negative interest rates, Directors encouraged the authorities to adjust the level and structure of interest rates so as to promote savings and stimulate inflows of workers' remittances.

In sum, all Directors urged the Egyptian authorities to tackle the basic economic problems in a firm and resolute manner. The medium-term program needed indeed to be underpinned by precise and corrective measures; further delays in implementing such measures would only complicate and exacerbate the task of

adjustment. Directors hoped that a comprehensive policy program, to which the Fund could lend its support, would soon be put together. They warmly welcomed the latest Article IV consultation with Egypt and hoped that it would give the authorities and the staff useful guidance on the policy priorities necessary for restoring internal and external balance in the Egyptian economy. Finally, it is expected that the next Article IV consultation with the Arab Republic of Egypt will be held on the standard 12-month cycle.

The Executive Board then adopted the following decision:

Decision Concluding 1983 Article XIV Consultation

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

2. The Fund notes the recent measures to improve the efficiency of the exchange system. The Fund considers, however, that the system remains complex and believes that further steps should be taken at an early date toward the complete unification of the existing exchange rates. The Fund welcomes the termination of the two bilateral payments agreements with Fund members and hopes that Egypt will terminate the two remaining agreements with Fund members as soon as possible.

Decision No. 7475-(83/112), adopted
July 27, 1983

2. AFGHANISTAN - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Afghanistan (SM/83/109, 5/31/83; and Cor. 1, 6/15/83). They also had before them a report on recent economic developments in Afghanistan (SM/83/115, 6/7/83; and Cor. 1, 6/15/83).

The staff representative from the Middle Eastern Department observed that a recommendation about the timing of the next Article IV consultation with Afghanistan had inadvertently been omitted from the staff report. Given the uncertainties regarding the security situation in Afghanistan, the staff felt that, consistent with existing guidelines, a flexible approach should be taken toward the timing of the next Article IV consultation.

Mr. Salehkhou made the following statement:

Four important interrelated factors have deeply affected economic developments in Afghanistan since the previous Article IV consultation with the Fund in 1978. These factors include a dramatic deterioration in the country's security situation; large population movements within Afghanistan and to neighboring countries; initial difficulties in the implementation of the new Government's fundamental social and economic changes, particularly the land reform program; and a substantial reduction in Western aid and grants, only partly offset by concessional loans and grants from Council for Mutual Economic Assistance countries. Even loans and grants from the CMEA countries have been declining in the last two years.

These developments resulted in a rapid general deterioration of Afghanistan's economy, particularly with respect to domestic output, which fell sharply in 1979/80 and 1980/81, resulting mainly from the destruction of infrastructural and production facilities, and, on the other hand, from the considerable decline in productive investments induced by the cessation of Western aid. Marked declines affected agricultural, mineral, and industrial production. Table 1 of SM/83/109 indicates that, in the case of cotton, output declines amounted to 20 percent and 38 percent in 1979/80 and 1980/81, respectively; a further 8 percent decline occurred in 1981/82. A noticeable exception to this trend was the substantial increase in natural gas production in 1980/81 with the opening of a new field. As Afghanistan's consumption of natural gas is small, the latter improvement allowed for an important increase in gas export receipts, which greatly attenuated the adverse effects of the above mentioned factors on the balance of payments and on public sector finances.

In the face of the continued deterioration in economic activity, the authorities have adopted annual socioeconomic development plans aimed at restoring economic growth. Other measures include the gradual implementation of the land reform program, substantial adjustment in industrial crops' procurement prices, an improvement in the provision of modern inputs to the agricultural sector, particularly to farmers' cooperatives, and an extension of workers' training programs. However, and owing mainly to the continued delicate security situation, considerable shortfalls from plan targets have been registered, and economic activity has remained sluggish.

With regard to domestic financial developments, the public sector's recourse to bank financing rose sharply during the past two fiscal years. This development resulted primarily from a deceleration in the growth of gas export revenues, large increases in debt service payments and security-related expenditures, a 27 percent adjustment in the salaries of civil servants, and from

the adverse effects of output declines and curtailed external aid on the finances of public entities. Although the authorities reacted to the deterioration in public sector finances by substantially scaling down development expenditures, the increased recourse to bank financing may have resulted in high monetary expansion, which contrasted with the downward trend in economic production and contributed to the acceleration in the rate of inflation.

Other factors contributing to consumer price increases included the exchange rate depreciation, particularly in the bazaar free exchange market, and the higher costs of both imported and locally produced goods.

The Afghan authorities are aware of the unsustainability of public sector finances and of the negative effects of high monetary expansion. In this regard, important measures envisaged for fiscal year 1983/84 should result in the containment of public sector expenditures and in an increase in budgetary revenues, possibly through higher tax rates.

With regard to external developments, despite a substantial increase in natural gas export receipts, the trade deficit increased further in the past two years, while net capital inflows were substantially lower than in previous years. The deterioration of the trade deficit intensified despite a slowing down of import growth and resulted mainly from output declines in traditional exports and from transportation difficulties. On the other hand, net capital inflows were adversely affected by a considerable decline in external aid and grants, and by rising debt service payments.

Although the overall balance of payments showed relatively large surpluses throughout the 1970s, mainly as a result of high workers' remittances and substantial external assistance, Afghanistan's international reserves can hardly be regarded as comfortable. Indeed, the authorities are concerned with the trend of deterioration in the balance of payments, and particularly with the sharp increase in the country's outstanding external debt and rising debt service payments. While the measures to be implemented under fiscal and monetary policy should reduce the pressure on the balance of payments, the authorities believe that meaningful progress in this area is largely dependent upon the resumption of external assistance and on improvement of the security situation.

Finally, concerning Afghanistan's exchange and trade system, although the measures implemented since the 1979 unification of banks' exchange rates have resulted in the re-emergence of multiple currency practices, they have generally been in line with the authorities' economic policy aimed, in particular, at

containing import-induced inflationary pressures. The large differentials between the various exchange rates have not apparently resulted in the development of illegal transactions, since foreign trade is mainly the responsibility of the public sector. On the other hand, the authorities have compensated for the disincentive effect of the exchange rate on export production by substantially increasing the procurement prices of industrial crops.

Extending his remarks, Mr. Salehkhou noted that his Afghan authorities had a few minor observations on points in the staff papers. The first sentence on page 10 of SM/83/115 talked about the "practice of keeping the budgetary accounts open for a complementary period of two-three months after the end of the fiscal year." In fact, those accounts were kept open for only two or three weeks. In the second paragraph on page 21 of the same paper, the staff had suggested that "a significant percentage of foreign trade is believed to be unrecorded." According to the authorities, only a small percentage of such transactions went unrecorded. Finally, in Table 19 of the Appendix covering balance of payments estimates, the figure for commodity aid imports from bilateral countries in 1981/82 should read $81.7 million rather than $87.8 million. For 1980/81 under the same item, the figure should read $118.8 million rather than $124.7 million.

In the absence of comments by Executive Directors, the Chairman made the following summing up:

Executive Directors, taking note of the statement made by Mr. Salehkhou, broadly agreed with the thrust of the staff appraisal in the report for the 1983 Article IV consultation with Afghanistan.

Given the uncertainties regarding the situation in Afghanistan and consistent with the existing guidelines, a flexible approach should be taken toward the timing of the next Article IV consultation with Afghanistan.

The Executive Board then adopted the following decision:

Decision Concluding 1983 Article XIV Consultation

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

2. Afghanistan's present exchange regime involves exchange restrictions and multiple currency practices as described in SM/83/115. The Fund hopes that the authorities will pursue a more flexible exchange rate policy, with a view toward the eventual establishment of a unified exchange rate system. The Fund encourages Afghanistan to terminate the bilateral payments agreements with two Fund members.

Decision No. 7476-(83/112), adopted
July 27, 1983

3. CHILE - STAND-BY ARRANGEMENT - WAIVER AND MODIFICATION OF PERFORMANCE CRITERIA; AND EXCHANGE SYSTEM

The Executive Directors considered a request by Chile for a waiver and modification of performance criteria under the stand-by arrangement and for approval of certain exchange measures (EBS/83/134, 6/28/83; Cor. 1, 7/13/83; and Sup. 1, 7/25/83).

Mr. Donoso made the following statement:

The first symptoms of economic difficulties in Chile appeared in the last quarter of 1980. From then until mid-1982, the authorities concentrated on maintaining fiscal equilibrium and a tight monetary policy while giving time to the economy to adjust to the external shocks affecting it. Already then, difficulties in financial institutions were the main reason behind losses of international reserves.

In mid-1982, the authorities decided to devalue and to eliminate wage indexation from the regulations governing collective bargaining and wage adjustments in the public sector in order to facilitate economic adjustment to the changed external conditions. Again, a weak financial system proved to be an obstacle to the application of appropriate policies in the areas of exchange rates and monetary management. It was during these months that the preferential exchange rate to service external debts contracted before August 6, 1982 was established as a way to lessen the impact of the devaluations on the financial system.

Finally, after a period of tight monetary policy and shortly after the Fund's approval of the stand-by arrangement for Chile, there was a crisis in the Chilean financial system. Three financial institutions were liquidated and five others were placed under temporary government control.

The banking crisis interrupted foreign bank lending to Chile and led to a sharp expansion of central bank credit and to major losses of international reserves.

After the crisis, the authorities started negotiations to refinance the external debt both of the public sector and of the financial system, something not contemplated in the original program supported by the stand-by arrangement. Also, several ways of transferring resources to the financial system were devised. To make these transfers compatible with a monetary policy oriented toward recovering external balance and maintaining a low rate of inflation, it was necessary to increase taxes and reduce public expenditures, thus freeing the necessary budgetary resources.

Resources equivalent to more than 2 percent of GDP will be transferred to the financial system in the remaining months of 1983 under the various programs.

The fiscal measures designed to generate resources to support the financial system and the actions to refinance the external debt were accompanied by monetary measures to limit the loss of international reserves and return to the original path of the stand-by program.

At present the resources needed by the financial system are being provided to it without exceeding the limits for the net indebtedness of the nonfinancial public sector. The limits applicable to net domestic assets and net international reserves of the Central Bank have been exceeded to the extent that external financing has not been available. These deviations from the stand-by path should also disappear when the resources required to refinance the external debt become available. The refinancing should begin as soon as Chile is able to draw from the Fund, in accordance with requests submitted by the Chilean authorities.

Thus, if the present requests are approved, Chile should be able to return to the path of the original program by the end of September of this year.

As the staff states, the record of the past three months demonstrates the determination of the Chilean authorities to achieve the objectives of the program.

The financial crisis has been faced at a time of enormous economic difficulties, as illustrated by rates of unemployment in the neighborhood of 20 percent and a very depressed level of production. However, throughout this period fiscal and monetary policies aimed at re-entering the stand-by program have been strictly maintained.

Fortunately, signals of economic recovery seem to have appeared in recent months.

In the first quarter of 1983 production was roughly at the same rate as it was in the last quarter of 1982, thus breaking a continuous declining trend since the last quarter of 1981.

During the second quarter of 1983, the rate of production was about 4 percent higher in real terms than in the first quarter thus adding to the impression that recovery from the crisis has started.

At the same time, the recovery of the world economy should help to consolidate the acceleration of economic activity in Chile. The positive effect of the replenishment of international reserves associated with the completion of the negotiations with foreign banks will also be very important in this respect.

Thus, the continuation of drawings under the stand-by arrangement should mark the beginning of a new stage in Chile's recovery from its deep economic crisis.

Having stressed the importance of the support of my colleagues for Chile's requests, I wish to thank the staff and management on behalf of my authorities and myself. They have been of great assistance to Chile in connection with the negotiation of its external debt, providing highly efficient work and offering valuable counsel during these last difficult months.

Mr. Robalino observed that real GDP had originally been expected to drop by 12.8 percent in 1982; that figure had since been revised, and it was currently thought that real GDP had fallen by 14.3 percent. Moreover, there had been no recovery of GDP in the first quarter of 1983. The authorities had reacted to the problem with an emergency plan, which involved even greater adjustment than called for in the January stand-by arrangement. It was expected that the emergency measures would lead to an additional improvement in the current account of the balance of payments of US$1.2 billion, with substantial budget resources to be transferred to the financial system to re-establish its solvency. The policies of the authorities were appropriate and represented a further adjustment effort equivalent to 2.6 percent of GDP.

There had been no reference in the staff paper to wage behavior in Chile, Mr. Robalino continued. In the first semester of 1982, the Chilean authorities had begun a drastic deindexation process in both public and private wages, and had lowered the wage floors to be used in the collective bargaining process. He would appreciate any further information that the staff might have on experience with those measures.

In December 1982, the staff had been cautious in its interest rate projections, assuming a 12 percent LIBOR rate for 1983, Mr. Robalino recalled. Through June 1983, the average LIBOR rate had been 9.6 percent, which should have given the Chilean authorities some room for maneuver if the international banking community had fulfilled its envisaged role. Unfortunately, it had not; indeed, the main reason for a request for a waiver and modification under the current stand-by arrangement was the lack of responsiveness by commercial banks. In any event, he was concerned about the staff's new estimate of only 9 percent for the rate of the Chilean debt service from 1984 to 1991, and he would appreciate hearing more about the basis on which the staff had made that estimate.

It was satisfying to note that the gap between the official and the parallel market exchange rates had been narrowing in recent months, Mr. Robalino observed. Certainly, that development should help to reduce private outflows of short-term capital, which had been plaguing the Chilean economy since 1982. Nonetheless, he was worried about the debt service ratio, which was expected to be equivalent to 60.4 percent of exports of goods and services on average from 1983 through 1991. It seemed obvious in the circumstances that the authorities and the commercial banks, with the help and advice of the Fund, should work toward an increase in the maturities of Chile's external debt. Finally, he was happy to note that the Chilean authorities had taken strong measures to resolve the problems of the economy, and he welcomed the Fund's help in concluding agreements on rescheduling of Chile's debt.

Mr. Connors said that he could support Chile's request for a waiver and modification of performance criteria and for approval of certain exchange measures. The authorities were to be commended for having implemented an emergency plan designed to put the economy back on the track envisaged in the stand-by arrangement by end-September 1983. If they were successful, the confidence of the markets in the economic and financial management of the Chilean economy should increase. In his view, Fund management had followed the appropriate course in bringing to the Board Chile's request for a waiver and modification of performance criteria only after it had become clear that the emergency measures would be sufficient to put the economy back on track and that the necessary external financing would be available.

The financial policies being pursued in Chile seemed to be broadly appropriate, Mr. Connors continued. However, he was concerned that the authorities had resorted to an import tax as a fiscal measure; he hoped they would find substitute fiscal measures that did not discriminate between traded and nontraded goods. Finally, with respect to the proposed decision on exchange measures, he could agree reluctantly to the temporary approval of the multiple currency practices and the exchange restriction.

Mr. Feito said that he too could support the proposed waiver and modification of performance criteria under the stand-by arrangement as well as the approval of the measures adopted in the exchange and trade

system. The commitment of the authorities to the original stand-by program and their determination to adjust the economy toward a healthier path of stable and sustained growth should be commended, particularly when account was taken of the difficulties and unforeseen developments faced by the economy since the beginning of the year. Those events had added to the already difficult situation when the stand-by arrangement had been agreed. It was clear that the deviation from performance criteria under the original stand-by arrangement had been due to factors entirely beyond the authorities' control. Given the temporary nature of the disturbances that had caused the deviation, there seemed to be no need to interrupt the stand-by program, whose major objectives would apparently be met as originally forecast. The staff paper provided clear evidence that all the measures adopted by the authorities had been necessary to cope with a very difficult situation brought about by the virtual cessation of capital inflows. That change in environment had called for a modification of the timing of the adjustment effort to ensure that the final objectives of the program would be met, once the temporary difficulties had subsided.

Mr. Malhotra stated that he could support the proposed decisions. The authorities had appropriately implemented an emergency plan to deal with the difficulties encountered in the implementation of the original stand-by program, and it was considered likely that, because of those emergency measures, the program would be brought back on track by September 30, 1983.

Mr. Joyce agreed with others that the Chilean authorities were to be congratulated for the progress made in recent months in tackling the severe economic and financial problems faced by the country. The emergency plan appeared to be succeeding in stabilizing the financial system, and he was greatly encouraged by the determination of the authorities to implement the necessary corrective measures. Performance in April and May had been well within the limits set under the emergency program, and the reserves target had been comfortably exceeded. Moreover, there had been a sharp reduction in the rate of inflation and a decline in real interest rates, and there were signs that the economy was beginning to recover. It was clearly important that by end-September the economy should be back on the path envisaged under the stand-by arrangement, which should not be fundamentally altered.

The deviation from the original targets for net domestic assets and international reserves had resulted mainly from the interruption of net lending by foreign banks, Mr. Joyce noted. According to the staff paper on Chile's request for a stand-by arrangement, an indication had been expected from foreign bank creditors that the required new financing would be forthcoming as planned. He wondered whether the banks had provided that indication.

With respect to the foreign exchange system, he had no difficulty in accepting the continuation of certain multiple currency practices until the end of 1983, Mr. Joyce commented. However, he recalled from

the January discussion of Chile's request for a stand-by arrangement that the authorities had introduced a preferential exchange rate applying to the servicing of external debt contracted before August 6, 1982, and that the stand-by program had called for the unification of the exchange system by the end of 1983. He found nothing in the latest papers to indicate what was happening with regard to the preferential rate, and he was unclear what progress was being made or was likely to be made by the end of the year toward the overall unification of the exchange system. He would appreciate some clarification on those matters.

Mr. Laske stated that he too could support the proposed decisions. The Chilean authorities had reacted expeditiously to the sudden crisis in the financial system earlier in the year, and the emergency plan adopted by the authorities should assure a speedy return to the adjustment path of the stand-by arrangement. The information provided in the supplement to EBS/83/134 was reassuring in that regard.

The commercial banks had made the resumption of Fund disbursements from the stand-by arrangement a prerequisite for reviving the flow of their own commercial credits, Mr. Laske observed. It was clearly important that those credits should be revived; otherwise, the adjustment program would be in danger of failing. His acceptance of the waiver with respect to the nonobservance of the two performance criteria under the stand-by arrangement was in recognition of that close relationship between disbursements from the Fund and the commercial banks; however, his support was based mainly on the policy actions and intention of the authorities. It was only through the appropriate policies, in combination with financial assistance, that the authorities would be able to return to the adjustment path envisaged under the stand-by arrangement. Finally, in addition to the measures adopted under the emergency plan, the authorities had introduced a number of restrictive exchange measures and multiple currency practices. In view of the prevailing circumstances, their action was tolerable as a stopgap measure, and he could support the draft decision approving those measures until the end of 1983 in the hope that the authorities would be able to remove them before then.

Mr. Gomel recalled that Chile's economic predicament had been difficult both before and after the inception of the Fund-supported stand-by arrangement. His chair, in fact, had expressed a number of doubts on the occasion of Chile's request for a stand-by arrangement and had noted at the time that domestic policies had played an important role in creating the 1982 recession in Chile, which had been harsh even by international standards in a depressed world economy. In particular, his authorities had been puzzled by the stance of policies envisaged in the stand-by program, namely, drastic deflation through real wage cuts coupled with monetary and fiscal restraint. It had been apparent to his authorities that the crisis in the financial system had not been unrelated to the disarray of the real economy, which had been plagued by rapidly falling domestic demand and output. In that regard, he had missed any reference in the latest staff papers to the proximate determinants of the banking crisis, other than fairly vague hints at a characteristically weak financial structure in Chile.

Turning to Chile's request for a waiver and modification of performance criteria under the stand-by arrangement, Mr. Gomel said that he was somewhat uneasy about the use of "shadow programs" or "emergency plans." Programs involving use of Fund resources were designed in terms of targets, and their success or failure was measured by the degree of compliance with performance criteria. Unfortunately, there appeared to be an evolution in practice whereby programs that could not be implemented were replaced by "shadow programs," which was a worrying precedent.

The cutoff of foreign bank loans and subsequent loss of reserves was an event not entirely unrelated to domestic developments, Mr. Gomel considered. An accurate assessment of the necessity and viability of a revised stand-by program required a precise investigation of the causal links between external events, the domestic policies in place, and the outcomes that had eventually triggered the deviation from the original path of the program. In his view, despite the optimism of the staff's appraisal, there were no stronger grounds at present to believe that the program would succeed than there had been when the stand-by arrangement had been agreed some months previously. He was thus concerned that a failure to move Chile out of its present economic distress could undermine the Fund's image, which was already at stake in the international community.

Mr. Polak remarked that the proximate cause of the almost immediate collapse of the Chilean program at the beginning of 1983 had been the sharp deterioration in the loan portfolios of the financial system. It was fair to say that that deterioration had been policy induced. The competitiveness of the tradable sector had been severely eroded by a combination of the hard-currency option, the system of wage determination, and the sharp increase in interest rates, all of which had resulted from government policies.

As he understood it, the emergency program was based on the idea that the cutoff of foreign loans would be covered by the Central Bank, Mr. Polak said, which would later be "reimbursed" after a restoration of external bank financing at the level originally forecast under the stand-by arrangement. The intention was that, for the next four or five years, about 2 percent of GNP would be transferred to the financial system. He found it difficult to assess whether such a transfer would be sufficient, especially as there was no clear indication of the amount of the nonperforming loans. Surely, the adequacy of the Government's action would depend on the speed of recovery, which could return at least some of the loans to a "performing" status.

On balance, Mr. Polak concluded, he was currently more confident about the Chilean program than he had been in January, when the stand-by arrangement had been agreed. It had been remarked at the time that the program would be addressed to the problem of restoring confidence, and he had not been convinced that the program as presented had justified such confidence. However, the actions taken by the Chilean authorities since the banking crisis deserved commendation, and he was happy to see that

they had begun to move the program back on track. Moreover, it was encouraging to note that the recession in the Chilean economy appeared to have bottomed out. Table 2 of EBS/83/134, Supplement 1 showed positive figures for all selected economic indicators in the preceding quarter. The turnaround should facilitate the authorities' task of holding to the stand-by program, which seemed to have attained some measure of internal consistency of the sort that had been lacking earlier. In the circumstances, he could support the proposed decisions.

Mr. Prowse, also supporting the decisions, commended the authorities and the Fund staff and management for having saved the stand-by program from collapse. As others had indicated, the immediate cause of the crisis that had derailed the stand-by program had been the decision of the Government not to guarantee the payments of foreign bank debts of the three liquidated financial institutions; as a result, the foreign banks had ceased lending to Chile, and there had been a rapid expansion of central bank credit and a loss of reserves. The staff paper had been less comprehensive than desirable in discussing the problem of the debt negotiation and the subsequent deadlock that had led to the deviation from the original program. For example, he was unclear about the extent of the Government's involvement in the three institutions that had been liquidated. Still, notification was expected soon about additional foreign credit, and it appeared that the economy was moving back on the track envisaged under the stand-by arrangement.

Seeking clarification in one or two areas not dealt with fully in the staff paper, Mr. Prowse noted that the wage and salary expenditure of the government sector would be lower under the emergency program than under the original stand-by arrangement, which seemed to imply a substantial fall in real wages. He would appreciate some elaboration by the staff on policies toward wage adjustment and indexation. Chile should continue to be vigilant with regard to expenditures, even though the deficit in 1982 had turned out to be smaller than foreseen. The central government deficit had been affected substantially by expenditure for employment and health programs and by expenditure to support the financial system. He wondered in that regard whether it was the appropriate time to be increasing expenditure on health programs, and he would welcome staff comment on the matter.

Another development that might benefit from some clarification was the decline in shipments of copper, Mr. Prowse said. He would find it curious if the decline in shipments had resulted from a decline in production, especially since prices for copper appeared to be on the increase. Finally, he was concerned that, even with rescheduling, the debt service ratio at the end of the decade of the 1980s would be more than 60 percent of GDP. A debt service ratio of such a magnitude was scarcely compatible with a dynamic recovery, and he wondered whether any adjustments aimed at reducing the debt service ratio were contemplated during the decade, or whether the authorities were willing to accept the projection as a satisfactory long-term objective.

Mr. Hull observed that, over the previous two years, the frequency of resorting to waivers of performance criteria under Fund programs had declined, and he welcomed that trend because it seemed to reflect, at least in part, a general improvement in the design of the Fund programs. He could approve Chile's request for a waiver because it stemmed from an unforeseen development that had been largely beyond the authorities' control and because a strong effort was being made by the authorities to put the program back on track. In that regard, he attached particular importance to a return to the path envisaged under the stand-by arrangement by end-September.

There had been little indication of the impending banking crisis when the request for a stand-by arrangement had been discussed in January 1983, Mr. Hull recalled. However, some Directors had expressed concern at the time about the high rate of central bank credit expansion. Since the crisis had broken, the authorities had made a determined effort to implement the emergency plan that had been formulated with the help of the Fund staff. It was of course difficult to assess whether the emergency measures would be sufficient to put the program back on track, especially given the difficult circumstances prevailing in Chile; however, he was willing to give both the staff and the authorities the benefit of the doubt. Approval by the Executive Board of the proposed decisions was apparently crucial to the release of disbursements under a new loan from international banks, agreement on which was due to be reached shortly. He would welcome further information on the progress toward that loan.

With respect to the exchange system in Chile, Mr. Hull said that he was pleased to note that the gap between the parallel and official rates that had opened up at the time of the banking crisis seemed to be diminishing, and he hoped that it would be possible to achieve the original aim of unification by end-1983. He urged the authorities to move as soon as possible to dismantle the temporary payments restrictions, and he trusted that a schedule for their elimination could be agreed during the forthcoming review. In the meantime, he could go along with the approval of the restrictions until end-December 1983.

The staff representative from the Western Hemisphere Department read out the following cable, which had been received from the lead bank in the refinancing arrangement:

> We are pleased to indicate to you that we have obtained commitments for funding of US$1.3 billion from the international banking community, which will be made available to Chile during the remainder of 1983. While some of the commitments continue to be contingent upon various conditions, the overall amount of conditional commitment is being reduced on a daily basis, and we expect that the majority of the remaining conditional commitments will fall away by Thursday (July 28). It is our intention to commence the signing of the US$1.3 billion new money facility on Thursday, July 28.

Responding to questions raised by Directors in the course of the discussion, the staff representative noted that, in May of 1982, Chile's wage indexation policy had been eliminated. Since then, there had been no direct linking of wage increases to the increase in domestic prices. The policy of the Central Government for 1983 was an austere one; the emergency plan included restraint in public sector wages and salaries, which explained why the latest projection was below the level projected under the stand-by arrangement in January. With respect to the private sector, wage negotiations were to take place between unions and employers, without government interference, and with no required indexation.

On the restrictive exchange measures adopted by the authorities, the staff representative indicated that the mission would be discussing the future of restrictions during the planned review in October. It was the intention of the staff to ensure that the authorities met their commitment to eliminating the restrictions by the end of 1983. Both the preferential rate and the official rate were determined by formulas that were proportional to the rate of inflation. The preferential rate advanced somewhat more quickly than the official rate; however, under the current formulas there would remain a sizable spread between the official rate and the preferential exchange rate by the end of the year. Clearly, the authorities recognized the high cost of the preferential exchange rate, and they would be making an effort to close the gap as soon as possible, preferably before the end of 1983.

It had been asked whether the cost of supporting the domestic banking system--an estimated 2 percent of GDP--was sufficient to maintain a stable financial system over the medium term, the staff representative recalled. The exhaustive calculations made by the authorities and reviewed by the staff seemed to indicate that a level of support of 2 percent of GDP should be sufficient, given the assumption that the economy would be growing in future. The size of the transfer would of course depend upon the speed of the recovery, although the growth projections for the medium term had been conservative, particularly given the sharp decline in the economy that had taken place in 1982.

On other matters, the staff representative noted, first, that there had been no government participation in any of the banking institutions that had been liquidated. Second, the decline in copper shipments had not reflected a decline in production; rather, the authorities had been accumulating inventories in the expectation of a higher price during the remainder of the year. Third, in response to questions about higher spending on health programs, he observed that the Government had shifted some expenditures into areas of social concern from areas that were considered to have less priority, given the high rate of unemployment.

The high debt service ratio had been mentioned by a number of speakers, the staff representative from the Western Hemisphere Department remarked. The implication was that there would be a large transfer of resources to the rest of the world, and it was relevant to ask whether that transfer was consistent with a good growth performance. If, in

future, commercial banks were willing to operate more on a "normal" commercial basis with Chile, the country's debt servicing would be facilitated. However, if the banks continued to feel that the high debt service ratio was damaging to Chile's creditworthiness, difficulties in servicing the debt could be encountered, and some medium- to longer-term solutions might have to be found.

The Chairman indicated that he also was disturbed by the high debt service ratio shown in Table 9 of the paper. He understood that the figures were not based on any assumptions about a rescheduling of existing maturities, and it was important for the Fund to ask itself whether the resources that it was providing to Chile were well protected.

The staff representative from the Exchange and Trade Relations Department said that the staff was quite concerned about the flow of total debt service payments and, in particular, about the flow of interest payments, which were equivalent to 10 percent of GDP in 1983 and would remain at 6 percent of GDP in 1991. Clearly, debt service could pose serious problems in terms of Chile's potential for growth and seemed to call for active policy action to make the export sector and foreign exchange earnings sector the most dynamic parts of the economy. Given the current debt situation, Chile would probably have to generate a surplus on all items in its current account, other than interest payments, over the next ten years, a requirement that could pose a severe constraint on the country if further rescheduling did not take place. In any event, it was clear that rescheduling could provide only some respite from the problem, since it served merely to postpone needed adjustment.

Much would depend on the outlook for the Chilean economy and for that of the world as a whole, the staff representative continued. The staff would be discussing the matter with the Chilean authorities in the context of the second year of the stand-by arrangement and would be looking at the adjustments that might need to be taken to deal with the debt service prospects. At present, however, the Chilean authorities seemed to have put in place a set of actions that augured well for exports, assuming that the world economy recovered and external markets were opened up to Chilean exports.

With regard to a question by Mr. Gomel, the staff representative said that he also would be concerned about a proliferation of emergency or contingency plans if they became necessary because regular Fund programs were not working as intended. However, he could reassure those who were worried about the Chilean request that, in principle, it did not set a new precedent. The practice that had been followed was the normal one for the granting of waivers and modifications. There had been a large deviation from the program path, but it had clearly been described as "temporary and reversible" within a short period of time. In that respect, the request was consistent with the normal procedures of granting waivers and modifications. The Chilean authorities, for their part, had been willing to undertake domestic steps to reduce the deviation, while the commercial banks had been willing to commit themselves to providing

financing that would make it feasible to bring the program back on track. Hence, not to grant the waiver at present would be inconsistent with normal procedures. The tendency was to think in terms of waivers only when the deviations from a program were minor, but it was also appropriate to grant waivers when the deviations were large but could be redressed in a short period.

Mr. Feito observed that the basic assumption behind the use of debt service in relation to exports of goods and services as an indicator to assess the burden of a country's external debt was that there was a constant relationship between the proceeds of goods and services and the balance of payments. However, that relationship might change, particularly if import substitution were developing rapidly as a result of adjustment. In countries where that was happening, the indicator of external debt should be looked at carefully.

The Chairman remarked that the interest component of the debt service in relation to exports of goods and services in Chile was large and therefore worrying. There would be a heavy interest burden on exports even if generous rescheduling were offered. Hence, he fully agreed with the staff that it would be important to concentrate on building up a strong export capacity to service the debt, and it would probably be necessary to reach agreement with the lenders to reschedule the debt in a realistic way over the medium to longer term.

Mr. Donoso agreed that Chile would face a number of difficult years in servicing its external debt. However, some considerations had to be taken into account. First, to include amortization payments in the calculations to derive aggregate debt service ratios might be very misleading. In fact, Chile--like many other countries--had for a number of years in the past experienced important levels of external debt at the same time as it had experienced trade account deficits. However, the financial community had allowed Chile to refinance payments of both principal and interest, thus making additional resources available. It was of course impossible to know what the situation would be in the next decade. Chile had to be prepared to face greater difficulty in obtaining financing but would not necessarily have to generate a trade surplus to pay the interest and amortization in the amounts appearing in the tables presented in the staff papers.

Second, in comparing the Chilean situation with other cases, it should be noted that, while the level of the debt was high, the type of indebtedness should facilitate the management of the debt, Mr. Donoso continued. In many other cases, the debt had originally been contracted by the public sector or had become public debt over time. In those cases, the debt service figures might appear low; however, they hid a fiscal problem. He had mentioned that problem in connection with the discussion of surveillance relating to external debt, and he believed that the matter should be looked at closely in a separate discussion. That fiscal problem had not yet arisen in Chile, where the public sector was not responsible for the servicing of the total amount of debt and where the public sector had financial assets as a counterpart of the public debt.

A matter that should be of concern to the Executive Board was related to the efforts of the International Monetary Fund to facilitate the provision of additional resources by the commercial banks, Mr. Donoso commented. The first priority of the Fund had been, and continued to be, to put the arrangements in place in order to avoid a crisis. However, it was also important for the Fund to be looking at the sorts of conditions under which the additional resources were being provided. There was a risk that, for some countries, governments could face grave difficulties in generating extra resources to service debt that they had not contracted first hand.

Approval of Chile's request by the Executive Board should clear the way for the completion of the refinancing of external debt in Chile, with a new loan contract to be signed with the commercial banks on July 28, Mr. Donoso remarked. The waiver of performance criteria would allow Chile to continue drawing from the Fund, and the next step was to draw some US$500 million of the total US$1.3 billion contemplated from the banks for the remainder of the year. Chile had a good chance of extricating itself from the crisis; indeed, some positive signs of revival had been evident in the economy. After a falling rate of GNP from the final quarter of 1981 to the final quarter of 1982, economic activity semed to be on the rise in 1983, and the return to the path envisaged under the stand-by arrangement with the Fund should facilitate a continuation of appropriate economic decisions in the country.

The staff representative from the Exchange and Trade Relations Department commented that the staff, too, had been concerned about the requirement of government guarantees of private debt and about the impact of various other elements of refinancing. The staff had generally been discouraging governments from extending such guarantees, and had explained the constraints that the assumption of private debt could impose on a country's resources well into the future.

While Mr. Donoso was correct in noting that the first priority for the Fund in its involvement in the relationship between member countries and the commercial banks was to ensure that the necessary amounts of financing were in place, it was also clear that attention should be devoted to the terms of the financing, the staff representative continued. If the necessary financing was made available, but on terms that made it difficult for the country to repay, the problem was not in fact solved. The issue at stake was the extent to which the Fund, from an operational and practical point of view, could establish rules or guidelines that could influence the terms of refinancing.

The Chairman remarked that the matter raised by Mr. Donoso was an important one and should perhaps be considered by the Executive Board in a separate discussion on the basis of the staff paper setting out some recommendations or guidelines for refinancing terms.

The Executive Board then adopted the following decisions:

Stand-By Arrangement - Waiver and Modification of Performance Criteria

1. Chile has consulted the Fund in accordance with paragraph 6 of the letter dated December 13, 1982 from the Minister of Finance and Economy and the President of the Central Bank of Chile attached to the stand-by arrangement for Chile (EBS/83/227, Sup. 2) and paragraph 4 of the stand-by arrangement.

2. The letter dated July 8, 1983 from the Minister of Finance and the President of the Central Bank of Chile shall be attached to the stand-by arrangement for Chile, and the letter from the Minister of Finance and Economy and the President of the Central Bank of Chile dated December 13, 1982 attached to the stand-by arrangement, shall be read as modified by the letter of July 8, 1983.

3. Accordingly, the limit on the contracting and guaranteeing of external debt by the public sector described in Table 3 of the memorandum annexed to the letter of December 13, 1982 shall be US$5,500 million as referred to in the letter of July 8, 1983, and the limit on the net domestic assets of the Central Bank of Chile for the period July 1-September 20, 1983 described in Table 4 of the memorandum annexed to the letter of December 13, 1982 shall be Ch$95.5 billion for the period July 1-August 15, 1983, and Ch$57.0 billion for the period of August 16-September 20, 1983, as referred to in the letter of July 8, 1983.

4. The Fund finds that in light of the letter dated July 8, 1983 no additional understandings are necessary concerning the nonobservance of the performance criterion on the net international reserve target of the Central Bank for June 30, 1983 and that Chile may make purchases under the extended arrangement, notwithstanding the multiple currency practices and exchange restrictions introduced by Chile as described in EBS/83/134.

Decision No. 7477-(83/112), adopted
July 27, 1983

Exchange System

The excessive spread between the official exchange rate and the parallel market rate, and the 12 percent exchange tax applicable to the purchase of foreign exchange for certain import payments constitute multiple currency practices. Chile has also imposed a 120 days' deferment period for all import payments. This measure represents the introduction of an exchange restriction. In view of the temporary nature of these measures, the Fund grants approval for their retention until December 31, 1983.

Decision No. 7478-(83/112), adopted
July 27, 1983

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/111 (7/25/83) and EBM/83/112 (7/27/83).

4. ECUADOR - STAND-BY ARRANGEMENT

1. The Fund takes note of the financing arrangements reached between Ecuador and the foreign commercial banks and finds that these arrangements are satisfactory.

2. The stand-by arrangement for Ecuador attached to EBS/83/91, Supplement 3, shall become effective on July 25, 1983.

Decision No. 7479-(83/112), adopted
July 25, 1983

5. SDR INTEREST RATE AND RELATED MATTERS, AND OFFICIAL ADOPTION OF TERM "SDR"

I. Amendments to Rules I-9, I-10, and T-1

Rules I-9, I-10, and T-1 of the Rules and Regulations of the Fund shall be amended to read as set forth below. The amended Rules shall apply with effect from August 1, 1983, provided that interest and charges on holdings of SDRs and remuneration accrued during the current financial quarter ending on July 31, 1983 shall be paid as of the commencement of the next financial year.

I - CHARGES IN RESPECT OF GENERAL RESOURCES ACCOUNT TRANSACTIONS AND REMUNERATION

I-9 (a) Remuneration shall accrue daily. The amount that has accrued during each quarter of the financial year of the Fund shall be paid as of the beginning of the following quarter.

(b) A member that wishes to receive in its own currency the whole or a specified portion of the remuneration payable to it shall so notify the Fund.

I-10 (a) The rate of remuneration shall be equal to 85 percent of the rate of interest on holdings of SDRs under Rule T-1(b), rounded to the two nearest decimal places.

(b) The Fund shall review the rate of remuneration on the occasion of the annual review of the rate of interest on holdings of SDRs under Rule T-1(d).

T - INTEREST, CHARGES AND ASSESSMENTS IN RESPECT OF SDRS

T-1 (a) Interest and charges in respect of SDRs shall accrue daily at the rate referred to in (b) below. The amount that has accrued during each quarter of the financial year of the Fund shall be paid promptly as of the beginning of the following quarter. The accounts of participants shall be credited with the excess of interest due over charges or debited with the excess of charges over the interest due. The accounts of holders that are not participants shall be credited with the interest due.

(b) The rate of interest on holdings of SDRs for each weekly period commencing each Monday shall be equal to the combined market interest rate as determined by the Fund at the beginning of the period in the manner described in (c) below.

(c) The combined market interest rate shall be the sum, rounded to the two nearest decimal places, of the products that result from multiplying each yield or rate listed below, expressed as an equivalent annual bond yield, for the preceding Friday by the value in terms of the SDR on that Friday of the amount of the corresponding currency specified in Rule O-1, as determined pursuant to Rule O-2(b). If a yield or rate is not available for a particular Friday, the calculation shall be made on the basis of the latest available yield or rate.

U.S. dollar	Market yield for three-month U.S. Treasury bills
Deutsche mark	Three-month interbank deposit rate in Germany
French franc	Three-month interbank money rate against private paper in France
Japanese yen	Discount rate on two-month (private) bills in Japan
Pound sterling	Market yield for three-month U.K. Treasury bills

(d) The Fund will review the rate of interest on holdings of SDRs at the conclusion of each financial year.

Decision No. 7480-(83/112) G/S, adopted July 26, 1983

II. Official Adoption of Term "SDR"

The following new Rule shall be included in the Rules and Regulations of the Fund as Rule B-6:

B-6 SDR refers to the special drawing right of the Fund. The term "SDR" (or "SDRs," as appropriate) shall be adopted as standard usage in Fund documents, correspondence, and publications where a reference to special drawing rights is intended, provided that if the text is in a language in which a different usage has become established, that usage may be retained.

Decision No. 7481-(83/112), adopted
July 26, 1983

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 83/35 and 83/36 are approved. (EBD/83/193, 7/19/83)

Adopted July 25, 1983

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/193 (7/22/83) is approved.

APPROVED: February 3, 1984

LEO VAN HOUTVEN
Secretary