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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/140

10:00 a.m., September 14, 1983

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
	G. Ercel, Temporary
	P. D. Péroz, Temporary
	J. Delgadillo, Temporary
R. D. Erb	T. A. Connors, Temporary
M. Finaish	T. Alhaimus
	S. R. Abiad, Temporary
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	M. Casey
	J. R. N. Almeida, Temporary
G. Laske	
G. Lovato	G. Gomel, Temporary
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	T. de Vries
	K. G. Morrell
	A. A. Agah, Temporary
F. Sangare	M. Camara, Temporary
	M. Toro, Temporary
	A. Lindø
	C. Taylor
Zhang Z.	Wang E.

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

1. Sudan - 1983 Article IV Consultation, and Review Under Stand-By Arangement . . . . Page 3
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Also Present

African Department: O. B. Makalou, Deputy Director. Asian Department: P. R. Narvekar, Deputy Director; P. Chabrier, J.-P. C. Golle, E. Gurgen, S. W. Kane, R. H. Nord, G. Szapary, Wang X. European Department: L. A. Whittome, Counsellor and Director; T. R. Boote, E. O. C. Brehmer, P. C. Hole, J. Prust, J. T. Reitmaier. Exchange and Trade Relations Department: C. D. Finch, Director; D. K. Palmer, Associate Director; S. Mookerjee, Deputy Director; D. J. Donovan, M. Guitian, J. M. T. Paljarvi, R. Pownall. Fiscal Affairs Department: R. K. Basanti, R. D. Kibuka. IMF Institute: V. Chitty, J. M. T. B. Jayasundara, M. Ionescu, Participants. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder, A. O. Liuksila, S. A. Silard. Middle Eastern Department: A. K. El Selehdar, Deputy Director; F. Drees, S. Geadah, S. H. Hitti, M. Hosny, K. Nashashibi, E. M. Taha, L. A. Wolfe, M. Yaqub. Research Department: R. R. Rhomberg, Deputy Director; K.-Y. Chu, T. K. Morrison, H. H. Zee. Secretary's Department: A. P. Bhagwat, J. A. Kay. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. El-Khouri, S. M. Hassan, L. Ionescu, Y. Okubo, I. R. Panday. Assistants to Executive Directors: H. Alaoui-Abdallaoui, R. Bernardo, J. Bulloch, M. Camara, M. B. Chatah, M. K. Diallo, M. Eran, I. Fridriksson, V. Govindarajan, C. M. Hull, H. Kobayashi, M. J. Kooymans, P. Leeahtam, W. Moerke, J. K. Orleans-Lindsay, G. W. K. Pickering, J. Schuijer, Shao Z., D. I. S. Shaw, Wang C. Y., J. C. Williams.

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

The Executive Directors considered the staff report for the 1983 Article IV consultation with Sudan and the review under the stand-by arrangement for Sudan (EBS/83/174, 8/16/83; and Sup. 1, 9/12/83). They also had before them a report on recent economic developments in Sudan (SM/83/197, 9/1/83).

The staff representative from the Middle Eastern Department said that the staff had recently been informed by the Governor of the Bank of Sudan that the delay in the discharge of the undertaking with respect to relicensing of private dealers in foreign exchange had been caused by procedural difficulties, and that the relevant institutional arrangements for relicensing had been completed. An announcement on licensing of individuals, partnerships, and corporations dealing in foreign exchange would be made before September 25, 1983.

Mr. Sangare made the following statement:

Directors will recall that approval was given for a one-year stand-by arrangement with Sudan for SDR 170 million on January 28, 1983, which became effective on February 23, 1983 after satisfactory arrangements had been made with donor countries to cover the balance of payments gap that could not be filled by resources from the Fund during the program period. This was in support of a program that represented a further attempt on the part of the authorities to address a complex situation of domestic and external imbalances caused, by and large, by slow growth in output, large budget deficits, a shortage of skilled manpower, cost-price distortions, and rising external indebtedness.

Support from the World Bank and the Fund for the adjustment efforts of the Sudanese authorities has been extremely helpful in bringing about some structural and institutional improvements, particularly with regard to the agricultural sector and government finances. However, the situation in the external sector remains critical, despite rising private and official transfers and debt relief arrangements. My authorities, therefore, fully recognize the crucial need to persevere in the pursuit of their adjustment policies. However, their efforts will require continued and meaningful financial support from donor countries to buttress resources that we believe will be obtained from institutions such as the Fund and the World Bank.

The basic objectives of the program have been to strengthen the balance of payments position by increasing exports, containing the growth in imports, and encouraging expatriate workers to increase remittances. Gross domestic product was targeted to grow by 3.5 percent, and the budget deficit was expected to be the equivalent of 7 percent of GDP for 1982/83. Performance during the first six months of the program has been mixed.

In the real sector, a number of policy measures were initiated by the authorities in the context of the structural adjustment program supported by the World Bank to increase production in irrigated agriculture. These included, among others, increases in procurement prices, and the rehabilitation of capital stock, which resulted in a 29 percent increase in cotton production. However, this success was overshadowed by a sharp drop in production in the rain-fed areas due to droughts. As a result, output in the agricultural sector in 1982/83 declined by nearly 8 percent in real terms. On the other hand, aggregate output in manufacturing increased, reflecting the rehabilitation work in the sugar and cement industries. However, many industries continue to operate at less than full capacity because of power shortages, inadequate spare parts, which have to be imported, and the scarcity of skilled labor. GDP is estimated to have declined by about 2 percent in 1982/83, compared with the program target of 3.5 percent growth, as improvements in other sectors were not sufficient to offset the sharp decline in agricultural production brought about by bad weather.

The situation in the financial sector was more encouraging, and net credit to the Government, public entities, and the private sector has remained below the ceilings set for the period ended June 30, 1983. Although the money supply increased by about 37 percent compared with the program target of 28 percent, this was caused by the revaluation of deposits in foreign currencies after the most recent devaluation and by the fact that the contractionary impact of the external sector was less than envisaged under the program. It is to be noted, however, that the authorities have already introduced measures to absorb the excess liquidity, including the introduction of a reserve requirement on commercial banks' deposits and an increase in the margin on letters of credit for imports.

The overall budget deficit has been reduced from the equivalent of 9.8 percent of GDP in 1980/81 to an estimated 6.1 percent in 1982/83, with domestic bank financing accounting for only 6 percent of expenditure compared with 23.7 percent just two years ago. The improvement in the budget has resulted from both revenue-generating and expenditure-reducing measures. The former included a change in the system of customs valuation, increases in various excise taxes, and the raising of certain rents and fees, resulting in an estimated increase of 41 percent in tax revenue. Nontax revenue also increased substantially in 1982/83. However, noncollection of excise taxes on some commodities caused by temporary closure of some factories and cash flow problems in others may result in total revenue being slightly below the program target. An important element of the efforts being made to control expenditure is the reduction in subsidies on various consumer goods. Despite higher debt service payments caused by liquidation of certain past arrears not provided for in the budget and underestimation of current debt service payments in the program, the overall increase in government expenditures in 1982/83 is likely to be below the program ceiling.

Sudan's current account position is estimated to have strengthened considerably in 1982/83 as the deficit has been reduced to less than half of its level in the previous fiscal year. This was made possible mainly by a 48 percent increase in exports, reflecting a notable recovery in most agricultural exports, cotton in particular. Imports also declined by 7 percent because of lower international prices for petroleum and sugar, and also because of increased domestic production of sugar. The depreciation of the Sudanese pound, which made imports more expensive, also played a role. The improvement in the current account position was also due to the mobilization of additional external assistance.

The authorities are continuing their efforts aimed at the gradual unification of the exchange rates. In this respect, some commercial banks have been licensed to operate in the free market, and almost all private sector imports are required to be financed through that market. On the supply side, 25 percent of all export proceeds are to be sold to banks at the free market rate. The slight appreciation of the Sudanese pound in the nonofficial market during the past month, reflecting the recent credit control measures, is an indication of improvement in the performance of the foreign exchange market. The authorities intend to enhance the role of the free market by relicensing private exchange dealers and allowing the market to operate without undue official intervention.

During 1983/84 the authorities intend to continue consolidating the gains made thus far, giving particular emphasis to the agricultural sector. Accordingly, the highest priority will be given to allocating credit and foreign exchange resources to the requirements of agricultural entities and to implementing measures that will further improve financial returns to farmers. The Rehabilitation Program in the agricultural sector, which is being supported by the World Bank, arrangements with aid donors for agricultural inputs, and the ongoing expansion of fuel storage capacity are all intended to encourage the production of agricultural commodities that can be exported as well as used in import-substitution industries. With the projected recovery in rain-fed agricultural output and in manufacturing, particularly the sugar industry, GDP is projected to grow at 4.4 percent in 1983/84.

Inflationary pressures are expected to continue during 1983/84 owing, in part, to the removal of all budget subsidies, which is to take effect from the beginning of the fiscal year, and to the fact that prices of all consumer goods will be allowed to rise in response to international prices and exchange rate changes. However, the recovery in domestic production and the slowdown in international inflation should help to lessen the impact of these factors.

The authorities realize that a significant reduction in the pace of credit expansion is required to achieve the program target of 18 percent growth in the money supply. Hence, they have already taken measures to control bank lending and absorb excess liquidity. The new reserve requirement and higher deposit margins on letters of credit are expected to discourage credit to the private sector. The authorities believe that social and religious factors limit the role that interest rate policy can play in Sudan.

As a further demonstration of their determination to see the program remain on track, the authorities, in addition to the measures that were taken on July 8, 1983, have taken several revenue-generating measures, including a 15 percent tax on sugar and higher customs duties on a number of items. However, as public sector savings have remained minimal, the authorities understand the importance of further improving the efficiency and pricing policies of public entities and the need to strengthen expenditure control measures.

The magnitude of Sudan's external debt and annual debt servicing obligations remains a matter of concern, and substantial debt relief extended over a number of years is an essential requirement for an orderly adjustment process. It is with this in mind that the authorities have initiated contacts with the concerned parties on a rescheduling arrangement for 1984. The authorities intend to reach an agreement on a new stand-by arrangement prior to the expected meetings of the creditors early next year.

Finally, I would like to express my authorities' strong commitment to the implementation of the program and to achieving its objectives. They intend to take further measures, should they become necessary.

It is to be noted that the staff is satisfied with the measures already taken and the overall performance under the program. Therefore, I urge the Directors to adopt the proposed decisions.

Mr. Suraisry said that he accepted the proposed decisions. In recent years, the economy had suffered from severe economic and financial imbalances due to adverse external and domestic factors. The present stabilization program constituted a courageous attempt by the authorities to deal with the problems facing the economy. They were to be commended for their performance under the program and should be encouraged to continue their adjustment efforts.

In the real sector, Mr. Suraisry went on, the commendable progress in increasing production of cotton and sugar should provide direct relief to the balance of payments. As a result of the introduction of a number of important corrective measures, cotton production and exports had more than doubled from 1980/81 to 1982/83--after declining during the second half of the 1970s--and cotton exports had once again become a main source of foreign exchange earnings. The efforts made by the authorities in recent years to reorganize and modernize the sugar factories had contributed to a significant increase in sugar production, which, in turn, had caused a sharp decline in sugar imports that had helped to ease the pressure on Sudan's balance of payments.

Nevertheless, Mr. Suraisry noted, the real sector continued to be generally weak and was operating far below potential. Most of the noncotton agricutural production continued to take place in rain-fed areas and was strongly affected by the weather. Furthermore, manufacturing production remained well below capacity, as industries had suffered from shortages of power, spare parts, and skilled labor. It was therefore important for the authorities to continue to maintain their policies aimed at strengthening the productive base of the economy in the medium and long term.

During the past two years, Mr. Suraisry observed, the authorities had introduced a number of important measures to strengthen the budget position. The measures had been mainly on the revenue side, but some progress had been made in controlling expenditure and, as a result, both the overall budget deficit and the domestic bank financing of the deficit had fallen steadily between 1980/81 and 1982/83. The staff projections indicated a deterioration in the budget position in 1983/84, and the recent measures to bring the position under control were commendable and encouraging. In the light of the continuing large fiscal imbalance, it was important for the authorities to maintain the adjustment effort in that area.

The rate of expansion of the money supply in 1982/83 had been much higher than had been expected, although credit expansion had been contained within the program limits, Mr. Suraisry noted. That apparent inconsistency was traceable in part to difficulties in compiling monetary statistics in Sudan, and the technical assistance provided by the Fund in that area was therefore welcome. Controlling the rapid growth in the money supply, which had added to inflationary pressures, was essential. The authorities would have to exercise greater control over credit expansion, and the measures adopted in connection with the program for 1983/84 were commendable.

Commenting on the exchange rate policy, Mr. Suraisry said that the authorities had introduced a number of actions in recent years that had resulted in a significant devaluation of the Sudanese pound. However, the exchange system continued to be complicated, and he hoped that the authorities would be in a position to implement soon the measures that had been agreed with the staff to reduce the divergence between the official and free market rates.

In sum, Mr. Suraisry concluded, the economic and financial situation in Sudan remained weak. The economy was severely burdened by external debt obligations, and its ability to meet those obligations was limited. The authorities should be encouraged to maintain their adjustment efforts.

Mr. Gomel remarked that, with the support of the Fund, Sudan had introduced a recovery program at the beginning of 1983. The economic situation at that time had been precarious, particularly because of the exceedingly large debt service obligations, among other disturbing factors. Debt service payments had exceeded total earnings from exports of goods and services, and there had been little room for maneuver in the effort to introduce a stabilization program. At present, the domestic and external imbalances seemed more manageable, although the developments in a number of areas of economic policy had been disappointing and the external debt outlook and balance of payments projections were uncertain, underscoring the need to keep the debt relief process begun in 1983 on track in the coming years.

He agreed generally with the staff's appraisal of the Government's performance under the stand-by arrangement, Mr. Gomel went on. The stabilization program included short-term measures to improve the balance of payments position by increasing exports, encouraging workers' remittances, and reducing nonessential imports, and also included a longer-range rehabilitation strategy. The Government's performance had been quite satisfactory: the current account deficit had been halved, as export proceeds had risen at a remarkable pace, imports had declined, and private transfers had picked up. Those positive developments had presumably been encouraged by the exchange rate adjustments made before and during the program period. What was the staff's view of the effects of the adjustments? In particular, had the staff made any rough estimates of the effect of the exchange rate adjustments on trade flows? He was pleased that the effective exchange rate was thought by the staff to be broadly adequate to provide the required incentives for domestic producers in the foreign sector. When the program had originally been presented, the staff had mentioned the possibility that the authorities would reassess the dual exchange rate regime and consider pegging the Sudanese pound to a currency basket instead of the U.S. dollar; the authorities had given assurances that measures broadening the free market could be introduced before August 1983. A staff comment on the developments in those areas would be useful.

The budgetary developments had been mixed, Mr. Gomel said, although he recognized that the implementation and effects of fiscal measures had to be seen in a longer-run perspective. The estimated overall budget deficit for 1982/83 was substantially smaller than the deficit in 1981/82, although solely because of cutbacks in expenditures; revenue collection had fallen short of expectations. The program for the present year provided for a slight increase in the overall deficit, as revenues as a proportion of GDP were to be unchanged from the previous year. Domestic resource mobilization by the public sector continued to be hampered by deficiencies in central administration and tax collection, and he agreed with the staff's general recommendations concerning the pricing policies of public sector industries and services. Was there any scope for expanding income tax collection, thereby reducing the heavy reliance on trade-based duties?

Commenting on the longer-term economic outlook for Sudan, Mr. Gomel remarked that the production policies seemed to be on the right track both in agriculture--where cotton output had responded quickly to the various measures introduced on the credit, foreign exchange, pricing, and marketing fronts--and in industry, where the policy of import substitution had encouraged domestic production of sugar, cement, and petroleum. The removal of budget subsidies and the recent adjustments in utility charges appeared to have been socially painful but necessary steps.

The debt rescheduling agreements covering 1983 had apparently been rather successful, Mr. Gomel commented, and preparations for similar undertakings covering 1984 had begun. It would be useful to have a further comment on the overall amount of debt relief provided by the reschedulings in 1983 and a rough indication of the likely relief in 1984.

Mr. Grosche said that he broadly agreed with the staff appraisal. The Government had had some success in improving the financial situation but still had a long way to go to eliminate the basic weaknesses in the economy. During the previous discussion on Sudan, the Chairman had concluded that decisive action was needed to eliminate the dual exchange rate system--which encouraged smuggling and caused distortions--the highly negative interest rates, and the remaining subsidies. The staff was satisfied with the measures that had been introduced to broaden the free exchange market and had recommended approval of the multiple currency practice. The staff had also stressed the importance of a realistic structure of interest rates for maintaining effective credit and monetary policies, while the authorities felt that the use of interest rate policy was constrained by certain social and religious factors. He wondered whether the staff expected the authorities to change their view in the coming period and, if not, what measures could be taken to provide the needed incentives for savings. How could the adverse effects of unrealistic interest rates be offset?

Considerable progress had been made in dealing with subsidies, Mr. Grosche commented. The most recent information provided by the staff showed that the authorities had introduced additional budgetary measures, including a further reduction in subsidies. He strongly hoped that those actions would generate more domestic savings than in the past, when the public sector had dominated the economy but had generated relatively little savings.

He shared the staff's concern about the poor performance of monetary policy in Sudan, Mr. Grosche remarked. The growth of domestic liquidity in 1982/83 had exceeded the program target, mainly because of the sizable credit to the nonfinancial public enterprises. He fully agreed with the staff that the efficiency of the public entities should be improved, that prices charged by them should be adjusted, and that their long-term investments should be financed increasingly through internal savings. Finally, the proposed decisions were acceptable.

Mr. Erb said that he broadly agreed with the staff appraisal and accepted the proposed decision. The authorities' commitment to continuing their adjustment effort and their compliance with all the performance criteria were encouraging. However, the performance of the economy under the stand-by arrangement had been mixed. The overall performance of agriculture had been disappointing, and, even more worrying, many manufacturing enterprises had continued to operate at levels well below capacity, in part because of a lack of supplies, equipment, and, at times, foreign exchange. In the future, development assistance should probably be concentrated more closely on the expansion of the manufacturing sector. Attention should also be paid to any possible constraints on manufacturers' access to capital due to the structure of the foreign exchange system. As a result of those constraints and the problems facing the agricultural sector, real GDP had declined by about 2 percent in 1982/83.

The rapid growth of the money supply was also disappointing, Mr. Erb commented; as a result, the rate of inflation had substantially exceeded the program target. It would be useful to have a further comment by the staff on the reasons why the rate of money growth and inflation had been much higher than had been anticipated; in that connection, the lack of a sufficiently flexible exchange rate regime seemed to be important.

The overall budget deficit had been reduced from 8.9 percent of GDP in 1981/82 to 6.1 percent in 1982/83, Mr. Erb observed, and the Government had been able to reduce its need to borrow from the domestic banking system. The most encouraging development was the significant decline in the deficit on the current account of the balance of payments resulting from the sharp increase in cotton exports, the decline in imports due to reduced expenditures on petroleum and sugar, and a large rise in official and private transfers. Moreover, the authorities had adopted a more realistic set of price incentives, raising the prices for bread, electricity, and water. All the budget subsidies had been eliminated, and the authorities appeared to be committed to adjusting the prices for consumer goods sold by the public sector to ensure that subsidies did not re-emerge. The elimination of subsidies was an important accomplishment, and the effort to avoid them in the future would play an important role in the adjustment process.

The authorities should adopt a much tighter financial policy in 1983/84 in the light of the excessive monetary expansion and higher than projected price increases in 1982/83, Mr. Erb considered. The recently adopted budgetary measures were welcome, and the credit measures announced in August 1983 were appropriate.

The ultimate goal of exchange rate policy, Mr. Erb continued, should be the unification of the two rates at a market-related rate as soon as possible. The recent emergence of a third exchange rate was particularly worrying; it indicated that the parallel market was unnecessarily constrained. The authorities should be encouraged to take appropriate steps to broaden participation and enhance confidence in the exchange market. The problems that the staff had described in the granting of licenses were disturbing, and future discussions with Sudan should include a closer look at the exchange regime, including the implications of a unification of the market for the set of regulations and controls over the market. The authorities should avoid regulations and controls that created uncertainties about licensing.

Sudan's external debt and debt servicing obligations were so large that significant debt relief would be required for a number of years, Mr. Erb commented. The authorities' record in meeting the terms of the 1982 debt rescheduling was encouraging. His authorities would continue to monitor the progress in the internal adjustment effort and the external financing requirement in the coming months.

The staff reports could have usefully contained a more thorough analysis of the medium-term prospects for the Sudanese economy, Mr. Erb remarked. The staff report on the stabilization program for the current year had included a section extending the analysis beyond the present year and had identified the areas to which the authorities would have to pay more attention in the future. That kind of elaboration in the context of the 1983 Article IV discussion would have been useful.

The staff intended to discuss a follow-on program with the authorities, Mr. Erb observed. The Fund had been deeply involved in Sudan for a number of years, and its holdings of Sudanese pounds in relation to quota were relatively large. It was therefore clear that the program for the coming year should be viewed in a medium-term context. It would also be important to look at the framing of the program in the coming year and any Fund commitment under it in the light of the recent discussions in the Executive Board on the scale of access to the institution's resources.

The authorities had achieved some success, Mr. Erb commented, and the previous year's approach of requiring that the debt rescheduling should be essentially in place and that there should be strong commitments to fill the financing gap had enabled the authorities to avoid the disruptions of earlier years. For the purpose of any follow-on program, the critical financing probably would be that which resulted from the Fund's catalytic role vis-à-vis Sudan's creditors and aid donors, as well as financing from development institutions. Sudan's needs over both the short and long run suggested that it was longer-term development assistance--rather than short-term financing--that would be needed over time.

Mr. Taylor noted that the economic situation in Sudan was clearly serious. Without further rescheduling, the debt service ratio would exceed 100 percent in each of the coming five years. Sudan was one of a number of heavily indebted poor countries that still needed to make major economic adjustments. On the other hand, some progress had been made in 1983: Sudan was beginning to come to grips with the uncontrolled budget and the excessive foreign borrowing, and its efforts had been matched by an exceptional effort by the international community in the form of a major aid pledging exercise and a favorable Paris Club rescheduling in February 1983. As a result of those combined efforts, the stand-by arrangement had been kept on track. It was especially important that the arrangement be implemented successfully and be seen to be successful in order to encourage confidence within Sudan and among the country's creditors and aid donors.

At the present stage, Mr. Taylor continued, the most pressing need was to sustain the improved financial performance and the commitment to structural reform. As previous speakers had noted, recent monetary developments had been worrying and somewhat mysterious. There seemed to have been excessive monetary expansion in the previous 12 months that could undermine much of the progress that had been made in other program areas. Greater determination was needed to keep monetary and credit growth within the program target for 1983/84, and, to that end, a stronger effort to raise real interest rates was certainly desirable.

During the previous discussion on Sudan, Mr. Taylor recalled, Mr. Sangare had suggested that the best way to raise real interest rates in Sudan was to reduce inflation, but the rate of inflation had actually accelerated. With lending rates at 17-20 percent and deposit rates at 13-15 percent, it was difficult to believe that real rates of interest were even slightly positive. Even if interest rates were not a fully effective means of mobilizing savings, they clearly had an important role to play in the management and allocation of credit. In the absence of an active interest rate policy, the recently introduced credit control measures were particularly helpful. Credit to the public sector should be carefully scrutinized to ensure that it was directed to areas that were genuinely productive and, if possible, market oriented. Investments that were not particularly productive should be avoided; he wondered whether further investment in the airport should not be relatively low on the authorities' list of priorities. In the private sector, if the rainfall in the coming year were sufficient, agricultural producers would probably require considerably larger advances than hitherto in order to sustain and procure a normal harvest. In that event, there might have to be cuts in the provision of credit to other areas of the economy.

The measures taken to reduce the fiscal deficit by the equivalent of 1 percent of GDP were welcome, Mr. Taylor said. Nevertheless, there was still cause for concern about the overall 1983/84 budget, even excluding the larger debt service payments, as it seemed to imply a weakening of the resolve to achieve a surplus on the current account. Of course, considerable attention should be paid to the supply side of the economy, particularly to increasing the efficiency of industry and agriculture. The management and employment policies of industries, including some in the public sector, needed to be reformed, and some public sector monopolies should become more competitive. In the private sector, price controls should be removed, and access to the free foreign exchange market should be broadened.

The economy had responded well to the reduction in price distortions that had been possible thus far, Mr. Taylor went on, and the authorities' intention of raising domestic procurement prices for cotton to bring them into line with international prices was welcome. In the longer run, there should perhaps be a mechanism to ensure that such adjustments took place automatically. A similar approach might be useful in setting sugar prices. The recent increase had brought them to a level that fully reflected the product's economic value. Would the proposed 15 percent excise tax on domestic sugar create a distortion in favor of sugar imports?

Given the persistence of inflation at an annual rate of 30-40 percent, Mr. Taylor commented, he wondered whether the exchange rate was still appropriate. The staff had studied the export incentives for the major agricultural crops, and its conclusions were fairly reassuring, but if inflation continued at the present rate, they might not remain valid for long. The gap between the official and free market rates was already fairly wide, and he wondered whether the staff was fully confident that the factors that had caused the free market rate to rise were purely temporary. If they were not, there seemed to be some risk that the arrangements for handling export receipts might provide inadequate incentives to the export industries. It was difficult to draw definite conclusions without knowing more about the staff's calculations. The staff had implied that the price incentives at the current exchange rates, together with the ability of exporters to receive 25 percent of their earnings at the free market rate, were probably sufficient. But, what had happened to the proposal for linking the official exchange rate to a currency basket rather than to a single currency?

Continuing Fund support would be needed in the coming period, Mr. Taylor considered, particularly since the current account deficit was expected to increase as a result of the existing debt service obligations. The amount of Fund assistance was likely to be more limited in the future than in the past, and the Fund's role would have to be mainly a catalytic one. The prospect of another Fund-supported program underscored the structural problems facing the economy, and he agreed with Mr. Erb that the time was ripe for taking a fuller look at the medium-term prospects for the economy. In preparing any further arrangement, the staff should pay particular attention to the policies that could improve the medium-term economic prospects; in that connection, an essential task would be to provide a fuller picture of the main economic magnitudes over time. It was of course difficult to forecast any of the critical magnitudes in an economy heavily dependent on weather conditions. Nevertheless, he hoped that the staff would be able to provide a more explicit medium-term scenario at a fairly early date, and that it could take a look in detail at the need to liberalize the exchange market still further and improve domestic investment incentives.

Given Sudan's difficulties in debt management, Mr. Taylor commented, he wondered whether a limit on short-term borrowing might not have been useful. During the previous discussion on Sudan, the staff had mentioned that such borrowing was difficult to monitor, that it was examining ways to deal with the problem and considering whether short-term borrowing should be one of the performance criteria. Finally, he broadly agreed with the staff appraisal and accepted the proposed decisions.

Mr. Delgadillo said that he agreed with the thrust of the staff appraisal. Since mid-1978, when the overall economic conditions in Sudan had been weakened by a combination of external and domestic factors, the authorities had been making commendable adjustment efforts in the context of programs supported by the Fund and the World Bank. A number of improvements had been made, particularly in agriculture, the fiscal position, and the debt servicing position. On the other hand, there had been negative developments with respect to real GDP growth, monetary expansion, and the rate of inflation.

Maintaining the policy of cost and price liberalization in agriculture and the adoption of sound management policies would probably help to improve the production process, Mr. Delgadillo continued. Appropriate and timely incentives to broaden the industrial base were needed to increase manufacturing's contribution to GDP. An increase in public savings to support investment could prove to be of crucial importance in the future, and to that end the authorities should maintain price flexibility and a high degree of efficiency in public sector enterprises.

He was pleased, Mr. Delgadillo said, that the ceiling on net domestic credit and the subceiling on net credit to the Government for the period ending June 30, 1983 had been observed. The recently announced budget and licensing measures were welcome, as their overall effect during 1983/84 should be an improvement in the fiscal position. The financial policies would have to be prudent and carefully monitored in order to avoid excess credit to both the public and private sectors. In that connection, interest rates could play an important role by reducing excessive bank borrowing and stimulating savings. Financial stability would help to sustain the improvement in the external accounts. He agreed with the staff that proper pricing, interest rate, and exchange rate policies should result in a reasonable performance under the stand-by arrangement. Given the performance thus far and the targets and policies for 1983/84, the proposed decisions were acceptable.

Mr. Casey commented that, while a number of improvements in the economy had been made, it was somewhat difficult to judge them in relation to both the productive potential and the urgent adjustment requirements of the economy. For instance, although the short-run trend in agriculture was impressive, only one fifth of the total arable land was under cultivation, and farmers continued to leave the land for urban centers. He wondered whether the price incentives in agriculture were adequate. On the fiscal side, the elimination of budgetary subsidies was of course welcome, but the overall fiscal deficit was expected to increase from 6.1 percent of GDP in 1982/83 to 7.4 percent in 1983/84. The figures should perhaps not be seen as painting a precise picture of the fiscal situation, but he wondered whether the likely fiscal developments were fully consistent with the urgent need to increase public sector savings. The present interest rate policy was unlikely to stimulate either private sector savings or workers' remittances, and a somewhat stronger fiscal correction than now planned seemed necessary.

Another cause for concern, Mr. Casey commented, was the recent excessive monetary expansion together with the acceleration in the rate of inflation. Economic growth continued to be hampered by the lack of imported inputs, an unreliable electricity supply, deterioration in the capital stock, and other factors.

Among the positive developments, Mr. Casey noted, pricing policy had been considerably improved, and the performance criteria for end-June 1983 had been met, although some of the promised measures had not yet been introduced. It was difficult to know whether or not the pace of adjustment was adequate in the light of the severe liquidity problem. Given the excessive growth of domestic liquidity in 1982/83, the tighter monetary targets for 1983/84 were welcome, and he hoped that they would be observed. The recently introduced credit control measures should be helpful.

Commenting on external developments, Mr. Casey said that the increase in working balances in 1983 had been lower than programmed because of the weak official capital inflows, and the overall balance of payments deficit expected in 1984 was a cause for concern. Substantial additional debt relief would be needed. It had been suggested that the Fund would help the rescheduling process if it agreed to a follow-on program before the expiration of the current one. That idea was novel but rather risky. To minimize the risk, the Fund should make it clear that the approval of the follow-on program would be conditional on the successful completion of the current one and on the financing of the resource gap in 1984/85. In that context, he agreed with previous speakers that the follow-on program should be framed in a medium-term perspective.

In the light of the serious balance of payments problems, Mr. Casey commented, he wondered whether the present exchange rate system was adequate. The opening statement by the staff representative was encouraging, but a greater effort should be made to broaden and deregulate the free exchange market.

Sudan's program seemed to be reasonably good, Mr. Casey remarked. Given the productive potential of the economy, the precarious balance of payments and liquidity positions, and the need to bolster the confidence of external creditors, a faster pace of adjustment was needed, especially with respect to fiscal policy, the various public entities, interest rates, and, perhaps, the exchange rate. The Fund and the World Bank had given Sudan considerable financial assistance in the past, and the Fund's holdings of Sudanese pounds would reach 564 percent of quota in early 1984. In addition, the Fund had provided a resident representative, a fiscal affairs expert, and a central banking expert. Given the large amount of assistance, he would have hoped that the economy would have adjusted more quickly than it actually had. Finally, the proposed decisions were acceptable.

Mr. Zhang stated that the decisions should be approved. The authorities had introduced commendable adjustment measures despite unfavorable internal and external conditions, and had met most of the performance criteria. Sudan would have to reschedule its external debt, but there was also an urgent need for continued external assistance to enable the country to meet its debt obligations. The problems facing the Sudanese economy were structural, and a medium-term or long-term program was clearly necessary.

Mr. Malhotra said that the decisions were acceptable. During the previous discussion on Sudan, his chair had stressed the need to take a medium-term or long-term view on the country's sizable debt, and debt rescheduling was clearly of crucial importance. Given the progress that the authorities had already made in implementing needed adjustments, the adjustment program should also be seen in a medium-term perspective.

Mr. Agah recalled that during the previous discussion on Sudan Mr. Salehkhou had stated that "I hope that Sudan will undertake to honor all its commitments in a nondiscriminatory manner, especially the loan which it contracted from another Fund member and which is now long overdue." His Iranian authorities wished to bring to the

Executive Board's attention the discriminatory practices of the Sudanese authorities concerning their outstanding financial obligations toward the Islamic Republic of Iran. The discriminatory action was inconsistent with the Fund's Articles and with the agreed minutes of the Paris Club meeting of February 4, 1983 on the consolidation of Sudan's debt, to which reference had been made in SM/83/54 (3/15/83). In paragraph 5 of SM/83/54, it was indicated that "for their part, the Sudanese representatives undertook that the Government of Sudan would (a) negotiate promptly rescheduling arrangements with all other creditor countries on debts of a comparable term; (b) seek to secure from external creditors, including banks, rescheduling on similar terms; and (c) pay all overdue obligations to, or granted by, the Club of Paris participants and not covered by this rescheduling as soon as possible but not later than September 1, 1983." None of those provisions had been respected by Sudan in its treatment of its outstanding obligations to the Islamic Republic of Iran. In addition, the Sudanese authorities had failed to reply to any of the communications from the Iranian authorities, including a letter of March 6, 1983 from the Ministry of Economic Affairs and Finance of the Islamic Republic of Iran to the Ministry of Finance and Economic Planning of Sudan, a copy of which had been given to the Fund staff on July 5, 1983.

On the instruction of his Iranian authorities, Mr. Agah continued, several efforts had been made in the past several months to approach the Sudanese authorities through the good offices of the Executive Director concerned and the staff, in order to have the Islamic Republic of Iran included in Sudan's debt rescheduling effort and to obtain a copy of the actual terms of agreement with other creditors, or to have the Fund staff given clearance to provide the information. Apart from the clearance given to the staff to provide a copy of the Club of Paris Agreement--which his office had received on September 12, 1983, but only after a letter had been written by Mr. Salehkhou to the staff--his Iranian authorities had received no firm commitment from the Sudanese authorities. One of the few pieces of indirect information that they had received was a copy of a communication dated August 31, 1983 from the Fund's resident representative in Khartoum to the Fund, in which the Sudanese authorities were said to have "reaffirmed their commitment to negotiate a bilateral agreement to reschedule the debt on a comparable basis with other official creditors. As a first step in advancing the negotiations, the Sudanese authorities have indicated their willingness to discuss this question with Mr. Salehkhou during the Annual Meeting."

A second piece of indirect information, Mr. Agah said, was a copy of the staff's cable dated September 11, 1983 indicating that "Minister has authorized to advise Iranian authorities that Sudanese delegation to Annual Meetings are ready to negotiate with Iranian authorities terms and conditions for outstanding obligations." If the Sudanese authorities were willing to treat all creditors on an equal basis, why had they refused to give his Iranian authorities a copy of the actual terms of agreement reached with Sudan's other creditors, including in authorities failed to meet their obligations in accordance with the agreed terms of agreement under the Paris Club, and why had they disregarded the Fund's Articles concerning financial relations between the two Fund members?

In the event of a further delay or the lack of a commitment by Sudan to hold a meeting with his Iranian authorities as a sign of good will during the 1983 Annual Meetings, Mr. Agah went on, his Iranian authorities reserved their right to oppose further purchases by Sudan under its stand-by arrangement. He hoped that the Chairman's summing up would include an explicit reference to the need for Sudan to treat all its creditors equally and encourage Sudan to meet the Iranian representatives during the 1983 Annual Meeting.

Mr. de Vries commented that it was established Fund policy to provide under stand-by arrangements for the nondiscriminatory treatment of all the member's creditors. Moreover, no drawings could be made under a stand-by arrangement if the country concerned introduced discriminatory payment restrictions, as appeared to be the case with Sudan. The Executive Board should express its concern about the possibility that a discriminatory payments restriction had been introduced. The staff should perhaps be asked to investigate the matter, and representatives of Sudan and Iran should be urged to meet during the 1983 Annual Meeting to solve the problem at that time.

Mr. Abiad remarked that the staff papers clearly showed that, while the performance of the real sector had been below expectations, signs of progress in the financial area had started to emerge as a result of the domestic and external adjustment efforts over the previous two years. In the real sector, the improved performance of the irrigated agricultural sector in response to the supply-oriented policy actions of the authorities was encouraging, but there had been a sharp decline in output in the rain-fed areas as a result of droughts. Moreover, the performance of the manufacturing sector, although somewhat improved, remained hampered by bottlenecks, including inadequate supplies of inputs, spare parts, and power.

The further reduction in the overall budget deficit, Mr. Abiad noted, had been achieved through a strengthening of expenditure control and the introduction of a number of revenue measures which, along with the recently introduced measures aimed at mobilizing supplementary domestic resources in 1983/84, reflected the authorities' determination to sustain the adjustment effort. He had noted the staff's statement that the current account position had strengthened considerably in 1982/83, as exports had rebounded while imports had declined broadly in line with the program objectives. A further improvement in the trade account was expected in 1983/1984.

The performance in the monetary area during the first part of the program period had been less satisfactory, Mr. Abiad continued, as the rate of monetary expansion had exceeded the program target. That development seemed to be attributable in part to financial accounting procedures and banking supervision over credit allocation, and continued Fund technical assistance would be helpful in those areas.

The staff analysis indicated that the targets for the remaining period of the stand-by arrangement were attainable if the planned adjustment policies were fully implemented, Mr. Abiad said. In addition to the adjustment policies that were to be introduced under the stand-by arrangement, much remained to be done over a number of years, particularly in view of the need to achieve the structural transformation of the economy's productive apparatus, to improve the efficiency of resource allocation, and to strengthen the finances of the parastatal enterprises. The magnitude of Sudan's external debt and annual debt servicing obligations made the adjustment task and the attainment of a viable balance of payments position particularly difficult. The staff had concluded that, in the absence of significant debt relief, the debt service obligation would exceed proceeds from exports during each of the coming five years. The Fund's support would continue to be particularly important, especially in view of the catalytic role that the Fund could play in encouraging the various creditors to provide adequate financial support.

Finally, it was important, Mr. Abiad observed, that the principle of nondiscriminatory treatment of all the country's creditors be upheld in all arrangements relating to the settlement of outstanding obligations.

The staff representative from the Middle Eastern Department said that the interest rate structure was clearly negative in real terms and had had an adverse allocative effect. The authorities were fully aware of the problem and wished to maintain a flexible approach, although positive real interest rates might not necessarily yield the desired economic results because of the social and religious factors prevailing in Sudan. The authorities were committed to making gradual and selective changes in interest rates, which had been adjusted at the time of the approval of the stand-by arrangement. At the time of the review, the authorities had indicated that they did not wish to make another change at the present stage, when the economy was still absorbing a wide variety of adjustments. They might be willing to discuss with the staff further possible selective changes in interest rates during the next round of negotiations.

It was true, the staff representative continued, that although the authorities had observed the credit ceilings, monetary expansion had greatly exceeded the target. That outcome was not the result of inadequate policies; indeed, the authorities had implemented the staff's recommendations. The rapid increase in the money supply in 1982/83, despite the observance of the credit ceiling, had been due to several factors, the most obvious of which was the invalidation of some of the assumptions on which the balance of payments projection had been based.

When that projection had been made, in October 1982, the staff had not known for certain the volume of aid that would be available and the amount of debt relief that would be accorded. Consequently, the staff had assumed that, because of the precarious balance of payments position and the need to finance essential imports, Sudan would have to use all the available Fund resources to undertake some short-term borrowing to finance the external deficit; the then-estimated balance of payments deficit would have had the assumed contractionary monetary effect. The staff had subsequently received information suggesting that the balance of payments position would be better than had been expected and that the contractionary effect of the external sector would be less marked than had been expected; by then, however, the program, including the credit ceilings, had been set in place. The staff had stressed to the authorities that the credit ceilings were only a means to an end, and that they should be cautious and vigilant in a number of areas so as to remain within the target for monetary expansion. However, some of the measures that the staff had hoped that authorities would introduce had not in fact been taken. For instance, they had not taken advantage of the substantial scope for retirement of seasonal credit by the public corporations. In addition, after the devaluation, the authorities had compensated the commercial banks for some of the resultant exchange losses by clients; they had not been legally required to make most of those payments but had felt it necessary to do so. The payments had, however, contributed to the expansion in the money supply. The staff's assumptions about the contractionary impact of the blocked accounts on the money supply also had not fully materialized.

Two exogenous factors had also contributed to the unexpectedly rapid monetary expansion, the staff representative continued. First, the foreign currency deposits of residents, which were a part of quasi-money, had been revalued by 44 percent in November 1982, thereby expanding the supply of broad money by 2-3 percent. Second, the authorities had drawn on LSd 50 million from blocked accounts to pay the subscription to the newly established import-export bank. However, they had fully recognized the adverse effects of excessive monetary expansion in 1982/83 and had agreed to compensate for overexpansion in 1982/83 by lowering the monetary growth target for 1983/84. Accordingly, the target for monetary expansion in 1983/84 had been reduced to 18 percent. The staff hoped that the new target would be achieved, partly because the authorities had already introduced a number of measures on the credit side.

Speakers had asked, the staff representative recalled, whether the staff was worried by the probable increase in the budget deficit as a proportion of GDP in 1983/84. The estimates for both 1982/83 and 1983/84 should be approached with caution, in part because they were not strictly comparable. Expenditures in 1982/83 had reflected the full debt relief that had been granted to Sudan, while the projection for 1983/84 did not include any debt relief that had not already been provided. In addition, the staff had made an effort to be on the conservative side in estimating expenditures for 1983/84. It had assumed a higher rate of development expenditure in 1983/84 than in 1982/83, and if the actual pace of expenditure were less rapid, the deficit would be reduced correspondingly. There had been some acceleration in current expenditure, but it was traceable basically to noneconomic factors, such as defense and security requirements and the reorganization of the southern region.

In any event, the projections should also be approached with caution because the data on GDP--particularly statistics on agriculture, the mainstay of the economy--were unreliable, the staff representative went on. A substantial decline in the rate of inflation in 1983/84 had been projected, and in nominal terms GDP growth was likely to be much less in the coming year than in the present one. Because of the inelasticity of taxes in relation to prices, the underlying budgetary situation might not change significantly even if the ratio of total expenditure to nominal GDP changed.

The authorities were aware, the staff representative explained, that the rate of income tax in Sudan was very low. They had recently received a comprehensive income tax report and were considering ways of implementing its recommendations. Still, the scope for direct taxation in a country like Sudan was rather limited, and a substantial increase in revenues in the short run from such taxation was unlikely to occur.

Although the price for sugar had been increased from LSd 250 per ton to LSd 400, the staff representative commented, it was still well below the average cost of production of approximately LSd 540. Further price adjustment would be one of the topics of discussion between the authorities and the World Bank mission currently in Sudan. The 15 percent excise tax on sugar was not a new tax. The authorities had stopped collecting it for a while because the prices that factories had been receiving from the sugar corporation had been well below the costs incurred by them. Had the taxes been collected, the factories would have had to approach the Bank of Sudan for loans; such loans were a form of borrowing by the public sector. With the increase in the price to be paid to the sugar factories by the sugar corporation, the authorities felt that the time was ripe to recommence collecting the excise tax.

All the explicit budget subsidies had been eliminated under the 1983/84 budget, the staff representative noted. There were still subsidized interest rates and a favorable exchange rate for government imports, but the last remaining explicit budget subsidy had been eliminated in July 1983.

Total debt service obligations in 1983, excluding Fund repurchases, were $961 million, the staff representative said, and debt relief of approximately $660 million had been provided. The debt service obligations in 1984, without taking into account any debt relief, were projected at close to $980 million. It was obvious that the debt could not be paid unless debt relief of the order of magnitude of that provided in 1983 were accorded.

A staff team had prepared a study on the cost competitiveness of Sudan's exports after collecting data during a visit to Sudan, the staff representative explained. The study had been undertaken basically because it had been felt that the traditional approach to judging the adequacy of an exchange rate would not be relevant for Sudan, partly because price data were not available for the calculation of the effective exchange rate. The staff had collected information on the latest yield for each agricultural crop per unit of land, the relevant international prices, and production costs for each crop together with such costs as insurance, storage, and the opportunity cost of labor. The staff had concluded that, on the basis of the official exchange rate and the provision of the sale of 25 percent of the foreign exchange in the free market, the commodities were price competitive. The conclusion depended upon certain important assumptions regarding the calculation of costs and the choice of prices. The staff was aware that the conclusions of the study were valid only at a particular point in time and might be changed over time owing to a high rate of inflation and changes in cost structure and international prices.

The authorities had expressed a willingness to be very flexible in their exchange rate policy, the staff representative noted. As for the free market, the staff was confident that the authorities were committed to stabilizing and increasing confidence in that market. The delay in relicensing the dealers had been caused partly by changes in personnel. The previous Governor had preferred to impose certain requirements for relicensing, including a large minimum deposit with the Bank of Sudan. As a result, only a small number of applications had been submitted. The present Governor had indicated that he was studying the matter and hoped to implement relicensing by end-August 1983. He had been unable to do so because of procedural difficulties, but after a discussion with the staff had subsequently stated that he would definitely relicense a number of individuals, partnerships, and corporations starting September 25. The staff was confident that stability would be restored to the free exchange market, thereby placing the staff in a better position to discuss the appropriate level of the official exchange rate in relation to the free market rate.

The previous Governor, the staff representative went on, had indicated an interest in pegging the Sudanese pound to a currency basket and had asked the staff to produce a report on the subject, which he had been given. The present Governor had asked for some information from the staff--which had been provided--and was still considering the matter, particularly from the standpoint of its budgetary and price implications as well as of the possible effects on the operation of the free market rate.

The present program had been framed in the context of a three-year program worked out by the authorities in close collaboration with the World Bank, the staff representative said. The Fund had collaborated with the World Bank to avoid any overlapping, and the medium-term framework given in the staff report was substantially based on the three-year program. The Sudanese authorities and the World Bank were revising the three-year program, which would include balance of payments and other targets for the period 1983/84-1985/86. A new stand-by arrangement for Sudan would be discussed in the three-year framework that was being worked out. While the Fund staff would have no difficulty in including specific figures, it was important to remember that projections quickly became outdated and had to be interpreted with great caution.

The flow of workers from agriculture to urban centers had been encouraged by the series of unfavorable crops, the incentives provided by neighboring countries, and the relatively more attractive services available in urban areas, the staff representative explained. However, as a result of the improvement in farm income and the increases in incentives and prices in recent years, the flow of workers had been greatly reduced. If it was to remain as low as possible, however, the authorities would have to maintain the policies that had been introduced in the previous two or three years.

Under the Paris Club Agreement, the staff representative from the Middle Eastern Department went on, debt rescheduling agreements were to be negotiated between Sudan and its individual creditors. The staff had all along stressed that the authorities should treat all creditors equally, and the authorities had consistently stated that they intended to do so. They had begun negotiations with all the countries concerned except two, with which the authorities had certain political difficulties. The staff had encouraged the authorities to meet with the authorities of the Islamic Republic of Iran, and any messages that the staff had received from one set of authorities had been communicated to the other set. The Sudanese authorities were committed to conducting negotiations with the authorities of the Islamic Republic of Iran during the 1983 Annual Meetings. As for the position under the stand-by arrangement, it had been envisaged that it would take some time before implementing agreements on the rescheduling of obligations were concluded, and that Sudan's drawing rights under the arrangement would be interrupted only if arrears were incurred on the formally rescheduled debt service obligations.

Mr. Sangare remarked that Executive Directors had noted the significant efforts made by the authorities and had expressed their concern about some of the remaining problem areas, including the budget, monetary developments, and the external debt. The main cause of the poor performance of the real sector in 1982/83, including the decline in agricultural output, was the drought in rain-fed areas. The weather had improved, and an effort had been made to increase output in the irrigated sector; as a result, if sufficient foreign exchange were available, a recovery in agriculture was likely.

The authorities, Mr. Sangare went on, had made a considerable effort to eliminate the subsidies in the budget and to reduce the overall budget deficit. Expenditure growth had been reduced, and revenues had been increased. The authorities' efforts in those areas were commendable, particularly in the light of the difficult internal and external environment. Security requirements and assistance for refugees had not kept the authorities from maintaining their adjustment efforts. The tax effort at the rate of 2 percent of GDP each year was relatively high for a developing country.

Commenting on monetary developments, Mr. Sangare said that all the credit ceilings and subceilings had been strictly observed. The rapid increase in liquidity had been due to the revaluation of foreign exchange deposits after the devaluation of the Sudanese pound. The measures that the authorities had recently introduced to curb credit expansion should result in a slower rate of growth of money in the coming year.

Interest rate policy was a difficult issue in a strongly Islamic country like Sudan, where interest rates could not be a major policy instrument, Mr. Sangare commented. Indeed, some recently established banks, acting in conformity with Islamic law, charged no interest rate on loans. In any event, interest rates had little bearing on savings in countries with very low per capita incomes. The banking system had not been extended to the rural areas of Sudan, and the main problem was the need to establish savings institutions in those areas, rather than a need to adjust interest rates.

During the previous two years, Mr. Sangare noted, the authorities had introduced several measures designed to reduce the distortions caused by the overvaluation of the Sudanese pound. The currency had been devalued twice, and the authorities had encouraged the evolution of a free exchange market. The joint study on the official exchange rate showed that, given the present exchange arrangements and cost structure, the exchange system provided adequate incentives for agricultural exports. The authorities were committed to keeping the exchange system under review.

The Sudanese authorities had indicated that they were prepared to discuss the loan from Iran with the Iranian authorities during the 1983 Annual Meeting, Mr. Sangare commented, and they had said that the minutes of the Paris Club meeting covered the Iranian loan. Hence, there was ample evidence that the Sudanese authorities were ready to negotiate with the Iranian authorities and to accord them the same treatment as Sudan's other creditors.

Mr. Erb said that he hoped that an effort would be made by the Sudanese authorities to respond to the Iranian authorities and to attempt in good faith to resolve the debt issue. He also hoped that the staff could help to bring the two parties together.

The Chairman remarked that he had noted with great interest Mr. Sangare's reply to Mr. Agah. The Deputy Managing Director would be pleased to help the authorities to organize a meeting between the two delegations.

Mr. Agah said that Mr. Sangare's office had offered to make the arrangements for a meeting between the Iranian and Sudanese representatives. His Iranian authorities had wished to bring the matter to the attention of the Executive Board in the hope that it would help to ensure that the Iranian and Sudanese authorities met during the 1983 Annual Meeting.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal contained in the report for the 1983 Article IV consultation with Sudan. Several Directors commented favorably on the policies that had contributed to higher output of the principal export commodity, cotton, better budgetary performance, and improved servicing of the external debt.

Directors expressed concern over the excessive monetary expansion in 1982/83 but welcomed the authorities' readiness to tighten the target for monetary expansion in 1983/84 in order to make up for the excessive expansion in 1982/83. While welcoming the credit control measures that had recently been implemented, Directors urged the authorities to monitor the monetary aggregates closely and to be prepared to adjust policies speedily during the coming months in order to achieve the monetary targets for 1983/84. A number of Directors stressed the importance of a realistic structure of interest rates for containing demand for credit, promoting a more efficient allocation of resources, and encouraging financial savings.

Directors generally considered that the Central Government's budgetary posture in 1983/84 was insufficiently tight and in particular that budgeted expenditure growth appeared excessive. Directors placed considerable emphasis on mobilization of savings, particularly in the public sector. It was noted that even though the Government had implemented a variety of revenue-raising and expenditure-reducing measures in recent years, there had been little generation of savings in the public sector. Several Directors emphasized the need to strengthen the base of tax revenue. The scope and need for additional expenditure controls was stressed, as was the need to improve the efficiency of the public sector entities so as to reduce their bank borrowings initially and ultimately to generate internal savings. Doing so would require increased flexibility in pricing policy and continued effort at strengthening management and rehabilitating the physical capital of public sector entities.

Directors welcomed the improvement in Sudan's external payments position in 1983 with some recovery of exports, a reduction in imports, and the availability of additional external assistance, but stressed that the fundamental situation remained weak. Directors stressed the importance of flexibility in exchange rate policy for the attainment of balance of payments objectives and urged the authorities to take measures to narrow the differential between the official and free rates as a first step toward ultimate unification of the rate. It was important to ensure stability and competition in the free foreign exchange market through relicensing of dealers and continued official noninterference in the determination of the rate. The emergence of a third "unofficial" exchange rate was regarded as disturbing, and the need for simplifying the exchange system was emphasized.

Directors noted with concern the extent of Sudan's external debt and the unfavorable medium-term debt profile, which indicates debt service exceeding export proceeds for the immediate future. This will require over a number of years strong and continuous adjustment and also debt relief and external assistance. Sudan was urged to treat all its creditor countries in a nondiscriminatory manner in debt rescheduling.

In sum, the Directors warmly welcomed Sudan's continuing commitment to the objectives of the stand-by program. They encouraged the authorities to persevere on the difficult road of economic rehabilitation and financial stabilization, to strengthen policies for 1983/84 to that effect, and to implement structural measures to improve the productive base in agriculture and manufacturing. In its further collaboration with the authorities, the staff would have to give increasing attention to the medium-term prospects and policies of Sudan in close collaboration with the World Bank.

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

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

The decisions were:

1983 Article XIV Consultation

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

2. Sudan's exchange system gives rise to multiple currency practices. The Fund notes that Sudan is taking steps to narrow the divergence between the official and free market rates with a view to unifying the two markets in due course. In the circumstances of Sudan, the Fund grants approval for the multiple practice arising from the existence of the dual market as described in EBS/83/174 (8/16/83) until February 22, 1984.

Decision No. 7524-(83/140), adopted
September 14, 1983

Review Under Stand-By Arrangement

1. Sudan has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Sudan (EBS/83/9, Sup. 1, 1/27/83) and paragraph 4 of the letter of the Minister of Finance dated January 5, 1983 annexed thereto in order to review policies and to establish performance criteria subject to which purchases may be made by Sudan during the remaining period of the arrangement.

2. The attached table setting limits on the expansion of net domestic assets of the banking system and the increase in net claims on Government during the periods ending September 30 and November 30, 1983 shall be annexed to the stand-by arrangement for Sudan, and the letter of January 5, 1983 shall be read as supplemented by this table.

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

During any period in which the data at the end of the preceding period indicate that:

(i) the limit on net domestic assets described in paragraph 16 of the statement annexed to the letter of January 5, 1983 and in the attached table, or

(ii) the limit on net claims on the Government described in paragraph 16 of the statement annexed to the letter of January 5, 1983 and in the attached table,

has not been observed.

Decision No. 7525-(83/140), adopted
September 14, 1983

2. ROMANIA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Romania (SM/83/173, 8/5/83; and Sup. 1, 9/12/83). They also had before them a report on recent economic developments in Romania (SM/83/195, 8/24/83).

Mr. Polak made the following statement:

On behalf of the Romanian authorities I thank the staff for constructive consultation discussions and for their continued assistance in helping to solve the problems facing the country in the past few years.

The international debt crisis has forced a major adjustment on the Romanian economy. After being negatively affected by several major developments that had occurred in 1979-80--the economic recession in the industrialized world and the accompanying compression of world trade, the major increases in the international lending rates and in the prices for oil--Romania saw its access to international bank credit terminated almost overnight as the result of developments elsewhere. As the staff notes, the Romanian authorities had to bring about a major adjustment in the current account position, which moved from a deficit of $2,400 million in 1980 to a surplus of $655 million in 1982--a change amounting to over 6 percent of GNP. For 1983, the achievement of the target of a further increase in the surplus to $800 million appears likely.

This massive adjustment was brought about by a sharp curtailment in investment expenditure and, in 1982, by a reduction in real wages of no less than 7.4 percent. In addition, the authorities have been implementing measures to promote appropriate resource allocation and to increase the efficiency of the economy in order to improve the medium-term perspective.

The year 1983 has been characterized by the continuation of the policy of demand restraint and the promotion of increased efficiency. The government budget is again expected to be in surplus, by some 2.5 percent of GNP, partly as the result of continued restraint with respect to the investment plan. A significant tightening of monetary policy has been implemented, and the increase in real wages will be modest indeed, to continue the constraint on consumption expenditure.

In spite of these sharp adjustments, Romania has not been able to meet all its debt service obligations, because the country has continued to have virtually no access to the international financial markets. Therefore, Romania has had to ask the creditor governments and commercial banks to reschedule part of the debts maturing in 1982 and 1983. It has also proved impossible to achieve the objective of increasing reserves significantly. For a while, an accumulation of payments arrears also proved unavoidable; however, I am happy to report that by May 1983 all arrears had been eliminated.

In order to promote efficiency in the economy, the authorities have for a considerable number of years pursued a steady policy of bringing about a fundamental readjustment. While maintaining the basic framework of a planned, socialist economy, the authorities have brought about fundamental changes in the role of pricing policies. Two of these changes stand out. First, the complicated exchange system involving a gamut of exchange rates has been abandoned. At present, only two exchange rates remain--one for commercial transactions and one for noncommercial transactions--and these exchange rates are to be unified no later than July 1, 1984. The second fundamental change has been the adjustment to the international price structure of the domestic price structure resulting from the unified commercial exchange rate.

Although this Board discussion is in the form of an Article IV consultation, it will inevitably also deal with the stand-by arrangement with Romania. The remaining two purchases for 1983 under this arrangement totaling SDR 183.6 million depend on the compeletion of two reviews, which will require understandings on the timetable for action in areas covered by the four joint studies envisaged under the arrangement. The staff report describes in detail the status of these studies. The Romanian authorities have actively cooperated with the staff in preparing them. While agreeing with the staff in some fields, they came to different conclusions in some other fields.

Agreement was reached on the basket of currencies to replace the U.S. dollar as the peg for the leu, and this basket is now in operation. A date has also been set for unifiying the noncommercial rate with the commercial rate: no later than July 1, 1984. The question of the costing of capital has also been settled, and the resulting quicker depreciation schedules for capital goods will be introduced at the beginning of 1984.

As to the subjects on which agreement is still lacking, reference may first be made to the price for natural gas, which is discussed on page 18 of the staff report. Here, the open issue is to decide on the relevant world market price so as to apply the agreed principle that natural gas prices in Romania will not be below the world market price. Because they consider it necessary to make allowance for transportation costs that would be involved in the export of natural gas, the Romanian authorities consider that the domestic price for natural gas will be in line with world prices when, starting October 1, 1983, the price will be brought to the equivalent of $86. This is an extremely complicated question, which, in my opinion, deserves further careful study and on which I shall want to comment further. Regarding the price for domestic oil, the Romanian authorities expressed their readiness to increase it up to lei 2,000 per ton starting July 1, 1984.

With regard to interest rates, the authorities made significant increases on January 1, 1983. They do not consider the sharp price increases in 1981 and 1982--which came after many years of extremely stable domestic prices--as indicative of future inflation rates. These increases reflect primarily the structural adjustment of relative prices to those in world markets and the adaptation to the new exchange rate system. For the future, the authorities intend to keep the rate of price increases to a modest level, to which the now prevailing interest rates for credits extended roughly correspond.

Interest rates on savings deposits are kept low for income-distribution reasons. The authorities agree with the Fund that the use of capital--whether provided through the budget, obtained from retained profits, or borrowed from banks--should bear an interest cost, reflected in the price of the product, that is of the same order of magnitude as the underlying rate of inflation in the economy. This is an important condition for the economical and efficient use of capital in the economy. The further contribution that can be made by raising rates to some--inevitably somewhat arbitrary--level of "positive real rates" is much more marginal. Interest rates, prices, and profitability play a less important role in a planned socialist economy than in market economies; this qualifies the weight of interest rates in the Romanian process of decision making on investment. Finally, private savers have few other effective investment opportunities for their savings than those offered by savings institutions.

Regarding the exchange rate system, the authorities have introduced comprehensive measures since the beginning of the present stand-by arrangement, which culminated with the unification of the commercial rates as of July 1, 1983, pegging to a basket of currencies instead of to the U.S. dollar, and a cumulative devaluation of almost 17 percent since December 1982 of both the commercial and the noncommercial rates. The authorities are also committed to unifying the noncommercial rate with the commercial rate no later than July 1, 1984. They feel that what they need now is a reasonable period of time to monitor the effects of all these changes before making further adjustments. They agree with the staff that the downward trend in exports needs to be reversed, and they are willing to consider all measures to that effect. They would be quite interested, in the discussions with the staff later this year, to explore other effective means that might be helpful in this connection.

The authorities fully agree with the standard 12-month consultation cycle.

Continuing, Mr. Polak said that there were at least three economic questions to consider in the complicated issue of natural gas in Romania. First, it was difficult to establish a relevant market price for a commodity with a high transport cost in a country that did not import or export the commodity in question; with the exception of minor transit trade in natural gas, that was the case with respect to natural gas in Romania. The current European delivery price of natural gas abroad was about $145 per thousand cubic meters, as exemplified by exports from the Netherlands to Belgium. However, if Romania expanded its production of natural gas in order to become an exporter to the convertible currency area, it would receive a net price of only about $85 per thousand cubic meters after allowing for the cost of liquefaction, the transportation of gas over long distances, special handling, and other factors. It was therefore difficult to determine the actual world market price for natural gas that was relevant for Romania.

The second economic question, Mr. Polak went on, had to do with substitution among fuels. The staff had indicated that the price for natural gas in Romania would be about three fifths of the world price of the calorific equivalent of heavy fuel oil. It was precisely that price differential that would provide a strong incentive for domestic users to switch from heavy fuel oil--which was either imported or easily exportable--to natural gas, which was domestically produced and expensive to export. The third question had to do with the policy variable that should be influenced. Should the emphasis be placed on the effect of energy prices on the long-run use of energy, or was the main interest in the effect on the balance of payments or on the budget? The price of natural gas had implications for all those variables. It would of course be difficult to determine at what absolute and relative prices for alternative forms of energy each of the policy variables would receive the optimal benefit from the joint effect of substitution among fuels and the reduction in demand for all fuels combined. The staff and the authorities had each examined the question, but they had arrived at different conclusions. In the circumstances, it seemed wise not to focus on the single standard solution, namely, the world market price; the staff should be prepared to explore other measures designed to achieve the desired overall effects on the Romanian economy.

Mr. Zhang commented that the adjustment process in Romania had begun in 1981. In order to consolidate and strengthen the process, new policy measures had been introduced in 1983, and additional ones were planned for 1984. The implementation of the adjustment program had been successful on almost all fronts, and the fulfillment of the target for the convertible current account was particularly noteworthy.

The achievements had been made under unfavorable external conditions: demand in the convertible currency area for Romania's exports had remained weak, and, more important, Romania had experienced debt rescheduling problems. Unlike other debtor developing countries, Romania had not maintained its access to international capital markets, and the consequences for the implementation of the domestic adjustment program had been significant.

Nevertheless, Mr. Zhang went on, Romania had met all the performance criteria for the first quarter of 1983, and two purchases had been approved in March and June. However, the approval of the remaining two purchases scheduled for 1983 would depend upon the completion of two additional reviews by the Executive Board; understandings would have to be reached on the timetable for action in the areas covered by the joint studies on the exchange rate, interest rates, the costing of capital, and energy prices. The staff had described the outcome of the recent discussions, and it was clear that there were some important differences in the positions of the staff and the authorities. The studies had been begun some time ago and should be completed promptly and to the satisfaction of both parties. Meanwhile, it was important to recognize that many basic policy measures had already been introduced during the previous two years and that structural adjustment had been proceeding on a solid basis. In the circumstances, he wondered whether it was necessary or advisable to insist that further adjustment should be made on the basis of the kinds of specific solutions that had been originally suggested at the time of the adoption of the stand-by arrangement for Romania. A more flexible approach would contribute to a rapid completion of the studies.

During the discussions between the staff and the authorities on the four studies, Mr. Zhang continued, the authorities had shown considerable flexibility and cooperation and had proposed several policy adjustments for 1984, including changes in the method of calculating depreciation, an increase in domestic prices of crude oil and natural gas, and an adjustment of the exchange rate. Of the four studies, complete agreement had been reached on the policy on the costing of capital, and relevant new practices and measures would be introduced in the beginning of 1984. On the remaining subjects, agreement was still lacking on certain important issues.

Romania had made a number of comprehensive and basic changes in the exchange rate system since the adoption of the stand-by arrangement, Mr. Zhang noted, and there had been a cumulative devaluation of the leu since December 1982. New measures concerning the composition of the currency basket and the margins between various exchange rates would come into effect in 1984, and the authorities were not prepared at the present stage to make more policy changes in the exchange rate field. The staff believed that, on the basis of its calculations of the real effective exchange rate, the Romanian currency was still overvalued and should be further devalued in 1984. In that connection, it would be useful to have the answers to the following questions: What elasticities of demand in the convertible currency areas for Romanian exports had the staff used in presenting its arguments? How important had such factors as the world recession and restrictive practices been on the demand by the convertible currency area for Romanian exports? Had the staff been able to determine the relative importance of those factors in the fluctuations in Romania's exports to its main trading partners? What would be the effect on domestic prices of a rise in import prices resulting from further devaluations?

Interest rates had been significantly increased at the beginning of 1983, Mr. Zhang remarked, but the staff insisted that they should be raised further. The difference in views basically reflected the varying opinions of the role of interest rates in a planned economy. It was a well-known fact that interest rates exerted much less influence on investment decisions and resource allocation in a planned economy than in a market-oriented one. Moreover, the level of interest rates, which had an income distribution effect, could not be ignored, particularly given the Government's social objectives. In previous discussions on interest rate policy, the Executive Directors had been divided on the question of the effects of interest rates in, and the appropriate interest rate policy for, various kinds of economies. As for the outlook for real interest rates in 1984, the authorities' assumption that the large price increases in 1982 and 1983 were the unavoidable result of structural adjustments under the stand-by arrangement and would not be repeated in 1984 was reasonable. The increase in prices in the coming period would probably be modest, and real interest rates would therefore be positive.

Decisions on energy policy were based on highly technical factors as well as economic ones, Mr. Zhang noted. The Government's pricing proposal had been fully supported by expert advice, which the Executive Board should respect. As for the staff's economic arguments, the concept of bringing domestic prices in line with the price in the world market was of doubtful value; it was imprecise and was not necessarily the most satisfactory solution in all circumstances. The staff should perhaps accept the view of the authorities on energy policy in Romania.

It was clear that flexibility and compromise would be needed if the joint studies were to be completed quickly, Mr. Zhang commented, and he hoped that the staff would make every effort in that direction. The authorities had gone a long way under the stand-by arrangement toward meeting the Fund's requirements. Their record of policy implementation was excellent, and it was important for the Fund to avoid giving the impression that a member country would always be asked to do more simply because it had already succeeded in doing a great deal. It was also important to remember that Romania was a planned economy whose policy objectives and institutional framework were quite different from those of market-oriented economies. Many policy recommendations based on market economy models and known to be effective in market economies were not readily applicable to a planned economy like Romania's. The Fund should refrain from insisting that market-oriented policies be applied in nonmarket economies. When seen in historical perspective, the Romanian authorities' gradual approach was clearly appropriate. Finally, experience suggested that it might not be advisable to include joint studies in future stand-by arrangements with other countries; while they helped to solve problems in one period, they tended to create more and larger problems--including the introduction of new conditions--later on.

Mr. Connors considered that the authorities were to be commended for the progress made in improving the external financial position since 1981. The current account of the balance of payments had had to be shifted into surplus rapidly in order to cope with the sharp deterioration in the capital account. Unfortunately, the move had been achieved largely through cuts in imports; exports had been weak. The present level of imports was clearly incompatible with an acceptable rate of economic growth over time. The authorities would have to maintain their adjustment efforts so that a balance of payments position consistent with timely debt service and acceptable import levels could be achieved.

The authorities had already made a number of important policy adjustments under the stand-by arrangement, Mr. Connors continued. The commercial exchange rate had been unified, and the commercial and noncommercial exchange rates were to be unified in 1984. In addition, the exchange rate had been adjusted to make it less uncompetitive, and moderate steps had been taken to rationalize some important prices in the economy, especially energy prices. The authorities had made some progress in 1982 both in adjusting interest rates toward positive real levels, and in implementing restrained monetary and fiscal policies, which, together with the restrictive wage policy, had enabled them to reduce domestic demand by the large amount that was required because of the external constraint. All the policy actions that he had mentioned had undoubtedly been difficult, but they had been needed to achieve the desired adjustment.

The staff report clearly showed, Mr. Connors went on, that substantial additional actions in the exchange rate, interest rate, and pricing areas were needed to maintain the adjustment effort. The authorities and the staff should therefore agree quickly on the remaining outstanding issues.

He broadly supported the staff positions on the remaining issues, Mr. Connors concluded. A further devaluation was warranted sooner rather than later, particularly in the light of the significant decline in Romania's export market shares. As for energy prices in Romania, they were relatively low by international standards despite the recent large increases in percentage terms. Tables 14 and 15 showed that, even under the staff proposals, there would be a significant gap between domestic and international prices for oil and gas. In that connection, the assumptions regarding the exchange rate were of course significant, and the importance that should be attached to flexible pricing should be emphasized; the effects of exchange rate changes had to be reflected in domestic prices if the exchange rate adjustments were to be effective. Further price adjustments would be needed in the coming period. As for interest rates, he shared the staff's doubts about the official inflation forecast and agreed that nominal interest rates should be raised to ensure that real interest rates did not become negative. His authorities attached importance to a resolution of the differences between the staff and the authorities as quickly as possible. The proposed decision was acceptable.

Mr. Taylor said that he agreed with the staff appraisal and accepted the proposed decision. The authorities were to be commended for having achieved such a large turnaround in the convertible currency account in the previous 18 months, and their commitment to seeking further improvement in the account during the coming five years in order to reduce the heavy external debt to the convertible currency area was welcome.

Nevertheless, Mr. Taylor continued, he shared the staff's reservations about the economy's ability to achieve the ambitious targets on the basis of present policies, which seemed to rely heavily on administrative controls and import cuts. Those expedients were not a satisfactory substitute for structural adjustment designed to overcome the present difficulties and to achieve a viable economic position in the longer run.

The implementation of the required measures would not be made easier as long as the authorities maintained what seemed to be fairly ambitious growth targets, Mr. Taylor remarked. GDP growth in excess of 3 percent was expected in 1983 as a result of increases in consumption and overall investment. The rapid growth had been made possible by a rundown of stocks, an unrealistic exchange rate, and interest rate and wage policies that had channeled resources from the export sector to the domestic market. The increasing uncompetitiveness of exports and the curtailment of imports to meet the convertible trade balance target were likely to prove unsustainable, particularly if shortages of inputs for industry further weakened the already weak export performance. In the circumstances, more decisive action was needed to reverse the underlying trends. The authorities should be encouraged to implement on an urgent basis policies designed to restore the competitiveness of exports, dampen domestic demand somewhat, and enhance the efficiency of resource allocation. They had already increased interest rates, devalued the leu, reduced budget subsidies, raised certain prices--particularly of energy inputs--and improved industrial efficiency by placing somewhat greater emphasis on profitability. Moreover, the measures agreed in the special study on the costing of capital were to be implemented. Those steps were welcome, but he agreed with the staff that they were probably not sufficient to generate the desired gains in productivity, competitiveness, and exports.

Genuine efforts had been made by the authorities to look at those issues with the staff, but it was regrettable that agreement had not been reached on important aspects of the three other special studies, particularly the study on exchange rate policy.

He was inclined to agree with the staff, Mr. Taylor said, that the overvalued leu was an important factor in the poor export performance. Difficult trading conditions could hardly account fully for the 10 percent decline in non-oil exports and the loss of market shares in 1982. The loss of competitiveness in the previous 12 months or so probably could be reversed only by a further significant depreciation. Although a steep devaluation caused transitional problems, the difficulties with which the devaluation was designed to deal could only worsen if exchange rate action were further postponed. If the authorities could maintain export competitiveness, the need for periodic step devaluations would be reduced. Meanwhile, the aim of eliminating the margin between the commercial and noncommercial exchange rates by July 1984 was welcome.

Unfortunately, Mr. Taylor continued, the authorities had felt unable to increase interest rates further after July 1983, despite their undertaking to do so. Although a decline in inflation might eventually make interest rates positive in real terms, the present underpricing of capital constituted a major distortion within the economy that should be corrected at an early stage, thereby helping to establish a more rational basis for decisions on saving and investment.

The authorities' continuing commitment to raise domestic energy prices toward world levels was also welcome, Mr. Taylor said, but their efforts seemed to be falling short. There were admittedly some difficult policy questions in the pricing field, but on balance he accepted the staff's view that, given the program's main objective of correcting the balance of payments in the short and medium term, Romania's natural gas was underpriced. The underpricing of gas and oil seemed incompatible with an effective energy conservation policy and could hinder the improvement of efficiency in the refining industries, something that was essential if Romania's international competitiveness in that sector was to be maintained.

The authorities' reluctance to implement a number of the staff recommendations was, to some extent, understandable, Mr. Taylor commented, as the measures would probably increase the rate of inflation in the short run. However, the short-term disadvantage would be outweighed by the subsequent improvement in resource allocation that would pave the way for achieving a more sustainable economic position in the longer run. Reaching understandings on the various aspects of the special study areas would be an important feature of the next stage of the stand-by arrangement. The need for structural reform was underscored by the weakness of the capital account of the balance of payments, which was projected to come under pressure again in the mid-1980s. It would therefore be important for the authorities to do everything possible to restore the confidence of official and commercial creditors.

They would have to be convinced of the viability of Romania's external position before the country's access to the international capital markets could be re-established. The authorities hoped to eliminate the large current account surplus with the nonconvertible area in the remaining months of 1983 in order to foster the adjustment effort vis-à-vis the convertible area. That priority was an important one, and he hoped that the authorities would take steps soon to achieve it.

Mr. Lovato considered that the magnitude and speed of the adjustment of the convertible current account--amounting to more than 6 percent of GDP in some three years--was remarkable by international standards. Nevertheless, it had not been sufficient to eliminate the overall payments imbalance, and international reserves had increased only slightly while payments arrears had been built up during 1982, when major rescheduling agreements with official creditors and commercial banks had been reached. Romania had been seriously affected by the "domino effect" of the global debt crisis; as a result of the debt problems in its region, Romania had been virtually cut off from international financial markets, and there had been a dramatic deterioration in the capital account.

During the previous review of Romania's performance under the stand-by arrangement, Mr. Lovato recalled, he had noted that, while exports had declined in 1982, imports had fallen to very low levels. The import cutbacks, achieved through administrative devices and restraint in domestic absorption, had not caused unduly severe shortages and dislocations in domestic production. Apparently the import component of domestic output had been reduced through import substitution, increasingly efficient production planning, some reorientation of the structure of domestic output toward less import-intensive industries, and possibly other factors. In striking a note of caution, he had asked the staff to assess the scope for further import savings, and he had wondered whether the staff's trade and output projections were realistic. The staff had said that exports would decline again in 1983, and that if the non-oil trade surplus target for 1983 was to be met, non-oil imports would have to rise by no more than 5 percent in value terms; the implied volume growth was zero or negative on the basis of reasonable price assumptions. Was the staff projection consistent with the GDP growth forecast of 3 percent to 3.8 per cent?

The authorities recognized, Mr. Lovato remarked, that if any reasonable medium-term scenario for Romania's external position was to prove to be accurate, the export performance would have to be strong. If reserves were to be increased and the external debt was to be reduced through the 1980s, as the authorities wished, export growth would have to be accelerated, and policies designed for that purpose would have to be implemented. In that connection, Romania's policy record was fairly good. The authorities had overhauled the exchange rate system by unifying the commercial rates, adopting a currency basket, and devaluing the reference rates. The staff had correctly concluded that there was ample evidence of a sizable deterioration in Romania's competitive position. On the other hand, the authorities' gradualist approach to manipulating the exchange rate seemed to be a sensible one, particularly in the light of the extensive institutional changes that had been made and given the other measures that were to be taken to improve cost efficiency and competitiveness in the export sector. The policy of wage restraint was to be maintained well into 1983/84. Pricing policy for energy inputs was designed to promote domestic supply and to restrain consumption, and the emphasis on productivity and product quality had been improved. As for the issue of crude oil and natural gas prices in particular, the rapid domestic price adjustments in recent years suggested that Romania was clearly committed to efficient energy use. It was difficult to draw firm conclusions about the staff recommendations.

Commenting on interest rates in Romania, Mr. Lovato said that he greatly sympathized with Mr. Polak. A strong case could be made against applying textbook solutions to individual countries, especially developing and centrally planned countries. Some of the arguments had been developed at length during the Executive Board's seminar discussion on interest rate policies. He was surprised that the staff study on interest rates in Romania had concluded merely that a "further early upward adjustment of interest rates is required to ensure that resource allocation benefits from positive real rates." The proposed decisions were acceptable.

Mr. Joyce considered that the staff report contained a useful summary of the strengths and weaknesses of the Romanian adjustment effort to date. The authorities were to be congratulated for their determination in implementing adjustment policies and for their flexibility during the recent discussions with the staff. However, the concerns expressed by the staff were indicative of the reasons why many members of the international financial community continued to regard the outlook for the Romanian economy with caution despite the dramatic turnaround in the balance of payments position, particularly in the convertible current account. The latest information suggested that the target for the current account in 1983 of a surplus of $800 million would probably be achieved. Unfortunately, the success story of Romania had a worrisome aspect: the surplus had resulted from import compression rather than from export growth, as originally projected, although the precise extent to which that had happened was difficult to determine because the changes in imports had been calculated in terms of U.S. dollars and the trade figures for Romania had been affected by the strengthening of the U.S. dollar. The staff or the authorities could have usefully provided estimates of the volume changes in imports and exports and a fuller explanation of the nature of the changes. For instance, it was important to understand that the decline in food imports had been made possible by the good harvest in Romania and had not been caused by a shortage of foreign exchange. A similar analysis of the oil trade would have been helpful. Nevertheless, he continued to worry about the sustainability over the medium term of the improvement in the external accounts, particularly because of the likely need for a higher level of imports for the domestic economy and for the further development of exports.

The authorities were to be commended for having met all the performance criteria for end-June 1983, Mr. Joyce remarked, but he had hoped that the present discussion would pave the way for further purchases in the period after July 31, 1983. He was concerned about the present status of the program and about the chances of reconciling the differences of view between the authorities and the staff in the near future. A large measure of agreement had been reached on the costing of capital, but significant differences remained in the areas of the exchange rate, energy prices, and interest rates.

He agreed with the authorities, Mr. Joyce continued, that the devaluation of January 1983 and the unification of the commercial exchange rate were important steps and that their full effects remained to be seen. However, the staff's arguments on the exchange rate were persuasive. Romania's competitive position had been deteriorating since 1981, and he did not share the authorities' optimism about the likely effects on productivity of the administered measures alone. On balance, the staff was probably correct in concluding that, at the present juncture, a further devaluation would help improve Romania's competitive position.

He agreed with Mr. Polak that the issue of energy prices, and especially the domestic price for natural gas, was complicated, Mr. Joyce commented. It was true that the authorities had already increased domestic natural gas prices substantially, and that a sharp escalation in household heating bills would be particularly onerous. Legitimate differences of opinion on such matters could certainly exist, and the staff should explore with the authorities other measures that could produce the desired budgetary and balance of payments results.

The authorities felt, Mr. Joyce noted, that interest rates would soon become positive in real terms, but the staff believed that a further rise in nominal rates was needed to encourage savings and to increase the efficiency of investment decisions. He sympathized with the staff. The staff report did not contain an explicit indication whether the different points of view were likely to be reconciled shortly.

It would be useful to know more about the likelihood that agreement would be reached on the unresolved issues, Mr. Joyce said, and to have some idea when the review might be completed. Executive Directors--and undoubtedly the Romanian authorities themselves--attached great importance to keeping the adjustment program on track. It was essential for Romania to place itself quickly in a position to be able to make the scheduled purchases, especially given the country's foreign exchange position.

The case of Romania raised questions about the kinds of adjustments that were appropriate for centrally planned economies, Mr. Joyce remarked. Previous discussions had shown that defining appropriate and useful mechanisms of economic management for centrally planned economies and judging their effectiveness were particularly difficult. The staff discussion of the differing views on the importance of interest rates, the role to be played by price adjustments, the costing of capital, appropriate measures for encouraging productivity, and the use of trade restrictions, including countertrade requirements, formed part of the slow process in the Fund of learning which policies were desirable and workable in nonmarket economies. The outcome of that process would have a significant impact on the Fund's future relations with centrally planned economies, which would continue to be a major factor in the economy of the world. While he generally agreed with many of the staff recommendations, which were designed mainly to increase the country's dependence on market forces, he appreciated that there were limits on the political feasibility of introducing market-oriented measures in centrally planned economies. He hoped that the process of understanding and defining the role of the Fund in centrally planned economies would continue in the coming period. He looked forward to an early and successful completion of the review with the Romanian authorities, so that the country could make further drawings under the stand-by arrangement.

Mr. Grosche considered that the authorities were to be commended for having met all the performance criteria and for having eliminated all the payments arrears. However, the fact that a member had met all the performance criteria did not mean that its economy was back on the right track. Romania had after all achieved the substantial improvement in its current account position only by sharply curtailing imports, particularly imports of investment goods. Mr. Polak had usefully noted that market-oriented economic policy tools, especially interest rates, prices and profits, played a less important role in planned economies than in market ones, but, on balance, he tended to agree with the staff's views on the need for further steps in those particular areas.

Commenting on exchange rate policy, Mr. Grosche said that the export performance had been disappointing: total exports to the convertible currency area had fallen by 8.5 percent in the first six months of 1983, compared with a decline of only 7.6 percent in the first five months of 1982. He agreed with the staff that a further devaluation would help to improve international competitiveness, thereby reversing the declining trend in exports.

Interest rate policy was a particularly sensitive issue in Romania, Mr. Grosche remarked. Mr. Polak had suggested that interest costs in a socialist economy should be roughly of the same order of magnitude as the underlying rate of inflation. However, because of discretionary price control, he doubted whether the underlying rate of inflation in

Romania would be as low as the actual rate of price increases, and he continued to believe that positive real interest rates were of more than marginal importance in the effort to improve resource allocation in a socialist economy.

Mr. Polak's position on natural gas prices in Romania was convincing, Mr. Grosche said. The authorities had expressed their willingness to increase the domestic oil price up to lei 2,000 per ton in July 1984. Had the staff meant to say that that price would not sufficiently close the gap between domestic and world price levels? Like Mr. Joyce, he wished to know more about the likelihood that the different views of the authorities and the staff could be reconciled in the near future. Finally, he broadly agreed with the staff appraisal and accepted the proposed decision.

Mr. Prowse considered that large and valuable changes had been made in the structure of the Romanian economy and that the achievements in short-term economic stabilization had been remarkable. For instance, real wages had been cut by 7.4 percent in 1982, a budget surplus equivalent to 2.5 percent of GDP had been reported, the payments arrears had been eliminated, all performance criteria had been met, and, as a result, further purchases under the stand-by arrangement would probably be made in due course. Successful completion of the stand-by arrangement would be important not only for Romania itself, but also for the Fund; it would add to the understanding of the adjustments that could be supported in planned economies.

The authorities, Mr. Prowse noted, had succeeded in recording a budget surplus, tightening monetary policy, slowing the growth of domestic demand, and improving the external current account, and they had devalued the leu twice. Of the unresolved issues, the most important was the exchange rate. The staff had usefully proposed that the balance of payments targets should be in volume terms rather than local currency terms. The staff had expressed reservations about the usefulness of measures of real exchange rates, and any agreement with the authorities would have to recognize that such measures could not be fully precise and were always subject to qualification. The staff should also recognize that a further devaluation would affect domestic prices and real incomes, and should bear in mind that wages had already been reduced.

Debate on the appropriate approach for streamlining exports was common to a number of countries, particularly some industrial ones, Mr. Prowse remarked. Korea had maintained the same kind of approach that the Romanian authorities favored, and, although the staff had been pessimistic, the policy had worked: exports had grown rapidly, and the rest of the economy had benefited from the relatively strong currency. Hence, the exchange rate was an area in which various reasonable views could be maintained at any given time. Still, he tended to agree with the staff that a further adjustment of the exchange rate in Romania would be beneficial, and it was on that topic that further discussions with the authorities should be focused.

Commenting on interest rate policy in Romania, Mr. Prowse said that the important issue was the cost of capital that was factored into investment decisions. The basic rule that Mr. Polak had endorsed--that the cost of capital should be broadly in line with the underlying rate of inflation, however measured--was probably a useful point of departure. For the reasons given by Mr. Polak, and from the evidence in the staff report, domestic savings would not necessarily respond significantly to increases in interest rates. It was the investment side of interest rate policy that was important, and Mr. Polak's rule was probably satisfactory for the present. The further discussions on interest rates in Romania should not be seen as sufficiently important to affect the decision whether or not the country should be permitted to make further purchases under the stand-by arrangement. Similarly, given the complexity of the matter of energy prices in Romania and the reasonable argument made by the authorities, the issue of natural gas prices in the coming relatively brief period should not hold up agreement on further purchases under the stand-by arrangement.

A review under a stand-by arrangement with a country that had met all the performance criteria should not necessarily be used to impose major policy adjustments that had not been previously planned by the authorities concerned, Mr. Prowse considered. At the same time, it was important for the Romanian authorities to restore the country's access to the international capital markets. To do so, they must acknowledge the perceptions of the markets and introduce policy adjustments designed to restore confidence; in that connection, domestic interest rates would have to be taken into account. Like Mr. Joyce, he hoped that the adjustment program would proceed more or less on schedule and would not be halted by debate on issues on which differing views could reasonably be held, namely, interest rates and energy pricing. On the other hand, the staff had made a strong argument in support of its position on the exchange rate for the leu.

Mr. Malhotra remarked that he broadly agreed with Mr. Zhang. He also agreed with Mr. Prowse that future discussions with the authorities should not overplay the issue of interest rates, as they were not crucial to the achievement of the program objectives. Mr. Polak's comments on energy pricing in Romania were useful, and that matter too need not be pressed during the coming discussions with the authorities. As for the exchange rate, there seemed to be a genuine difference of opinion between the staff and the authorities. The currency had been devalued by 17 percent in December 1982, and although exports subsequently had not increased significantly, it was moot whether an even larger devaluation would have given the desired results. There were problems with respect to demand in the convertible currency area, and judgments on such exchange matters were usually fine ones. Still, he was inclined to feel much less positive about the matter than Mr. Prowse, and he would agree with Mr. Zhang's comments. In his opening statement, Mr. Polak had explained that the Romanian authorities were prepared to discuss various approaches to increasing exports. The staff should not be preoccupied with any particular policy instrument, especially in the light of the slack demand in the convertible currency markets.

The staff representative from the European Department said that he had noted the comments by Mr. Polak and other Directors on the subject of energy pricing, and on natural gas pricing in particular; he agreed that it was an extremely complex issue. It turned in part on difficult technical questions concerning the precise calorific content of different fuels, on the possibilities of substituting one fuel for another, and the cost of such substitution. The staff agreed that for natural gas, unlike oil, it could not be said that there was a single world market price; certain member countries had adopted a variety of different pricing policies. The staff also recognized the sensitive social considerations that were inevitably involved in energy pricing decisions, and it would continue to explore those issues with the authorities while bearing in mind the comments made by Executive Directors. It would be difficult to formulate optimal policy proposals, but the staff attached importance to continuing to pursue policies that would foster energy conservation. In that context, a progressive movement of domestic energy prices toward comparable world levels--a policy that the Romanian authorities endorsed--remained relevant.

The lack of demand had admittedly been an important factor in the decline in convertible non-oil exports, the staff representative continued. However, the data in the staff reports clearly showed that there had been a decline in Romania's export market shares, a development that was worrying. There had also been temporary or special factors, such as the appreciation of the U.S. dollar--which had reduced export prices in terms of dollars by 2 percent in the first five months of 1983 compared with the same period in 1982--and the prohibition of unprofitable refining for export. Nevertheless, the staff continued to believe that a devaluation was needed to counter the decline in non-oil exports, which had accelerated in July 1983. The staff had been unable to measure the elasticity of exports, because it did not have data on export unit values or on exports in volume terms. The staff had explained to the authorities that such data were important for gaining a better understanding of the country's export performance.

A devaluation would have an unavoidable effect on import prices, the staff representative went on. As imports represented about one quarter of GDP, devaluation would raise the rate of inflation in the short run.

It was true, the staff representative remarked, that the nonconvertible current account of the balance of payments had shown a large surplus in 1983, rather than the deficit that had been expected. However, there had been a turnaround in July 1983, when a deficit on the nonconvertible trade account had been recorded, suggesting that the account was moving in the right direction.

Commenting on the prospects for further import substitution, the staff representative said that, as Mr. Polak had noted, replacing crude oil imports with domestic natural gas could have a considerable impact. The various efficiency measures that the authorities had introduced would undoubtedly also have an effect on the import side, as they should reduce the amount of energy and other inputs required for each unit of domestic production.

The question had been raised, the staff representative recalled, whether the projected rate of increase in GDP was consistent with the decline in non-oil imports in the first half of 1983. According to the official data, industrial production in the first half of 1983 had risen by 4-5 percent. On the other hand, given the recent developments in imports, the staff might wish to revise the GDP growth projection further downward.

The staff would have Executive Directors' comments in mind during the discussions with the authorities at the 1983 Annual Meeting, the staff representative said. A staff mission would probably visit Romania some time after the Meeting to complete the work on the joint studies. The staff would make every effort to reach an agreement on the outstanding issues as quickly as possible, but it could not say for certain when agreement would be reached.

The increase in the price of crude oil to lei 2,000 per ton, which the Romanian authorities were prepared to make on July 1, 1984, would leave a gap between the domestic and world prices of two thirds at the present exchange rate, the staff representative explained. If the authorities devalued by the amount that the staff had suggested, the domestic price would still be about half of the world price.

He agreed with Mr. Prowse, the staff representative from the European Department concluded, that measuring the real effective exchange rate in a planned economy was difficult because prices were set below market-clearing levels, thereby raising doubts about the accuracy of international price comparisons. The staff fully agreed with Executive Directors who considered that exchange rate action was one of the most important suggestions that the staff had made as a condition for further drawings under the stand-by arrangement. Demand would be an important factor in the desired pickup in non-oil exports, but the considerable loss of market shares and the increasingly rapid fall in non-oil exports during the previous several months also had to be taken into account.

Mr. Polak said that he was encouraged by the discussion in the Executive Board. Every effort should be made, beginning at the 1983 Annual Meeting, to bring the Romanian authorities and the staff into agreement so that the stand-by arrangement could be reactivated. Such an outcome should be possible if the parties concerned did not adopt unduly rigid positions.

The Chairman made the following summing up:

Executive Directors commended Romania for the major turnaround in its convertible current account position between 1980 and 1982 and the continuation of this trend in the first half of 1983. They noted, however, that, given the poor export performance, the improvement had mainly been achieved by a curtailment of imports and had not led to a significant increase in international reserves despite substantial debt rescheduling and use of Fund resources.

Directors generally agreed with the thrust of the economic policies designed to bring about further improvement of the convertible current account in 1983. These policies include not only continued restraint in fiscal and wage policy and a tightening of monetary policy but also measures to improve the efficiency of resource allocation, including two devaluations of the leu, the unification of the commercial exchange rate system, sharp increases in the price of crude oil and natural gas, increases in interest rates, and more recently a longer-term program to improve efficiency in industry. Most Directors were of the view, however, that in view of the remaining substantial distortions in the relative prices of energy, capital, and imports and the recent sharp decline in convertible non-oil exports, the structural price reform measures and removal of controls need to be more far-reaching than the authorities currently envisaged. They felt that more extensive measures in these fields were needed; without them, there is the risk of continued undue restraint on imports with negative implications for economic growth and, given also the unfavorable capital account outlook, the risk of a considerable shortfall from the envisaged increase in reserves in 1983.

With reference to the four joint studies, Directors noted with considerable interest the degree of agreement between the Romanian authorities and the staff on a number of points as well as the remaining differences in positions on other points. Directors welcomed the preparedness of the Romanian authorities to introduce in 1984 further increases in the cost of capital and in domestic energy prices and to eliminate by mid-1984 the margin between the commercial and noncommercial rates of exchange. Most Directors felt, however, that further basic adjustments were needed to ensure a viable balance of payments position in the medium term. It was noted that the real effective exchange rate of the leu remained significantly appreciated relative to its level in early 1981. Although a few Directors were in favor of a more gradual approach to this problem, most Directors pointed out that the present lack of competitiveness, reflected in particular in the declining export shares of Romania, significantly hampered the export performance of that country, and that a further significant devaluation was in their view needed and would supplement the authorities' program to improve efficiency. They stressed the need for a continued strategy to maximize domestic energy production and reduce energy consumption, in which an appropriate pricing policy would play an important part. The difficulty in establishing an appropriate price for natural gas highlighted the need for careful further consideration of this issue. Some Directors also believed that further increases in interest rates up to real positive levels were needed to ensure a better allocation of capital; other Directors took the view that in the Romanian circumstances present levels of lending rates are broadly adequate for that purpose, while interest rates are of little relevance to the level of savings.

Most Directors agreed that, in view of the prospective rise in debt repayments in the mid-1980s, a sustained adjustment effort was indispensable. In that context, Directors stressed the desirability of the continuation of the financial arrangement between the Fund and Romania and the need to reach new understandings on the occasion of the next review of the arrangement. The continuation of the dialogue between the staff and Romania to eliminate remaining differences on important policy issues was considered urgent in the view of some Directors.

It is expected that the next Article IV consultation with Romania will take place on the standard 12-month cycle.

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

The decision was:

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

2. The Fund notes that the exchange system of Romania involves comprehensive restrictions on payments and transfers for current international transactions and a multiple currency practice as described in the 1983 recent economic developments paper (SM/83/195, 8/24/83). The Fund welcomes the elimination of the external payments arrears outstanding as of the end of 1982. The Fund also welcomes the unification of the commercial exchange rate system on July 1, 1983 and the intention of Romania to eliminate the remaining multiple currency practice subject to approval under Article VIII by no later than July 1, 1984. Accordingly, the Fund grants approval

for the maintenance by Romania of the multiple currency practice as set forth in SM/83/195 (8/24/83) until July 1, 1984 or the completion of the 1984 Article IV consultation, whichever is earlier. The Fund encourages Romania to continue its efforts to reduce reliance on bilateral payments agreements with Fund members and welcomes its progress to date in this area.

Decision No. 7526-(83/140), adopted
September 14, 1983

4. COMPENSATORY FINANCING FACILITY - REQUIREMENT OF COOPERATION - GUIDELINES

The Executive Directors considered a redraft (EBS/83/171, Sup. 1, 9/12/83) of the guidelines on cooperation under the compensatory financing facility based on the discussion at EBM/83/130 and EBM/83/131 (9/6/83).

Mr. Malhotra recalled that during the previous discussion he had asked the staff to provide information on the number of defaults in repurchase obligations under the compensatory financing facility and on the number of cases in which new arrangements with members had to be negotiated in order to place them in a position to make repurchases under the facility. His contention was that unless there were strong evidence showing that the Fund's resources had been placed in jeopardy by the existing guidelines governing the use of the facility, there was no reason to make fundamental changes in them. His authorities felt very strongly about the staff proposals, and it was difficult for him to proceed until the information that he had asked for was available.

The staff representative from the Research Department said that there had been no cases of formal default. There had been delays in repurchases because of difficulties encountered by members at the time repurchases fell due. Virtually all the member countries that had made drawings under the compensatory financing facility had also made drawings under other Fund facilities and policies. Countries that had delayed making repurchases in respect of purchases under the compensatory financing facility had also delayed making purchases under other facilities, including the conditional facilities. Hence, the repurchase problem had been a general one; it had not been confined to the compensatory financing facility.

Mr. Ismael remarked that he had three general impressions of the proposed guidelines. First, the distinction between the upper and lower tranches of the compensatory financing facility would become blurred because the Fund could require a member to change its policies in order to qualify for a drawing whether above or below 50 percent of quota. Second, the guidelines constituted a tightening of conditionality that was inconsistent with the objectives of compensatory financing. Third, the guidelines would introduce conditionality on upper tranche compensatory financing that was similar to the conditionality under stand-by arrangements; that change constituted a departure from past policies and was inconsistent with the spirit of the decision on the compensatory financing facility. For those reasons, he had difficulty in supporting the proposed guidelines.

The intention of portions of the text was unclear to him, Mr. Ismael continued. For instance, did the words "willingness to receive Fund missions" in the text of the requirement of cooperation for the lower compensatory financing tranche mean that missions would be required in all cases involving requests below 50 percent? If the answer was yes, he wondered whether the change would not result in practice in a tightening of the conditions on the use of compensatory financing below 50 percent. Indeed, such drawings had traditionally not been subject to conditions. Under the proposed guidelines, however, a country might be required to make policy changes before submitting a request for a drawing below 50 percent. Under the present practice, a member was required only to submit a statement that it would cooperate with the Fund in seeking appropriate solutions to its balance of payments problems. He doubted whether requiring a country to make policy changes to qualify for a purchase below 50 percent was consistent with established policy and practice.

Commenting on the interpretation of the test of cooperation for drawings above 50 percent of quota under the compensatory financing facility, Mr. Ismael noted that in cases in which a member country faced balance of payments difficulties, the Fund had to be satisfied that the country had been cooperating in an effort to find appropriate solutions to the difficulties. How would the Fund handle cases in which there was disagreement between the member and the staff about what constituted "appropriate solutions"? In a case involving one of his countries that had been interested in drawing above 50 percent of quota, the country's export shortfall had been temporary, and the staff had projected a marked improvement in the balance of payments position in the medium term. However, the staff had insisted that the exchange rate be devalued, while the authorities had maintained that the rate was appropriate. As was widely known, the usefulness of exchange rate policy in developing countries was debatable. In cases involving disagreements between the staff and the authorities about the appropriateness of particular policies, the country should be given the benefit of the doubt.

The words "a satisfactory balance of payments position" in the first sentence of the text on drawings above 50 percent could be subject to various interpretations, Mr. Ismael considered, depending on the circumstances at a particular time, and the time horizon of the interpreter. In any event, in all cases in which the balance of payments deficit of a country was of roughly the same order of magnitude as its export shortfall, the member should not be required to undertake any policy changes in order to meet the test of cooperation; in those cases, the test should be presumed to have been met. That point should be clearly stated in the text.

The conditions governing purchases below 50 percent should remain unchanged, Mr. Ismael stated. Conditionality would be appropriately applied only for drawings above 50 percent and if the balance of payments deficit was far in excess of the export shortfall and was clearly due to inappropriate policies of the member country.

Mr. Erb commented that, while the language of the proposed text was not as precise as he would have wished, he was prepared to go along with it. The text was the result of an extensive discussion by the Executive Board and reflected a strong majority view. The Executive Board should approve the proposed guidelines forthwith.

Mr. Laske considered that the proposed text reflected the outcome of the previous discussion and should be adopted at the present meeting.

Mr. Polak said that the revised text on drawings below 50 percent constituted an improvement over the uncertainty that had existed about the subject in recent months. The new text would assure members whose policies were not seriously deficient of virtually automatic access to the compensatory financing facility, provided that the technical conditions for such access were met. Article IV consultations were an important occasion on which the Fund could arrive at a view on the quality of a member's policies, and the new text of the guidelines should have some implications for the conduct of the consultations. In particular, in expressing their views on the consultations, Executive Directors should be careful to avoid presenting suggestions for possible policy improvements in a way that could leave the impression that there was a serious deficiency in those policies, when such a deficiency did not actually exist.

For countries that did have seriously deficient policies, the proposed language provided as much certainty of treatment of their requests for compensatory financing as he would have wished, Mr. Polak commented. It did at least establish a general guideline, namely, that the member must take action of a kind that "gives a reasonable assurance that policies corrective of the member's balance of payments problem will be adopted." The meaning of that text was not very precise, but it was sufficiently precise to establish a distinction between compensatory financing conditionality for countries with seriously deficient policies and the more rigorous conditionality that such countries would have to meet for purchases above 50 percent of quota: the text in question, and particularly the reference to "reasonable" assurance, and to "policies corrective of the member's balance of payments," had been carefully chosen to make that distinction, and the text on purchases below 50 percent was therefore acceptable. The guideline for purchases above 50 percent was also satisfactory, particularly the inclusion of the word "broadly" before "satisfactory performance" in the second sentence.

Mr. Kafka stated that, for the reasons that he had put forward during the previous discussion, he shared the doubts and concerns expressed by Mr. Ismael.

Mr. Alfidja said that he too agreed with Mr. Ismael; he was opposed to the proposed text.

Mr. Hirao considered that the revised text would provide useful guidelines for dealing with requests to use the compensatory financing facility. The text reflected the previous discussion and should be approved.

Mr. Taylor said that he could go along with the revised text, which represented a useful clarification of conditionality under the test of cooperation but left a reasonable degree of flexibility and adjustment for the Fund.

Mr. Alhaimus remarked that the revised text obviously was not much different from the previous draft. Thus, Directors would have to go back to the essence of the exercise. He continued to doubt whether there was any need to codify the guidelines on cooperation. Judging from the present draft, it seemed to him that the objective of such a codification was to tighten conditionality rather than ensure a more efficient working of the important facility.

Mr. Wang said that he fully agreed with Mr. Ismael.

Mr. Joyce considered that the proposed text was an accurate reflection of the suggestions that had been accepted during the previous discussion and should be approved.

Mr. Lindå and Mr. Lovato stated that the proposed text was acceptable.

Mr. Toro said that he agreed with Mr. Ismael.

Mr. Prowse recalled that he had consistently had difficulty in accepting the need for guidelines. The decision on compensatory financing was clearly written, and the proposed guidelines seemed to represent an extension of that decision. The previous draft guidelines had made no significant distinction between the upper and lower credit tranches and had been inconsistent with the decision on compensatory financing. The revised draft had been modified in significant ways. He agreed with Mr. Polak that the addition of the words "serious deficiency" was important. In addition, the use of the word "corrective" instead of "for correction of the balance of payments" was probably significant because it presumably meant that partial correction, rather than full correction, would be acceptable, thereby helping to establish a distinction between drawings above 50 percent and below 50 percent. Despite that improvement, the proposed guidelines would have significant implications for compensatory financing, which was meant to be immediately available to qualifying member countries. If the original decision on compensatory financing had intended that an elaboration such as the one proposed should be made, the text of the decision would have clearly said so.

He assumed, Mr. Prowse went on, that lack of cooperation in the past would not be an obstacle to the approval of a request for compensatory financing below 50 percent of quota if the country's current policies were appropriate. He wondered whether the previous discussion had provided a sufficiently clear idea of what cooperation would consist of. Would a disagreement between the country and the Fund about the country's policy stance constitute a lack of cooperation? Were there any technical developments that might constitute a lack of cooperation? For instance, if a country had not made a repurchase or other payment on time, would it be seen as having failed to cooperate in the context of the proposed guideline on use of the lower tranche of the compensatory financing facility? The general principles that applied to the use of all Fund resources seemed to make it unnecessary to spell out guidelines for a particular facility. Hence, the second part of the guideline for purchases below 50 percent under the compensatory financing facility seemed unnecessary. Further clarification of the concept of cooperation in the future would be useful.

Mr. Delgadillo said that his position on the guidelines for compensatory financing remained unchanged.

Mr. Suraisry considered that the guideline for purchases below 50 percent of quota reduced the difference between the two texts. The text of the guideline for purchases below 50 percent was unacceptable, although he could go along with that text for purchases over 50 percent.

Mr. Malhotra said that he continued to feel strongly that changes in guidelines were unnecessary and that the proposed text should not be adopted. If it were, the circumstances in which the guidelines were to be applied should be clearly understood. From the beginning of the debate on the guidelines, Mr. Erb had taken the position that the guidelines should be applied in cases in which an export shortfall was part of a much larger payments imbalance. The text for purchases below 50 percent would be clearer if the first part of the second sentence was changed to read: "Where the payments imbalance goes well beyond the impact of the export shortfall, and where the Fund considers that the existing policies of the member in dealing with its balance of payments difficulties are seriously deficient...."

In the same sentence, Mr. Malhotra went on, the word "or" should be replaced by "and." The use of the word "or" was worrying, because it meant that a member would be expected to take prior action if its existing policies were thought to be seriously deficient or its record of cooperation in the recent past had been unsatisfactory. That outcome apparently was not the intention of speakers who had addressed the matter during previous discussions. Their aim had been to ensure that the guideline for drawings below 50 percent would be applied when a member's export shortfall was embedded in a much larger balance of payments problem. The proposed text contained a tautology: the test of cooperation was whether or not the country had been cooperating. It would be advisable to revise the text in question.

In the text of the previous paper on the subject, Mr. Malhotra recalled, it had been stated that: "Where the payments problem is solely the result of a reversible export shortfall, there is of course no need for policy changes, whether the member requests more or less than 50 percent of quota." That explanation should be part of the proposed guidelines themselves; however, the word "solely" should be replaced by "mainly" to cover other circumstances. That text would be consistent with the majority view in the Executive Board.

Mr. Camara said that, for the reasons that he had stated on previous occasions, the proposed guidelines were not acceptable.

Mr. Agah commented that he wished to associate himself with Mr. Ismael.

The Director of the Legal Department said that the words "in the recent past" in the second sentence of the text for purchases under 50 percent included the period up to the time that the request was discussed in the Executive Board. A country that had not cooperated, say, some months previously, but had been following appropriate policies since then, would be seen as having restored its cooperation.

A special staff mission would not be required in all cases involving requests to make drawings below 50 percent of quota under the compensatory financing facility, the Director continued, although Article IV consultations with the countries concerned could acquire a special significance. A special mission could, of course, be required if the necessary data for analyzing the request were unavailable.

A member would be required to take action prior to submitting a request for a purchase, the Director said, if such action was needed for the Fund to satisfy itself that the member was cooperating with it in an effort to find solutions to its balance of payments problem. If there was a disagreement about whether the member needed to take action, the view of the Executive Board would, in the final analysis, determine the attitude of the Fund, as the Board would have to decide whether or not the Fund was satisfied that the member's policy stance was approriate.

The question had been raised, the Director of the Legal Department recalled, whether a member would be required to take prior action if the size of its export shortfall was of the same order as its balance of payments imbalance. Under the decision on compensatory financing, a member had to have an export shortfall that was largely beyond its control. Accordingly, if a member had an export shortfall due to factors largely beyond its control and if the shortfall were roughly of the same magnitude as the balance of payments deficit, the country normally would not be required to take policy action prior to submitting its request for a purchase. As was stated in the third paragraph of the introductory text of EBS/83/171, which contained the previous version of the guidelines, if a member had been following appropriate policies and if its payments problem were solely the result of a reversible export shortfall, there would be no need for policy changes, whether the member requested more or less than 50 percent of quota.

The Chairman remarked that a majority of the Executive Directors appeared to accept the proposed text. The guidelines would not lead to any fundamental change in present practice, which was based on common sense. When an export shortfall was embedded in a much larger external imbalance, the Fund could not provide compensatory financing without first paying attention to the country's overall economic situation. He had no particular difficulty in using the word "mainly" instead of "solely" in the sentence in question in the third paragraph of EBS/83/171, but if the Fund were not satisfied with a country's economic policy stance, it would have to conclude that it was not satisfied with the member's degree of cooperation. The requirement was not merely that the country would state that it would cooperate with the Fund; the Fund had to be satisfied that the country was cooperating.

Thus, in some cases, the Fund would have to say that a country had to address the problems facing the economy, the Chairman concluded. He appreciated that a number of Executive Directors did not share that view, and all the views that had been expressed would of course be taken into account in the future. However, the proposed guidelines represented the Fund's practice, and very different language would have to be agreed in order to reverse the practice. There would have to be radical changes in the practice if some of the suggestions that had been made were accepted. That the Executive Directors were not unanimously in favor of the proposed guidelines was unfortunate. Still, the compensatory financing facility was clearly an important one and would continue to be treated as such by staff and management.

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

The decision was:

The Executive Board approves the guidelines on cooperation under the compensatory financing facility set out in EBS/83/171, Supplement 1 (9/12/83).

Decision No. 7528-(83/140), adopted
September 14, 1983

APPROVED: March 14, 1984

LEO VAN HOUTVEN
Secretary