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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/163

10:00 a.m., November 28, 1983

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	W. B. Tshishimbi
	H. G. Schneider
B. de Maulde	X. Blandin
A. Donoso	M. Teijeiro
R. D. Erb	
M. Finaish	T. Alhaimus
	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	L. Leonard
A. Kafka	C. Robalino
G. Laske	G. Grosche
G. Lovato	
R. N. Malhotra	
	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
F. Sangare	
M. A. Senior	J. L. Feito
J. Tvedt	
N. Wicks	T. A. Clark
Zhang Z.	Wang E.

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

Also Present

African Department: O. B. Makalou, Deputy Director; A. C. Woodward. Asian Department: W. G. L. Evers, S. Kimura, R. J. Niebuhr, S. Shah. European Department: L. A. Whittome, Counsellor and Director; L. L. Perez. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; M. Allen, H. W. Gerhard, M. Guitian, S. Kanesa-Thasan, T. Mayer. External Relations Department: H. P. Puentes. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; P. L. Francotte, W. E. Holder, Ph. Lachman, A. O. Liuksila, S. A. Silard. Middle Eastern Department: Z. Iqbal. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; L. Alexander, L. U. Ecevit, N. M. Kaibni, E. C. Meldau-Womack, P. R. Menon, E. A. Milne, T. K. Morrison, A. Salehizadeh, H. H. Zee. Treasurer's Department: D. Williams, Deputy Treasurer; D. Gupta, D. V. Pritchett, O. Roncesvalles. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; P. D. Brenner, M. Caiola, J. Ferrán, E. S. Kreis, J. E. Leimone, D. C. Ross, J. F. van Houten, Bureau of Statistics: E. Ayales. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, A. A. Agah, E. A. Ajayi, J. R. N. Almeida, C. J. Batliwalla, J. Delgadillo, K. A. Hansen, H.-S. Lee, Y. Okubo, I. R. Panday, P. D. Péroz, D. C. Templeman. Assistants to Executive Directors: H. Alaoui-Abdallaoui, H. Arias, J. Bulloch, M. Camara, M. B. Chatah, M. Eran, G. Ercel, G. Gomel, V. Govindarajan, D. Hammann, N. U. Haque, A. K. Juusela, H. Kobayashi, A. Kone, M. J. Kooymans, G. W. K. Pickering, E. Portas, M. Rasyid, J. Reddy, C. A. Salinas, A. A. Scholten, Shao Z., S. Sornyanyontr.

1. BHUTAN - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Bhutan (SM/83/228, 11/4/83). They also had before them a report on recent economic developments in Bhutan (SM/83/229, 11/8/83).

Mr. Malhotra made the following statement:

On behalf of the authorities of the Royal Government of Bhutan, I would like to thank the staff for its thorough and informative report on the 1983 Article IV consultations. The authorities are in general agreement with the staff's analysis and appraisal.

Bhutan is a small landlocked country, but it is relatively well endowed with natural resources of forest, hydropower, and mineral wealth. The ratio of population to land area is low, and there is little pressure on land or housing. However, owing to limited availability of arable land, lack of irrigation facilities, inadequacy of capital for exploitation of natural resources, and insufficiency of social services, its per capita income is very low. The country's difficult, mountainous terrain and geographical isolation have been constraints on economic growth. But this is gradually changing. Planned development began in about 1960, and since then Bhutan has made steady progress toward establishing basic economic and social infrastructure and a measure of diversification and modernization of the economy.

Agricultural and animal husbandry account for half of GDP and a quarter of total export earnings. In recent years, more attention has been devoted to cultivation of cash crops. However, because of the variable weather conditions as well as limited irrigation facilities, agricultural output has not always kept pace with the increase in population and per capita consumption. In 1982/83, about 25,000 tons of foodgrains had to be imported because of a poor harvest. The Fifth Plan now under way aims at self-sufficiency in foodgrains. As rugged terrain limits extensive agriculture, emphasis has been placed on intensive cropping through more irrigation and improved agricultural inputs. Accordingly, one half of the Fifth Plan's outlay on agriculture is allocated to irrigation projects. But a thin network of transport and communications, long road hauls, and limited trained personnel make the task of bringing agricultural services to the farmers difficult. However, Government's extension services have made a favorable impact on farmers' attitudes toward new agricultural technology. In earlier plans, the Government had made use of subsidies to help promote new practices, but, realizing the heavy budgetary burdens involved, it is increasingly emphasizing institutional agricultural credit.

Although Bhutan's forest resources are large, their exploitation has been low and uneven, owing mainly to difficulties of terrain. While the southern and more accessible areas have suffered from overexploitation, northern areas remain virgin forest lands. The authorities are acutely conscious of the need to conserve their forest wealth while increasing scientific exploitation. A survey of forest resources has been undertaken so that appropriate working plans can be drawn up.

So far Bhutan's enormous hydropower potential has remained unexploited, and hydropower has contributed only marginally to Bhutan's GDP. Its share in GDP is however expected to increase sizably once the Chukha project goes on stream by 1985.

Bhutan's manufacturing sector is still small and accounts for barely 5 percent of GDP. Cement production, distilling, food processing, and chemicals constitute the bulk of value added in the manufacturing sector. The domestic market is limited, and inadequacies of power and entrepreneurial talent are important constraints. The power situation should improve greatly once power from the Chukha project begins to flow. The Government's industrial policy is aimed at encouraging local initiatives. Since mid-1982, the Government has stopped its policy of government-guaranteed loans for all approved projects in favor of a case-by-case approach. The Bank of Bhutan continues to scrutinize carefully all projects requesting financing, to assess their viability. The Fifth Plan has shifted resource allocation in favor of industry.

To reduce overdependence of the population on the Government, efforts are under way to decentralize, where appropriate, development activities. Though this may initially strain the limited administrative resources, the approach should promote people's participation and self-reliance and also help reduce budgetary burdens. Accordingly, about a quarter of Plan expenditures is now allocated to local projects.

Overall, the economy has performed well, with growth rates averaging 6 percent during 1978/79 to 1980/81 and reaching 9 percent in 1981/82. However, in 1982/83, the growth rate plummeted to a low of 1.4 percent owing to a severe drought that also pushed inflation from about 9 percent to 17 percent in 1982/83, principally because of tighter food supplies.

Bhutan's modern financial system is gradually evolving. Historically, the Government has tailored its expenditures to the availability of resources. It has eschewed bank borrowing to finance the deficit despite the high liquidity of its financial institutions. Development outlays are met predominantly by external assistance. Though a part of the revenue gap is at present also covered by grants from India, the Government expects to cover this gap once the Chukha project becomes operational. The authorities recognize the need to broaden the tax base, but domestic resource mobilization is constrained in an economy that till recently operated as a barter economy. Besides, its ability to raise revenue in the form of import duties and export taxes is constrained by free trade relations with its neighbor, India. Despite these limitations, in the face of growing current deficits, the authorities have adopted measures to increase revenues. Performance under the current account in 1983/84 is expected to show considerable improvement. The excess of current expenditures over domestic revenues will come down from 5.3 percent to 1.2 percent of GDP by the end of 1983/84. This is to be achieved through additional tax and nontax measures and a freeze on salaries of civil servants. With the introduction of a corporate profit tax of 30 percent, revenue receipts are projected to increase from Nu 101 million in 1981/82 to Nu 189 million in 1983/84. Nontax revenues are projected to double as royalties from logging increase and new public enterprises come on stream. The projected overall fiscal deficit of Nu 113 million in 1983/84 will be financed by external loans and by nonbank borrowing.

Monetization of the economy of Bhutan is a recent development, and the history of financial institutions is relatively short. Monetary policy has played a passive role because of the open border and free trade with India and widespread circulation of the rupee in Bhutan. The objective of the authorities is to move over time to a ngultrum-based monetary system. The Royal Monetary Authority, established in 1982, will assume responsibility for basic central banking functions. Currently the authorities are engaged with technical assistance from the Fund, in laying down the Authority's institutional and operational framework to enable it to undertake the management of foreign exchange reserves and to maintain government accounts.

With the higher cash incomes derived from construction activity and further monetization of the economy, the Bank of Bhutan--the only commercial full-service bank--has sought to improve further its deposit base by offering a variety of deposit facilities, resources from which it hopes to deploy as advances to public and private enterprises and as part of the country's foreign assets. The Bank's assets have grown significantly, but, since its investments have been slow in materializing, it had been unable to use its deposits for expanding lending operations. As a result, its liquidity position has remained fairly comfortable. In the present stage of development, the capacity of the economy to absorb larger doses of credit is somewhat limited, and this explains the low ratio of advances to deposits. Under special arrangements, these deposits are held with foreign banks, including the State Bank of India. But as industrialization of the economy gathers momentum, the authorities are confident of correcting this position. A campaign to educate the farmer in the use of credit is already under way. The role of nonbank financial institutions is also expected to grow with industrial development of the economy. The aim of the authorities is to develop a strong and stable monetary and financial system that is supportive of their development effort. In financial matters, they are pragmatic and cautious and instinctively take the line that they should not spend what they cannot finance. If there is an uncovered financial gap, they would rather prune spending than resort to deficit financing.

An overwhelming proportion of Bhutan's foreign trade is with India. In 1982/83, the trade deficit with India increased to $29 million, principally on account of reduced exports of cement and potatoes. On the import side, a decline in capital imports following the near-completion of the Chukha project was offset by a rise in imports of foodgrains. Despite an overall current account deficit of over $71 million in 1982/83, Bhutan had a small overall surplus of $3.2 million.

In sum, Bhutan has a prominent subsistence sector on which is superimposed the monetary sector represented by export-linked activities, construction, and services. It is also an import-based economy in which imports loom large in relation to the monetary sector. This situation could change only slowly. The aid-related deficits will remain a feature of the external accounts for a long time. These deficits are sustainable in view of the inflows of aid, which are being prudently utilized and are expected to continue. Technical assistance is another valuable ingredient that will be needed at all stages to promote and enhance efficient resource utilization. In this context, the authorities have greatly valued the advice and policy guidance Bhutan has received from the Fund and the World Bank, and they hope that it will continue to be avaiable.

Mr. Yamashita recalled that, at the time of the previous Article IV consultation with Bhutan (EBM/82/137, 10/27/82), his chair had noted the commendable performance of Bhutan's economy over recent years. Despite a severe drought in 1982/83, real GDP had continued to grow, albeit marginally; the authorities should be given credit for weathering the turbulent environment. Self-reliance, participation by the people, and decentralization of the development effort had been made important objectives in the Government's overall development strategy. He agreed with the staff that those objectives, particularly, decentralization of the development effort, would serve Bhutan well in the long term by improving efficiency and limiting the burden on the budget. It was especially striking that regional development projects were being carried out by "voluntary labor" of the local people. The staff did not indicate how much of the total required labor was accounted for by voluntary labor, but he believed that the traditional self-reliance of the Bhutanese people might be an important factor behind such an almost unique phenomenon.

The Government's readiness to postpone projects for which adequate financing had not been arranged was appropriate, Mr. Yamashita continued, and Mr. Malhotra's statement that the authorities "are pragmatic and cautious and instinctively take the line that they should not spend what they cannot finance" was encouraging. It would be important for the authorities to manage their external borrowing with prudence and to strengthen their efforts to increase earnings in convertible currencies by promoting tourism and by providing marketing and other assistance to exporters. He invited the staff or Mr. Malhotra to comment further on what specific measures were being contemplated to promote tourism. He supported the proposed decision and agreed with the proposal that the next Article IV consultation should be held on an 18-month cycle.

Mr. Salehkhou observed that half of Bhutan's GDP resulted from agricultural output and animal husbandry, which between them provided subsistence livelihood for 95 percent of the 1.2 million people. A severe drought had reduced Bhutan's real GDP growth to 1-2 percent in 1982/83 from an average of 6 percent during the previous three years, although there had been an increase in timber production and rapid growth in the modern sector, especially in the processing of natural resources. However, another dry weather spell was expected to depress the growth rate in FY 1983/84. As a result of food supply shortages, inflation had jumped to 17 percent from 9 percent in 1981/82. The acceleration of inflation had taken place despite a noticeable slowdown of the price increases of imported goods from India. Although the deficit of the current account had increased as a result of lower exports and higher imports, the overall balance of payments remained in surplus.

The authorities' production and investment policies were correctly geared toward raising agricultural production by 25 percent in order to achieve self-sufficiency, Mr. Salehkhou continued. He agreed with the staff that the authorities' overall development strategies and policies would, in the long run, serve Bhutan well by concentrating on self-reliance through participation by the people and gradual decentralization of the development program. The lack of required skills and expertise, as well as the scarcity of financial and material resources, had forced the Government to be particularly prudent in planning and implementing its policies. He hoped that the Chukha Project would be completed as scheduled so that at least part of the revenues required to achieve the Government's objectives would be provided through the sale of electricity; that the staff's suggestion concerning the reorganization of the tax system and restraint on current expenditures would be observed accordingly; and that the commendable assistance by India would also be geared toward the self-sufficiency and self-reliance of the Bhutanese people, given that "most of the [Bhutanese] Government's capital expenditure and about 35 percent of its current expenditures are financed with aid from that country." He supported the proposed decision and the suggestion that the next Article IV consultation with Bhutan should be on an 18-month cycle. The latter proposal was consistent with his chair's view that Article IV consultations with small countries need not be on a 12-month cycle when there was no particular problem or policy issue involved.

The staff representative from the Asian Department commented that, with regard to the question of voluntary labor, the Government of Bhutan was designing programs that would call for the regional communities to supply manual labor. Thus, only skilled labor would need to be supplied by the Central Government. With regard to tourism, the Bhutanese authorities were planning to increase the number of tourists by about 10 percent a year. In addition, they planned to aim at a higher segment of the tourist market, and they would, therefore, be improving hotel and transportation facilities.

Mr. Malhotra stated that during his recent visit to Bhutan he had had wide-ranging discussions with his Bhutanese authorities. Although Bhutan had significant constraints in terms of the need for more trained personnel at middle and technical levels, the level of expertise among the senior administrators was impressive. Those administrators were relatively young and highly motivated, taking a great deal of pride in the opportunity to participate in their country's planning and development. The highest authority in the land, the King, took a keen interest in development, while leaving the detailed administrative issues to his Ministers. Ministers showed a striking concern for maintaining Bhutan's ecological balance. For example, some time earlier, they had taken measures against overexploitation of forestry resources in the southern part of the country, even with the realization that forestry income would decline temporarily. Replanting of the overexploited areas had been undertaken. The authorities were pursuing policies aimed at bringing about diversification in various areas, including agriculture.

They were also proceeding with commendable care in social services, Mr. Malhotra continued. For example, they were taking a pragmatic and well-informed approach to reforming the educational system so that it could serve the needs of the economy over the coming years. The authorities had adopted a conservative approach in fiscal policy, being unwilling to undertake expenditures for which financing was not available. It was encouraging that they had requested technical assistance from the Fund in such areas as budget classification and accounting, and that the Fund had responded positively to their request. Thus, despite the major constraints facing Bhutan, the prospects were good.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the views expressed in the staff appraisal for the 1983 Article IV consultation with Bhutan. Directors noted that two successive years of dry weather had led to lower rates of growth and a rise in inflation. They commented favorably on the policies to promote decentralization of the development effort and to pass to the private sector some of the existing commercial functions of the Government. They observed that, particularly over the longer term, those policies would lead to greater efficiency and economy in expenditures.

Directors welcomed the expenditure control measures that had been adopted with the introduction of the FY 1983/84 budget, and the intention of the authorities to postpone projects for which adequate financing could not be arranged. They considered it equally important that government borrowing from the banking system should be circumscribed by the credit requirements of the private sector and by the need to maintain an adequate level of international reserves. Directors also pointed to the need for cautious external debt policies and for additional efforts to increase earnings in convertible currencies.

Directors commented favorably on the philosophy of self-reliance of Bhutan and the pragmatic attitude of the authorities. They noted the importance of India's assistance to the development efforts.

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

The Executive Directors then took the following decision:

Decision Concluding 1983 Article XIV Consultation

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

2. The restrictions on the making of payments and transfers for current international transactions, as described in SM/83/229, are maintained by Bhutan in accordance with Article XIV. The Fund encourages the authorities to administer these restrictions in a liberal manner.

Decision No. 7568-(83/163), adopted
November 28, 1983

2. PERU - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Peru (EBS/83/236, 11/3/83). They also had before them a report on recent economic developments in Peru (SM/83/235, 11/14/83).

Mr. Donoso made the following statement:

Under the program supported by the arrangement with the Fund, the Peruvian economy has made important advances toward improving its external situation. Basic prices in the economy have moved in the right direction.

From 1981 to February 1983, the minimum wage decreased by 15 percent, salaries in the private sector decreased by 12 percent, and wages in the private sector decreased by 4 percent, measured in terms of U.S. dollars of constant purchasing power. The salaries of workers in the collective bargaining sector are estimated to have decreased in real terms by 8 percent in 1982 and by 22 percent in the 15 months until March 1983. The average remuneration for civilian personnel of the Central Administration is expected to decline 25 percent in real terms in 1983, after a decline estimated at 15 percent in real terms in 1982.

Looking at exchange rate indices, a clear change can be observed. In July 1983, the real value of the sol in terms of the U.S. dollar was cut back to the level of the first quarter of 1979, after a real depreciation of 20 percent since the first quarter of 1982.

This evolution in relative prices has facilitated a positive change in the external accounts. For 1983, a current account deficit equivalent to 6.6 percent of GDP, down from 8.3 percent in 1982 and 8.7 percent of GDP in 1981, is expected.

This change has been made possible by a continuous reduction in imports from $3.8 billion in 1981 to $2.8 billion in 1983. Exports have decreased, and financial sevices have increased during this period.

This progress, however, is insufficient. The program for 1983 contemplated a higher trade surplus and a lower current account deficit. From the analysis of the execution of the program, it is clear that the main explanation is to be found in the deviation of public finances from the programmed path. The overall deficit of the public sector will be 9.4 percent of GDP instead of 4.1 percent of GDP as originally contemplated. The higher financing needs of the public sector led to an excessive expansion of the net domestic assets of the monetary authorities, which has sustained a rapid rate of inflation.

The extremely difficult circumstances, generated by events beyond the authorities' control, have to be considered in order to understand the deviations from the program. In early 1983, Peru was affected by natural disasters. The Peruvian authorities reacted by cutting public spending, to make room for the extraordinary expenditures that became necessary, tightening their monetary policy and accelerating the depreciation of the sol. With all the difficulties reported by the staff, the program was still maintained roughly on track during the first quarter of the year. After that period, the recession became deeper, and the rate of inflation accelerated.

In January 1983, GDP for 1983 was projected to rise by about 0.5 percent above GDP in 1982. When the extent of the natural disasters became known and the targets for the second year of the program were defined, the assumption was that GDP in 1983 would decrease by 4.7 percent in real terms. The staff papers prepared for this Article IV consultation with Peru to provide a new estimate, that is, a reduction of 7 percent for the year.

At this moment, the Peruvian authorities expect the decrease in GDP in 1983 to be 10.6 percent of GDP. They estimate that the natural disasters have cost $227 million in lower exports and $212 million in higher imports. Part of the loss has been compensated by donations of $43 million and long-term foreign loans of $95 million.

The effect of the weather conditions on the public finances has been equally severe. It is estimated that for this reason, lower revenues and higher expenditures of the Central Government will be 2.4 percent of GDP. For public enterprises, the emergency will imply additional expenditures of 0.6 percent of GDP.

In all, the estimates of the Peruvian authorities for the evolution of GDP in 1983 at the sectorial level are as follows:

Sector	1983 Value Added Relative to 1982
Agriculture	-8.0%
Fishing	-36.0%
Mining	-6.5%
Manufactures	-13.0%
Construction	-25.0%
Government	0.0%
Others	-10.5%
GDP	-10.6%

The change in the GDP projections for 1983 from +0.5 percent to -10.6 percent reflect the dramatic change in the basic scenario to which policies were to be applied. It is easy to imagine the difficulties of adapting and reacting to this type of change.

As noted by the staff, the authorities introduced in September a deceleration in the rate of adjustment of controlled prices and in the rate of depreciation of the sol. They were aiming at a reduction in the rate of inflation and a reduction in the difference between the rate of return on financial assets expressed in foreign currency and assets denominated in soles.

It is expected that the increase in prices will reach 17.6 percent in the fourth quarter of the year as a consequence of this change, down from 22.2 percent, 24.8 percent, and 25.2 percent in the first, second, and third quarters, respectively. Given the preannounced rate of depreciation of the sol for the rest of the year, the Peruvian authorities expect the real exchange rate in December 1983 to be at the same level as in August 1983.

They also foresee a positive real return on financial assets denominated in soles for the rest of the year as a result of higher interest paid on deposits and lower rates of inflation. The differential return in favor of assets denominated in dollars is also expected to disappear while the policy of preannounced exchange rate is applied.

The latest figures on the fiscal situation are judged by the Peruvian authorities, as by the staff, to be inconsistent with the rates of inflation assumed in their policy of preannounced exchange rates. Thus, they plan not to preannounce the exchange rate as of February 1984 and to replace this policy with devaluations in line with the domestic rate of inflation in previous months.

To compensate for the effect of this policy on the relative return on financial assets (soles/US$-denominated), they plan to liberalize the rate being paid on the certificates of deposit subject at present to monetary correction or to introduce a new instrument with the same objective.

To correct the fiscal disequilibrium, they are considering measures to increase revenue and to reduce expenditure. By mid-December, the authorities expect to have congressional approval to introduce the revenue-related measures. They are considering changes in sales tax, in minimum tariffs on imports, and in taxes on income and on wealth. They are also contemplating taxes on traditional exports and the elimination of various existing ways to obtain tax exemptions.

In relation to expenditure-reducing measures, the authorities will apply a new criteria to control wage increases in public enterprises, measures to transfer to the Treasury the increase in public enterprises' surpluses arising from price increases, in addition to a generalized reduction in current and investment expenditures, including elimination of subsidies. They are also considering the liquidation or sale to the private sector of some public enterprises.

Extending his remarks, Mr. Donoso commented that the effect on the Peruvian economy of events beyond the authorities' control deserved emphasis. Those events included weak external demand for Peruvian exports, a tightening of external capital markets, trade barriers in importing countries, and weak commodity prices that had discouraged private ventures in spite of major reforms in the agricultural, mining, petroleum, and manufacturing sectors implemented since the beginning of the program. In addition, the natural disasters that had occurred at the beginning of the year had resulted in the costs reported by the staff, and they had accounted for most of the reduction in GDP for 1983 of 10.6 percent, according to the latest estimates by the authorities. If the Peruvian economy had developed in line with the projections made when the program had been devised, GDP in 1983 would be 20 percent higher in real terms than currently estimated. On the basis of previous and current estimates by the staff, current revenues of the Central Government for 1983 would be only 60 percent in real terms of the figure originally contemplated in the 1983 program.

The adjustment effort indicated by the evidence that the staff had presented also deserved emphasis, Mr. Donoso continued. Total consumption in 1983 would be approximately 90 percent of consumption in 1982. Capital expenditures by the public sector in 1983 would be more than 30 percent below the 1982 level. In early 1983, when the Peruvian authorities had faced serious difficulties caused by natural disasters, they had cut public spending, tightened credit and interest rate policies, and increased the rate of depreciation of the sol.

Irrespective of the reasons for the economic deterioration, adjustment had been unavoidable, Mr. Donoso remarked. The authorities had applied corrective measures, and they considered it absolutely necessary to correct fully the present imbalances and to return to the program path. They hoped that Executive Directors would derive an accurate description of the political economy of Peru in 1983 from the staff papers. The authorities believed that the situation had been characterized by a strenuous effort to cope with the most adverse circumstances. They considered that they had been successful in many areas; they were, therefore, optimistic with regard to the prospect of putting in place the elements that remained missing from the measures recommended by the staff, some of which were close to or were being implemented already.

His Peruvian authorities stressed the importance of a thorough understanding of the economic and political realities facing the country, Mr. Donoso added. They also stressed the need to take those realities into account when devising realistic policies for 1984 aimed at ensuring a rapid and smooth adjustment and recovery from the present difficulties so as to return to the program path, to which they remained strongly committed.

Mr. Kafka said that he agreed with Mr. Donoso that the staff reports did not reflect the full dimension of the natural catastrophes or of the other problems that had confronted Peru in 1982. As a result of the sharp decline in GDP, current revenues had fallen by almost one third in nominal terms. At the same time, Peru had had to take exceptional and costly measures to maintain constitutional normality. Under those conditions, the ability of the authorities to maintain the public sector deficit at the figure finally achieved had required considerable courage and effort. The impact on exports of the natural catastrophe that Peru had suffered had been devastating. The authorities' achievement in reducing the current account deficit to the extent that they had done was, therefore, even more remarkable, and they had done so while preserving a reasonable level of net and gross reserves, not because reserves were simply unavailable to pay for larger imports than they had permitted.

The Peruvian authorities needed to pursue the thrust of the program, Mr. Kafka continued. However, it was also essential to recognize that departures from it should not prejudice the final results, although the authorities would have to change their timetable in view of the impact of uncontrollable events. Peru had a long history of cooperation with the Fund. The Fund could not deny Peru its cooperation in return; it ought, rather, to be flexible in helping the member to resume the program quickly.

Certain statements in EBS/83/236 were formulated in a fashion that might easily be misunderstood, Mr. Kafka considered. The staff correctly described the course of exchange rate changes. However, in its appraisal, the staff gave the impression that there had been a major reversal in policy after August 1983 in the direction of a real appreciation of the exchange rate. In reality, the reversal had begun with a major real devaluation in August that had been part of the subsequent policy of preannouncing the exchange rate depreciation at a lower rate than previously. In sum, the Fund should help Peru to resume the thrust of its program in a flexible fashion, and it should do so by negotiating with the authorities expeditiously and with understanding of the extraordinary difficulties that the country had faced in 1983, to which it had reacted courageously.

Mr. Grosche remarked that a number of unfavorable events outside the authorities' control had contributed to the sharp deterioration of Peru's internal and external imbalances. However, slippages in almost all major policy areas appeared to have occurred, conveying the impression that the authorities had not so far shown enough strength in pursuing the necessary macroeconomic policies. The most alarming development was the increase in the public sector deficit, caused equally by shrinking revenues and growing expenditures. The lack of determination that the authorities had shown so far in redressing the fiscal position was discouraging. The situation was strikingly similar in other areas; the staff reported that the authorities attempted to assess, to analyze, to consider, and the like, while the necessary policy actions were unduly delayed. Some delay might have been caused by the inadequacy of the reporting system, which had resulted in the magnitude of the deviation from the program path becoming known only with a lag. The additional assistance to be provided by the staff in that area was, therefore, welcome.

The rise in budget expenditures resulted mainly from emergency spending, additional military outlays, and interest payments, Mr. Grosche noted, but also from higher wages and salaries. Delayed price adjustments had led to higher subsidies and had contributed to the weak performance of public enterprises. While general wage increases for civil servants had been held well below the rate of inflation, a series of exceptions had been made. Such a policy would not only be a burden on the current budget, it would be difficult to sustain such discriminatory practices over the longer term. It was questionable whether an extension of centralized spending controls would remedy the situation of the public enterprises. On the contrary, the authorities should increase the room for maneuver of those enterprises. To regard their pricing policies as instruments with which to fight inflation was not useful for that purpose, nor would it enhance rational planning procedures within those enterprises.

The efforts undertaken by the Peruvian authorities to develop a more efficient financial system, particularly the unification of interest rates, were welcome, Mr. Grosche went on. Those efforts would, however, be fruitless as long as the interplay of nominal interest rates and inflation did not allow positive real interest rates to emerge. The introduction of new administrative regulations--for example, the expansion of subsidized credit lines--tended to be counterproductive. The volatility of exchange rate policy was also a matter of concern. There appeared to be no economic rationale for allowing the sol to depreciate much faster than inflation at first, then to change course and to allow a substantial real appreciation that could seriously endanger the competitiveness of Peruvian exports. However, Mr. Donoso's statement that, by the end of December 1983, real exchange rates were expected to be at the level of August 1983 was welcome.

He fully recognized the exogenous problems confronting Peru, Mr. Grosche remarked, but Peru's economic future appeared bleak unless a thorough and drastic policy reorientation took place. The authorities should be encouraged to place more weight on general macroeconomic policies and less emphasis on administrative controls that would only aggravate the already serious internal and external imbalances. It appeared difficult to reactivate the extended arrangement by granting a waiver and by reaching agreement on new performance criteria. The best approach would probably be to reach agreement on prior actions as the basis for a stand-by arrangement that could lay the foundation for a subsequent new extended arrangement.

Mr. Leonard commented that the staff had clearly established a disappointing divergence in the performance of the Peruvian economy from the path envisaged in the adjustment program agreed with the authorities in 1982. The divergence was apparent in the fiscal area, in the current budget deficit of the Central Government, in weak control over the spending policies of the public enterprises, in the failure of pricing policies, and in the lack of conformity between investment outlays and the approved investment plan. Significant divergences were also recorded in monetary, exchange rate, and external trade policy. Overall, the deterioration in the annual rate of growth of GDP had been even greater than the 4.7 percent decline envisaged in the program, being estimated at 6.8 percent in EBS/83/236, and at 10-11 percent in Mr. Donoso's statement.

In assessing the causes of divergence, Directors should recognize that the conditions faced by policymakers were much worse than had been envisaged when the program had been put together, Mr. Leonard continued. Not only had climatic conditions been particularly bad, but the failure of the econony to perform as expected in certain areas had compounded the degree of failure in others, exacerbating the difficulties with which policy had to contend. The staff gave proper weight to those special factors; the Peruvian authorities were aware of the seriousness of the deterioration in the performance of the economy and had already taken action to remedy it.

Other factors had to be considered, Mr. Leonard stated. The much larger than expected budget deficit reflected not only revenue slippages as a result of incomes being lower than expected, and emergency expenditures for disaster relief, but also inadequate controls on government expenditure, higher pay for some groups of government workers, slower than programmed changes in administrative prices, and perhaps an increase in tax avoidance. Interest rates had not been raised sufficiently to take account of a much higher rate of inflation than had been envisaged, and they were sharply negative at present. That development had led in turn to a reduced role for financial intermediaries and had reduced the supply of funds for lending to the private sector. The change in exchange rate policy in September 1983, apparently intended in part to make sol-denominated assets more attractive than dollar-denominated assets, was less appropriate for that purpose than raising domestic interest rates; furthermore, it carried the risk of impeding the internal adjustment of the economy.

He could understand how statistical factors had delayed recognition of the degree of deterioration in the economy that had been taking place in 1983 and had masked the consequent need for action to deal with the situation, Mr. Leonard went on. It was also clear that the time required before policy took effect might be longer than the authorities would wish. Nevertheless, there was nothing to be gained by a failure to put the necessary corrective measures in place. It was clear that the authorities had to strengthen further their ability to control government expenditures and, in the light of the slippage that had occurred in 1983, to monitor carefully the implementation of fiscal policy. He welcomed the provision of technical assistance in that area; it might be worth considering establishing a monthly budget deficit ceiling as an aid to expenditure control. The authorities would also need to improve their ability to respond to unforeseen and adverse fiscal developments. He urged them, as part of their planning for FY 1984, to formulate measures that could be implemented quickly in the event that, as in the two preceding years, fiscal developments turned out to be less favorable than expected. The staff might also consider whether, in addition to the usual ceilings on domestic bank financing of the government deficit, a performance criterion should not be established in any future program for total financing of the government sector including domestic arrears, since meeting the present criterion in that area had been facilitated in the first part of 1983 by incurring arrears in domestic payments. Such a provision would help to ensure that too high a proportion of scarce domestic and foreign savings would not be absorbed by the government sector.

The emphasis of action to improve the budget position should switch from cutting back on capital expenditure to restraint on current expenditure and to increasing revenues, Mr. Leonard considered. Defense expenditures and further wage restraints were two areas in which additional actions were required. It was obviously necessary to ensure that the prices of products sold by the Government were increased much more quickly. He welcomed the Government's intention to return to a more realistic public sector pricing policy, which should include the speedy elimination of the freeze on administered prices on certain goods and the limitations on the increase in the prices of other goods implemented in September. He urged the authorities to make, as soon as possible, the appointments necessary to implement improved supervision of public enterprise activities by the Ministry of Economy, Finance, and Commerce.

The Government's willingness to undertake a major new effort to raise revenue was welcome, Mr. Leonard added. In light of the extensive tax evasion prevalent and the growth of the underground economy, the success of such an effort would depend largely on the improvement of tax administration and collection. The Government had made earlier efforts in that direction with Fund technical assistance, but some of the measures decided upon were still being implemented and had not yet begun to take effect. The authorities should implement those measures as quickly as possible and at the same time consider increasing the penalties for tax evasion. In a period when additional revenue was needed, it was a mistake for new laws to provide for an extension of tax holidays and other tax incentives.

Commenting on monetary policy, Mr. Leonard noted that the authorities had taken a number of measures to improve the efficiency of the financial system, including unification of interest rate ceilings, more uniform regulation of financial institutions, and relaxation of the requirements for entering into the domestic financial system. However, real interest rates remained negative, reflecting inadequate adjustment of interest rate ceilings for unindexed instruments, together with insufficient inflation adjustment for indexed instruments. It was also a matter of concern that the introduction of indexed certificates of deposit might have strengthened expectations that inflation could last a long time and that it might obscure the need for more substantial action to improve real interest rates.

While the authorities might have viewed the slower depreciation of the exchange rate begun in September as a desirable way of rendering domestic financial instruments more attractive than foreign currency instruments, Mr. Leonard said, it would have been preferable to eliminate or to raise interest rate ceilings considerably, or to introduce realistic indexation mechanisms to improve the attractiveness of sol-denominated instruments. The authorities had been afraid that such action might have resulted in domestic real interest rates higher than those abroad. Did the staff share that concern? Higher real interest rates reflecting the scarcity of funds would improve incentives for savings and encourage the channeling of more of those savings through financial institutions, thereby increasing the amount of credit available to the private sector.

He agreed with the staff that the slower depreciation of the exchange rate introduced in September could endanger competitiveness if it continued during a period in which inflationary pressures remained strong, Mr. Leonard remarked. There had been some improvement in competitiveness in 1982 and 1983, but it had been sufficient only to restore the position prevailing in 1980. According to the staff, nontraditional exports had fallen in the first part of 1983 owing, among other factors, to increasing competition from other suppliers, and there continued to be subsidies in the form of trade payments certificates on exports of certain goods.

He strongly supported the staff's recommendation that rigidities in the economy limiting capital and labor mobility should be reduced, Mr. Leonard added. The proposed World Bank programs in that area were welcome. Those rigidities appeared not only to have limited the economy's flexibility, thereby contributing to inflationary pressures, but also perhaps to have driven some firms underground. He agreed with the staff that appropriate action should be undertaken in fiscal, exchange rate, interest rate, and pricing policies, before further Fund financial support was considered.

Mr. Clark said that he recognized the difficulties that the Peruvian authorities had had to face. In addition to a hostile world economic environment, they had had to contend with severe weather and with its consequences for agricultural output in particular. However, the staff made clear a number of shortcomings in performance within the discretion of the authorities. More generally, the experience with the Peruvian program as a whole underlined the difficulties of securing successful implementation of extended arrangements in current circumstances.

Directors should be concerned that, in two successive periods, the fiscal objectives of the program had been frustrated by the use of means of finance not covered by the performance criteria, Mr. Clark continued. While comprehensive monitoring of public finances was difficult in circumstances in which data were not readily available, the size of the loopholes in the present case was disturbing. He invited the staff or Mr. Donoso to comment on the circumstances in which the shift in the structure of financing had taken place. Bearing in mind the points raised in the Executive Board's discussion of Honduras (EBM/83/158, 11/21/83), he noted that Peru had drawn a total of SDR 165 million in 1983, on the basis of compliance with performance criteria that had turned out to be illusory. Such a situation was unsatisfactory.

There were four areas of anxiety with regard to the structure of policy, Mr. Clark considered. They included the extent to which price adjustments continued to be needed; the efficacy of wage controls, especially the balance between parts of the public sector and the rest of the economy; the procedure for adjusting the exchange rate, particularly the notion of using an overvalued rate as an anti-inflationary device when wage increases were not being effectively controlled; and monetary policy. The staff made little mention of developments in the financial aggregates, and it was clear that real interest rates remained strongly negative. In considering proposals for a new or revised program, his chair would attach considerable importance to having the medium-term implications set out clearly.

Mr. Erb observed that Peru had been faced with external circumstances and exogenous shocks that had made adjustment more difficult. However, it was necessary to conclude that those developments had increased the need for the Government to make the necessary adjustments in its economic policies in a timely fashion. Unfortunately, in the previous year there had been retrogression in many policy areas. Certainly, the difficult economic circumstances facing the authorities, the decline in gross national product, the impact of that decline on unemployment and on labor market developments, had made it difficult to follow through on the policy commitments that the authorities had made. But the importance of making those policy adjustments was even greater in light of the changed external circumstances as well as the exogenous shocks.

He generally agreed with the staff's recommendations on the areas in which major action by the authorities would be needed in order to resume the extended arrangement, Mr. Erb continued. On the fiscal side, steps would have to be taken with regard to both revenues and control of expenditures. He agreed with other Directors that it was important for the authorities to tighten the administrative management of the tax system in order to reduce the degree of tax avoidance. Simplification and modification of the system might enable the Government to improve the rate of revenue generation. There also appeared to have been retrogression in the Government's pricing policies. Much more aggressive action on prices was needed to reduce subsidies.

It was clear that the exchange rate adjustments that had previously been made in light of the domestic inflation rate should, at least, be continued if there was to be no deterioration in the competitiveness of the Peruvian economy, Mr. Erb considered. His authorities believed that the real effective depreciation of the sol that had taken place until recently laid the basis for a more significant growth in nontraditional exports, and they looked forward to that prospect in 1984. It would be a mistake if the authorities were to reverse that improvement in the competitive position of nontraditional exports by allowing the exchange rate adjustment to proceed more slowly than the domestic inflation rate. The need to make structural adjustments in the economy had been correctly underscored; without such adjustments, the prospects for restoring economic growth would be much lower. While there were difficulties in making such adjustments, given the special interests attached to each of the rigidities and restrictions existing in the economy, the effect of all the rigidities and restrictions was to make the economy much less resilient in the face of both domestic and external developments and much less able to adjust to opportunities both domestically and externally. He agreed with other Directors that structural adjustment had to be made in addition to fiscal adjustment, so as to establish the basis for domestic economic growth.

Executive Directors had expressed differing views on the question of maintaining or renewing the extended arrangement, Mr. Erb remarked. There were disadvantages in an extended arrangement in circumstances such as those in Peru, where the economy was faced with major changes; at the same time, external sources of finance, including debt reschedulings and commercial bank financing, were geared to the continuation of the existing program. However, the significant changes in external factors and the exogenous shocks caused by climatic conditions had modified the circumstances facing Peru to the extent that it might be considered better to put into effect a one-year stand-by arrangement. At present, the continuation of the extended arrangement was warranted, depending on the kind of economic adjustment that the authorities were willing to make in the coming weeks and on whether they would be able to respond with adequate fiscal and structural adjustment measures. If the extended arrangement provided an incentive for the Government to return to the original path described in the program and to make the necessary major economic policy adjustments, it would serve its purposes well. The need for such adjustments was as great, if not greater, than at the outset of the program.

Mr. de Vries commented that Executive Directors agreed that the current situation of the Peruvian economy was unfavorable. Mr. Donoso had pointed to the cutbacks in growth, in government expenditure, and in capital investment; no clear improvement appeared in sight. While it was true that external circumstances and disasters had played a role, he agreed with Mr. Erb that those factors increased the need for reinforcing the program rather than allowing it to slip. A number of countries had responded appropriately in such circumstances and had thus been able to maintain the main thrust of their programs.

There had been both slippages in policies and the implementation of mistaken policies, Mr. de Vries continued. The most striking example of slippage was the inflation rate of 140 percent. It was difficult to have confidence in the authorities' ability to carry out a program when the inflation rate was clearly out of control. More specifically, slippages in the public sector were the result of four factors: a decline in the ratio of revenues to GDP, an increase in defense expenditures, emergency expenditures, and deterioration in the financial performance of the public enterprises. Only one of those categories related to external disasters. As a result of such slippages, domestic payment arrears had arisen. The situation might be explained in part by the lags in the reporting system, which had resulted in the authorities' being unaware of developments. However, such a situation was not a favorable context in which to provide Fund assistance, particularly as the amount of Fund resources received by Peru, in comparison to the degree of adjustment achieved, was a matter of concern. In monetary policy, there had been a number of improvements, but there had been various counterbalancing adverse developments. Similarly, in exchange rate policy, a promising start had been made, but the policy had been abandoned, or at least softened to a considerable degree.

The general policy approach and the economic rigidities in Peru were perhaps even more important, Mr. de Vries considered. There was an excessive degree of government participation and intervention in the economy, including guarantees for employment, wage indexation, restrictive laws governing property rights, and the like. While some of those measures no doubt reflected political realities that the authorities had to take into account, it was the Fund's responsibility to point out that such political preferences resulted in greatly reduced economic efficiency to the extent that the smooth working of the adjustment program would be impossible unless changes were made. He agreed with the staff's view that prior actions would be needed in relation to the budget, the exchange rate, interest rates, and pricing policies. In addition, actions should be taken with regard to reporting, so that the Fund could be kept abreast of developments. If such actions were taken, the question of whether a stand-by arrangement or an extended arrangement should be put in place was of a lower order of importance. The confidence of commercial lenders would be improved more by the Peruvian authorities' pursuit of a well-designed adjustment program in collaboration with the Fund than by a particular legal framework.

Mr. Senior remarked that the Article IV consultation with Peru represented an interesting case in which performance under a Fund-supported program was difficult to evaluate as a result of the appearance of important unforeseen adverse circumstances. While serious deviations from the program had occurred in 1983, those slippages were understandable in light of the extremely difficult circumstances faced by the authorities as a consequence of exogenous factors such as natural disasters, weaker than expected world demand for Peru's main exports, and limited access to world capital markets. If analyzed in that context, it was not clear whether performance under the program had been as poor as indicated by the staff, or whether it had been the best that could be expected in such a situation.

There had been significant adjustment in the external sector, Mr. Senior continued, as could be seen from the 25 percent reduction in imports, and the greater than expected reduction in economic activity. The latest estimate of a decrease of more than 10 percent in GDP in 1983 would imply that, if the nominal program targets had been observed, the adjustment of the Peruvian economy would have been much greater than the magnitude originally envisaged. It was not surprising, therefore, that some slippages had occurred.

Nevertheless, adjustment had not been achieved, Mr. Senior observed. Clearly, the Peruvian situation was untenable at present, and major corrections continued to be needed. Mr. Donoso had pointed to the authorities' awareness of the need for additional efforts; the latest measures that had been adopted or that were being announced were welcome. More would need to be done, particularly in the fiscal area; he was confident that the authorities would persevere in their commitment to adjustment. Given the inadequacy of data in present circumstances, it was not difficult to understand certain, unintentional, deviations from the program. The request for technical assistance from the Fund in that regard was welcome; it indicated the authorities' concern with the problem and with the implications for the formulation of economic policy.

Mr. Zhang noted that the staff considered that "the principal policy actions in the fiscal, exchange rate, interest rate, and pricing fields should be put in place before further consideration is given to continued financial support from the Fund for the program of the authorities." Was the staff advocating new prior policy actions other than those already contained in the present extended arrangement? The staff had also referred to rigidities affecting the economy, specifically mentioning such examples as the participation of labor in profits and management, and the laws governing agricultural land property. Was the staff proposing that institutional changes should be introduced in those two areas?

Mr. Malhotra said that he agreed with those Directors who had suggested that the staff had not given sufficient weight to the deterioration resulting from exogenous factors that had affected Peru in 1983. A deterioration of more than 10 percent of GDP in the short period of one year was massive, and it was unsurprising that there had been important deviations from the path originally laid down in the program. However, the program under the extended arrangement should be continued, following further negotiations and assurances that action would be taken in various policy areas. He agreed with Mr. Zhang that the last sentence of the staff appraisal was unclear. Was the staff suggesting that action would have to be taken in all the areas referred to in order for the program to be restored? A flexible approach in that regard would be appropriate. There were evident weaknesses in the system of data reporting, for which the authorities had requested technical assistance. He was confident that the authorities and the staff could improve the system, and he hoped that they could reach early agreement on the continuation of the extended arrangement.

The staff representative from the Western Hemisphere Department recalled that Directors had commented on the way in which the authorities had financed the fiscal deficit outside the technical provisions of the program, specifically, through domestic payments arrears. The ceiling on public sector indebtedness had been included in the program in an attempt to capture the measurable types of financing. It was open to question whether domestic payments arrears in Peru could be measured in the time required to determine whether Peru could purchase under the program. If the period were extended until all the appropriate data became available, the link between performance under a program and purchases would be broken. The staff would be looking into the question with the authorities, but there would be difficulties in devising an adequate system for measuring such arrears, because they occurred not only on the part of the Central Government but also through the public enterprises. In the latter instance, timely information was particularly difficult to secure. Perhaps more important than the specific number for a ceiling was the overall content of policy. If the authorities reoriented their fiscal policy along the lines originally agreed, many of the current difficulties could be avoided.

Although improvements had been made in interest rate policy in the past year, the staff representative continued, interest rates remained negative in real terms. The staff believed that domestic interest rates would have to be increased, and it supported the authorities' intention to allow at least some interest rates to be set by market forces.

As Directors were aware, in 1981 the Peruvian authorities had embarked on a strong policy of opening up the economy to the rest of the world, the staff representative from the Western Hemisphere Department recalled. However, that policy had been insufficient to alter the structure of the domestic productive sector. In SM/83/235, the staff had referred to a number of the factors that had hindered firms from taking advantage of the opening up of the economy, including the areas in which the authorities were considering legislation to modify current practices, such as employment guarantees and labor participation in management. The authorities were also considering legislation to correct a number of deficiencies with respect to the land reform efforts of the early 1970s. The various elements involved in structural rigidities would be dealt with in a structural adjustment program to be supported by the World Bank.

The staff representative from the Exchange and Trade Relations Department noted that one Director had asked whether the ceiling on total financing of the public sector could be adapted to include domestic payments arrears. In principle, such an adaptation could be made, but, as the staff representative from the Western Hemisphere Department had pointed out, a major difficulty was whether the requisite data could be gathered in a timely fashion. The staff hoped that the establishment of a resident representative in Peru would help to improve matters in that regard. On an issue also related to the timeliness and accuracy of data, the staff would be preparing a paper for Executive Board consideration on the question of what procedures might be adopted to deal with the problem referred to by one Executive Director as "illusory compliance with the performance criteria."

On the general question whether it would be appropriate to continue with the extended arrangement or to establish a new one-year stand-by arrangement, the staff representative continued, the staff believed that the particular format of the Fund's assistance was less important than the quality of the policies that the Peruvian authorities were willing to undertake. To the extent that commercial banks might react negatively to the cancellation of an existing arrangement, it would be preferable to retain the flexibility to continue with the present arrangement. In the final sentence of its appraisal, the staff had intended to emphasize the importance of the quality of the policy measures required to deal with the departures from the original program path. Because the departures had been large, it was reasonable to argue that the program could only be brought on track through prior actions. Such a view did not necessarily mean that every appropriate measure had to be taken before the Executive Board could decide on the continuation of the arrangement or establishment of a new arrangement, but the authorities could be asked to implement as many of the required actions as possible. Experience had shown that in cases in which prior actions were undertaken, the chances of successful implementation of the program increased rapidly.

Mr. Donoso stated that the authorities planned to discontinue their policy of preannouncement of the exchange rate after January 1984. Beginning in February, they would reinstate the policy of devaluation on the basis of inflation in the two or three preceding months. The preannouncement policy had been introduced in order to control inflation and to reduce the differential in return between financial assets denominated in foreign and national currencies. The authorities had already introduced a new instrument denominated in soles on which the return was determined by market forces. The market would determine the rate of interest necessary to compete with the return on assets expressed in dollars, and it could be expected that the rate would be high, given the expected rapid depreciation of the sol in the months ahead.

The authorities were also preparing strong measures in the fiscal area, Mr. Donoso continued. Following approval by Congress, expected to be obtained in the middle of December, the authorities intended to raise revenues by adjusting the sales tax, raising the minimum tariffs on imports, applying taxes on interest income, and increasing taxes on other income and wealth. In addition to general measures to reduce expenditures, they were concentrating on improving the financial performance of public enterprises. That policy involved the elimination of subsidies through increases in prices already subject to approval by the Ministry of Economy and Finance. The authorities also intended to implement a system to transfer the surplus of public enterprises to the Treasury before taxes on profits were due. They expected to achieve a marked reduction in the deficit of the nonfinancial public sector through those measures.

Commenting on the question of structural reforms, Mr. Donoso observed that there were rigidities in the labor market. There were also institutional questions in relation to property rights in agriculture that limited the possibility of channeling resources to that sector and that also made it necessary for subsidiary action on the part of state agencies to maintain production. In addition, labor was sometimes allowed to participate in the profits and management of enterprises in the industrial sector. The Peruvian authorities perceived those institutional factors to be costly in terms of growth, and they had expressed their commitment to replacing them with arrangements that would favor improved resource allocation and the ability to manage resources. However, the institutions had been in existence for many years, and some were in areas in which the executive could not act on its own authority. Congressional approval was required, implying that a broad consensus in the country would be necessary to introduce the reforms. The authorities were confident that the reforms would be enacted. Dealing with those issues was a fundamental objective of the structural adjustment loan being negotiated with the World Bank.

The Chairman made the following summing up:

> Executive Directors expressed concern about the recent adverse trends in the Peruvian economy and about the sizable slippages in the implementation of the program under the extended arrangement. Directors noted the unexpectedly weak performance of the economy as a result of adverse weather conditions, a point particularly stressed by a number of Directors. Those circumstances explained the expected decline in GDP of about 10 percent in real terms between 1982 and 1983 which had reduced government revenues below the projected level, while government outlays had exceeded the program level because of, inter alia, reconstruction expenditures and internal security requirements. In addition, however, Directors stressed that there had been serious inadequacies in expenditure control, and that the delays in effecting adjustments of controlled prices in 1983 had impeded the planned elimination of subsidies. Wage policy in the public sector had also been clearly inappropriate under the circumstances.
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> Consequently, in 1983, for the second consecutive year, fiscal performance would fall far short of the program targets. The prompt adoption of substantial revenue measures, together with much needed improvements in tax collection, the intensification of expenditure controls, and the correction of controlled prices for food and energy, were viewed as central to the improvement of the public finances and the return to the adjustment path envisaged in the extended arrangement. The emphasis of expenditure control ought to shift from cutting back on investment expenditure to major cuts in current outlays and improved financial management of public enterprises. Directors also noted that the Peruvian Congress was considering urgently needed additional revenue measures.
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> Directors stressed their concern about the acceleration of inflation in 1983 to well over 100 percent, an outcome that they considered closely related to the weakening of the fiscal position. They emphasized the importance of strengthening fiscal policy, of pursuing a strict monetary policy conducive to positive interest rates in real terms and of a firm wage policy aimed at achieving a major reduction of inflation.

The expected deficit in the current account of the balance of payments in 1983, although somewhat lower than the 1982 level, was viewed with considerable concern by Directors in the light of the high debt service burden faced by Peru. Directors noted that for a time the sol had been depreciated at least in line with domestic inflation, but strong reservations were expressed about the recent decision of the authorities to preannounce the exchange rate. Directors stressed the need to restore, on the contrary, greater flexibility in exchange rate management in order to assure an adequate degree of international competitiveness, and they welcomed the expressed intention to discontinue the system of preannounced exchange rates in early 1984.

Directors emphasized the importance of structural reforms to reduce economic rigidities. The continued existence of those numerous rigidities, notwithstanding commitments to reduce them in the context of the extended arrangement, had obviously impaired the efficient functioning of the economy and of the trade liberalization pursued by Peru in the previous few years.

Recent adverse developments in the Peruvian economy had increased the urgency for the Government to take appropriate action, and Directors called on the authorities to implement without delay a major, comprehensive, and coherent program, including a tightening of fiscal and monetary management, more flexible pricing, interest, and exchange rate policies, and a firm wage policy to reduce inflation, to adjust the balance of payments position, and thereby to lay the basis for sustained economic growth. The importance of accurate and timely data was an essential prerequisite to sound policy implementation, and Executive Directors regretted the inadequacy of the information procedures that had led to sharp departures in the completion of the program without the Fund's being aware of them. The staff view that the principal policy actions should be put in place before the extension of further financial assistance by the Fund was supported by Directors.

In sum, the considerable external difficulties that Peru has had to face and that were recognized by Directors should not be an excuse to relax or to defer adjustment; on the contrary, they made it all the more essential to address the country's problems without delay and to get the economy back under control through strong, decisive measures.

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

3. ACCESS LIMITS - SPECIAL FACILITIES

The Executive Directors considered a staff paper reviewing access limits for special facilities (EBS/83/232, 10/31/83).

Mr. Ismael stated that his chair favored the preservation of the present limits on the special facilities and the retention of the present 50 percent of quota as the threshold level dividing the lower and upper segments of the compensatory financing facility.

The facilities had served members well, Mr. Ismael continued. Indeed, they had been the most successful of all Fund facilities. Because of their quick-disbursing nature, the facilities, particularly the compensatory financing facility, came closest to acting as a bridging credit facility for members. In a number of cases, the compensatory financing facility supplemented the use of the Fund's general facilities. Preserving the existing limits would not necessarily erode the revolving character of Fund resources. The Executive Board had effective means of determining whether a balance of payments deficit would reverse itself and more than adequate safeguards, through the policy of conditionality, to protect against deficits arising from members' policies.

It was not appropriate to reduce potential access when the Executive Board had recently tightened the concessional nature of the compensatory financing facility, Mr. Ismael considered. In addition, approval of the present limits would serve to underscore to the international community the Fund's resolve and commitment to assist members in overcoming their temporary difficulties. That commitment had been eroded when the Fund had decided to scale down drastically access to the general facilities, although it had been amply demonstrated that global economic conditions had severely weakened members' growth and income prospects. The situation had not changed, and the need for assistance had not diminished. In view of the importance of the special facilities, particularly to the less developed countries exporting primary commodities, many of which preferred to use the special facilities rather than the general facilities, Executive Directors should reinforce their support for members by maintaining the present limits.

Table 2 of EBS/83/232 provided information on the impact of quota limits on absolute access, Mr. Ismael noted. The previous change in the limit on the compensatory financing facility, extending it to 100 percent of quota, had been in August 1979. Inflation since then had averaged slightly more than 9.5 percent a year, suggesting that the real value of access since 1979 had been eroded by about 39 percent, equivalent to the percentage increase in absolute access under the new quotas for the "core" 120 members, i.e., excluding 12 industrial countries and 12 oil producing countries, indicated on line 1, column 4 of Table 2. Thus, a reduction below the present level of the limit would erode members' potential access to those facilities in real terms.

Mr. Tvedt recalled that, in previous discussions of the question of access to the special facilities, his chair had favored reducing those access limits in proportion to the change agreed upon under the enlarged access policy. His authorities continued to hold that view. It was not easy to interpret "proportionality" within the proposed "dual" enlarged access policy, and the Fund should maintain uniform access limits for each of the facilities in question because drawings under the special facilities were not subject to the same strict criteria as those under the enlarged access policy. Hence, a range of access limits for the special facilities would be inappropriate and would undoubtedly complicate further the Fund's rules.

A straightforward application of the Interim Committee's conclusions would point to access limits within the range of 68-83 percent of quota, Mr. Tvedt continued. An access limit of 75 percent would have followed from the suggestion made by his authorities in connection with the discussion on access limits under the enlarged access policy. However, he could accept any access limit in the range of 75-85 percent. The staff had estimated that a limit of that nature would not have a serious impact on the extent of requests for drawings in 1984 and that, therefore, it would not greatly affect the Fund's liquidity position. The limit should not be lower than 75 percent, because to go below that figure would result in a sharp rise in the number of countries faced with a decline in absolute access. On the other hand, the limit should not exceed 85 percent; at that limit, virtually all countries would be better off after the new quotas took effect. With regard to the buffer stock financing facility, the staff estimated that drawings would remain modest, well within the limits under discussion at the present meeting; nevertheless, for the sake of simplicity, he preferred a limit of 40 percent of quota.

Mr. de Maulde remarked that Executive Directors would need to seek a compromise among the range of preferences favored in the Executive Board. For a number of compelling reasons, his first preference would be to retain the present access limits unchanged as percentages of quotas. First, the special facilities primarily benefited the poorest countries in the world. Since 1963, more than 100 countries had made purchases under the compensatory financing facility, among them no industrialized countries and only a small number of oil exporting countries. On economic, political, and moral grounds, it would be extremely inappropriate for the Fund to appear to cut back on assistance to the poorest countries, especially when they were facing exceptional financial problems and most needed the resources.

Second, the special facilities played an extremely useful countercyclical role, Mr. de Maulde continued. The level of drawings on the compensatory financing facility was closely related to the level of world economic activity, as clearly indicated in Chart I of SM/83/131 (9/6/83). The annual drawings had been large in the aftermath of the 1975 recession, amounting to SDR 2.3 billion in 1976. After stabilizing at about SDR 500 million between 1977 and 1980, they had peaked again at SDR 2.6 billion in 1982 following the second oil shock. Drawings on the special facilities bolstered weakening global demand, and they faded when that demand strengthened, thereby constituting one of the few automatic stabilizers of the international economy. In that regard, it was difficult to understand the staff's estimates that drawings under the compensatory financing facility would be SDR 1.2 billion in 1984 and SDR 2-2.5 billion later. That estimate appeared inconsistent with the projections made in the World Economic Outlook, which had suggested the prospect of a relatively sustained rate of growth in the years beyond 1984. If the latter forecasts were to turn out to be correct, drawings under the compensatory financing facility would decrease, not increase.

A third argument in favor of the special facilities was their usefulness as a substitute for bank credit, Mr. de Maulde commented. The few bank credits that developing countries could obtain were, for the most part, backed by export receipts. When the countries were faced with export shortfalls, there was a consequent drying up of bank credits. A drawing under the compensatory financing facility more often than not constituted a means of refinancing when other resources had become unavailable. In that regard, the Fund's special facilities again played the role of automatic stabilizers. Finally, it was sometimes argued that the special facilities should be reduced because they were unconditional, i.e., they did not contribute to adjustment. Such a view was inaccurate. Between January 1976 and October 1981, of a total of 67 upper tranche drawings under the compensatory financing facility, 47 had been associated with other Fund arrangements. Between November 1981 and June 1982, 21 of 22 such drawings had been associated with credit tranche arrangements. In practice, therefore, a substantive drawing on the compensatory financing facility was almost always associated with a stand-by arrangement and was, therefore, part of a highly conditional package.

While the preceding arguments represented strong grounds for maintaining the present limits, Mr. de Maulde went on, he was prepared, in a spirit of compromise, to move from his initial preferences. However, he could not agree to a reduction in the limits on the buffer stock financing facility or on the cereal facility. A decrease in the former would constitute an inappropriate political signal at a time when the establishment of the UNCTAD Common Fund represented an international priority. Should the Common Fund come into force, however, a general review of the buffer stock financing facility would be appropriate. Experience with the cereal facility remained surprisingly limited, with only six requests during the previous two years, although a number of countries were facing a critical food situation. It was clearly politically impossible to reduce financing for food for the poorest countries.

With regard to the export shortfall portion of the compensatory financing facility, Mr. de Maulde observed, he could accept a two-tier system of limits, with a limit of 85 percent in general and 100 percent in exceptional cases, similar to the proposals agreed to by the Interim Committee with regard to enlarged access policy. Under the 85 percent limit, the ratio of access under the compensatory financing facility to access under the credit tranches would fall. In February 1963, the ratio had been 25 percent. If the limit on the compensatory financing facility were set at 85 percent, compared to the 500 percent upper limit on ordinary resources at present, the ratio would decline to 17 percent. At the same time, access for the "core" countries would increase by 18.4 percent, with a decline in access for only one country. In particular cases, Executive Directors could increase the limit from 85 percent to 100 percent. He did not have a firm proposal with regard to the criteria that would govern movement from the general to the particular cases; such criteria had not yet been agreed upon under the enlarged access policy. Perhaps access of 100 percent of quota could be considered in cases of significant shortfalls, for example, more than two times the member's quota, or perhaps when there was only limited room for further drawings under the facility. Such possibilities could be considered at a later date.

Mr. Finaish commented that an important consideration to be kept in mind in the present review was that the special facilities served a purpose distinct from that served by other forms of Fund assistance. The experience of the previous few years had again demonstrated the need to preserve the important role that the special facilities, and the compensatory financing facility in particular, could play in mitigating the negative impact of unavoidable trade fluctuations on economic growth and stability. While the availability of Fund resources put a constraint on the ability of the Fund to perform that role, as well as its other roles, the substitutability of those roles should not be exaggerated. Neither should an undue link be drawn between access limits under the special facilities and those under the enlarged access policy. While the enlarged access policy was temporary, subject to a phasedown as conditions permitted, the case was not the same with the special facilities. Thus, while the Interim Committee had recommended an annual review of access limits under the special facilities together with the review of the enlarged access policy, there was no justification for linking changes in the former, either conceptually or in practice, to possible changes in the latter.

Projected drawings under the compensatory financing facility for 1984-88 were not particularly sensitive to changes in access limits to the facility, Mr. Finaish continued. Hence, the liquidity impact of a reduction in those limits was relatively small. None of the drawings projected for 1984 was expected to exceed 85 percent of the new quotas. That situation weakened the main argument for reducing access limits under the special facilities, namely, that such a reduction was necessitated by the Fund's liquidity position.

While it was useful, in reaching a decision on access limits, to know the impact of various quota limits on absolute access, care should be taken in interpreting that impact, Mr. Finaish considered. Offsetting quota increases by lowering access limits would maintain the level of absolute access. However, it was only natural for absolute access to increase along with the increases in quotas. It was not surprising, therefore, that, historically, there had been no link between increases in quotas and reductions in access limits. It would be odd to expect absolute access in nominal terms to remain constant, ignoring inflation, the growth in world trade, and the total volume of quotas.

Commenting on the question of proportionality between access limits under the special facilities and under the tranche policies, Mr. Finaish remarked that, to the extent that the two sets of facilities served different purposes, they should be viewed separately. Even if the principle of proportionality were accepted, it should be borne in mind that, under the policy of enlarged access, the upper limit could be exceeded in exceptional circumstances, while no such provision existed under the special facilities. It might also be argued that access limits under the special facilities should be reduced more than proportionately in order to shift the balance in favor of conditional Fund assistance. It was questionable, however, whether such a justification could continue to be used in light of recent Executive Board discussions on conditionality under the compensatory financing facility and the test of cooperation in particular. He noted Mr. de Maulde's comments on that question.

When considering the impact of lower access limits on Fund members, Mr. Finaish went on, special attention ought to be given to the disproportionate effect that might fall on small-quota, low-income countries. In EBS/83/233 (10/31/83), to be discussed by the Executive Board at EBM/83/166 and EBM/83/167 (12/2/83), the staff specifically referred to the dependence of many of those countries on single export commodities and to their vulnerability to shifts in the terms of trade and to natural disasters. It was significant that about half of the use of Fund resources by those countries had been through the compensatory financing facility. Those kinds of considerations had prompted the Interim Committee to state in its communiqué that, "in implementing its policies on access to its resources, the Fund should be particularly mindful of the very difficult circumstances of the small-quota, low-income member countries." In light of such considerations and others that he had stated on previous occasions, he continued strongly to prefer the maintenance of the present access limits under the special facilities as percentages of quota. The threshold separating the lower and upper segments of the compensatory financing facility should continue to be 50 percent of quota, which also represented 50 percent of access. In any event, the limit on the lower segment should not be reduced below 50 percent of quota.

The revised staff estimate for drawings under the compensatory financing facility in 1984 indicated a considerable reduction in the levels of drawings projected previously, Mr. Finaish observed, partly owing to the accelerating pace of economic recovery. At the same time, medium-term projections appeared to remain unchanged. While he did not dispute the staff's statement that members' use of the facility varied substantially from year to year, it might have been expected that the medium-term projections would have been revised downward on the basis of the new 1984 estimates and the improved prospects for a global recovery.

The usefulness of the method set out in EBS/83/232 to classify potential users of the special facilities was not clear, Mr. Finaish suggested. The distinction drawn between "core" countries and those referred to as "compensatory financing facility countries" might be unwarranted. The Executive Board had already clarified the question regarding possible requests under the compensatory financing facility by oil exporters, and it had been agreed that those countries would not be treated differently. The classification used in EBS/83/232 not only complicated the terminology, but might also give the appearance of special treatment, which the Executive Board had agreed to avoid. Moreover, if the distinction between oil exporters and other developing countries had been based in the past on the assumption that oil exporters were unlikely to draw on the facility, oil market developments in recent years had made that distinction much less meaningful.

Mr. Lovato recalled that, on several previous occasions, he had indicated his authorities' preference for a reduction in access limits for the special facilities roughly in proportion to the agreed reduction of quota limits under the enlarged access policy. The philosophy underlying that position was based on the consideration that the special facilities had merit in themselves and that the Executive Board should avoid reducing the potential access, in absolute terms, of member countries to those facilities. At the same time, the Board should avoid creating liquidity problems for the Fund.

He favored quota limits of 83 percent, corresponding to the reduction to 125 percent of the annual limit under the enlarged access policy, Mr. Lovato concluded. However, he could accept 85 percent if a wide consensus in favor of such a figure emerged. A proportional reduction should be applied to the limits on combined access under both components of the compensatory financing facility. His first preference would be to continue to use the midpoint of the ceiling as the threshold between the two tranches of the facility. However, he would be prepared to retain the present 50 percent of quota as the limit for access under the lower tranche, if that alternative helped to facilitate a solution to the problem. With regard to quota limits for the buffer stock financing facility, he supported the staff suggestion to reduce the limit in proportion to the reduction in the limit on access to the compensatory financing facility that would be agreed upon by the Executive Board.

Mr. Schneider remarked that the discussion of the current topic in the Interim Committee in September 1983 had not been conclusive, because a number of different views had been expressed. That situation suggested that the Executive Board would have to reach a compromise in order to come to a conclusion. Such a compromise solution would require some adjustment in access limits for the special facilities. His authorities' preference was for an adjustment more or less in line with the adjustment under the enlarged access policy. He noted that a number of countries continued to prefer to maintain the existing limits. However, in present circumstances, it would be inconsistent for the Fund to reduce its conditional financing in relative terms, while leaving untouched its financial assistance with low conditionality. Moreover, the fact that export shortfalls were the result of causes largely beyond the authorities' control was taken into account through low conditionality and not necessarily through maintenance of a given limit.

The staff had provided indications of the impact of different limits on access for individual countries, Mr. Schneider continued. In view of all the pros and cons, he could accept limits for the compensatory financing facility of between 80 percent and 85 percent, with a combined limit of 100 percent. He had no difficulty with the clarification of the test of cooperation as long as that guideline was applied flexibly. With regard to the threshold between the lower and upper segments of the facility, he favored using the midpoint between zero and the ceiling, thereby preserving equality of access under the two segments.

The agreed access limits under the special facilities would remain in force until a specific decision to change them was made, Mr. Schneider observed. That fact did not exclude an annual revision of those limits in line with the review of access limits under the enlarged access policy, although he was not convinced of the necessity for such a review. In the past, the Executive Board had adjusted the limits on the special facilities on the occasion of quota increases, as it was doing at present, but it had not thereafter proceeded with yearly reviews.

Mr. Kafka stated that he saw no justification for reducing proportionate access to the special facilities. The Executive Board had never before reduced proportionate access to the special facilities when quotas had been increased, nor had it ever linked access to those facilities to access to the extended facility or to enlarged access. The special facilities had one important characteristic: they were the Fund's only quick-disbursing facilities. Even though that characteristic had been damaged by recent decisions of the Executive Board, and damaged to the detriment of the international financial community, the special facilities remained the Fund's only approach toward a bridging credit facility, which the community badly needed. The implications for the Fund's liquidity position of maintaining proportionate access limits were by no means intolerable. Therefore, the limits ought not to be tampered with at present.

Mr. Erb said that his authorities continued to favor a limit of 68 percent for access to the compensatory financing facility. Such an adjustment corresponded to the adjustment to 102 percent in the enlarged access limit. He continued to favor the practice of setting the threshold for the lower and upper segments of the facility at the midpoint between zero and the ceiling. He could support a reduction in the access limit on the buffer stock financing facility in proportion to the reduction in the compensatory financing facility limit. Given the need for a compromise to facilitate agreement, such a compromise might be found in the range of limits comparable to the 102-125 percent range under the enlarged access policy, i.e., somewhere between a limit of 68 percent and 83 percent of quota for access to the compensatory financing facility.

Mr. Wicks suggested that the access limits under the export and cereal components of the compensatory financing facility should each be set in 1984 at about 75 percent of quota or perhaps a little higher, with a limit on combined access of 100 percent. A limit of 75 percent for access to the facility came close in generosity to the midpoint of the range of limits agreed by the Interim Committee for access under the enlarged access policy. The latest staff projections of drawings under the compensatory financing facility in 1984 reinforced his view that the suggested levels were appropriate. The information in Table 2 of EBS/83/232 indicated that limits of 75 percent and 100 percent would maintain or increase absolute access for many countries, including most of the "core" countries likely to draw on the facility.

The staff stated that "the projections for actual use of the facility in 1984 are not greatly sensitive to which access limit is selected," Mr. Wicks noted. That statement suggested that an access limit of the level that he had proposed could be accommodated without great hardship to member countries. A similar line of argument could be used to support an access limit of 40 percent of quota in 1984 for the buffer stock financing facility. The threshold between the lower and upper segments of the compensatory financing facility should be set at no higher than half of the limit for the export portion of the facility, i.e., at 37.5 percent of quota if the limit were set at 75 percent, or at 40 percent if the limit were set at 80 percent.

In line with the recommendations of the Interim Committee, the limits on the special facility should be reviewed annually together with the review of access limits under the enlarged access policy, Mr. Wicks considered. Those reviews should take account of the resources available to the Fund as well as of the demand for different kinds of Fund assistance. Although the Executive Board had discussed the special facilities on several occasions in 1983, there remained a number of aspects of the compensatory financing facility policy that were unclear and had not been resolved in earlier discussions. The question of the import content of exports would be taken up by the Executive Board in 1984. Following that meeting, perhaps a further general discussion could be undertaken to resolve outstanding issues affecting the special facilities.

Mr. Malhotra noted that his chair had already expressed the view that it did not favor any reduction in the access limits under the special facilities. As Mr. Kafka had pointed out, an increase in quotas had never previously been an occasion for reducing those access limits. There was no justification for reducing such access in the present particularly difficult state of the world economy, because those facilities were of special relevance to the poorer countries, countries with small quotas, and countries that depended heavily on the export of commodities. His chair had consistently believed that access levels should be considered in real, not nominal, terms. In light of the trend of inflation in recent years and the prospect for the immediate future, a reduction in access as a percentage of the new quotas, maintaining only absolute access, would reduce real access.

Nor was there any justification for establishing a link between access under the enlarged access policy and access under the special facilities, Mr. Malhotra continued. It was also worrisome that further reviews of access under the special facilities were contemplated, even when there were to be no quota increases. Such retrograde trends would be against the interest of the Fund's economically weaker members.

The liquidity position of the Fund had been a matter of concern to the Executive Board, Mr. Malhotra observed, and some Directors had suggested that because the demands on the Fund's resources were expected to be high it would be necessary to reduce access under the special facilities. However, in EBS/83/248 (11/21/83), the staff has stated: "It is estimated that the use of Fund resources in 1984 will be below the level assumed at the beginning of the financial year by approximately SDR 2 billion on average." It had added: "Insofar as 1984 is concerned, the financing under the special facilities is likely to be slightly less than SDR 1.5 billion." Furthermore, in SM/83/131 (6/16/83), the staff had stated:

> At a quota limit of 100 percent, the aggregate ratios of drawings to shortfalls might be in excess of those which prevailed on average in the period 1966-70...[but they] would be below the ratio that prevailed since the liberalization of the compensatory financing facility in the period 1976-83, and significantly below the ratio for 1980-82.

Indeed, the staff had gone on to point out that even an access limit of 125 percent would leave the ratio substantially below the level in 1980-82. Thus, the earlier fears that financing under the special facilities would be a problem for the Fund's liquidity position were unjustified. Further, according to the staff, a 1 percentage point increase in access under the special facilities would involve additional financing of only about SDR 30 million; in other words, the difference between access of 85 percent and 100 percent would involve additional financing of about SDR 450 million a year. On balance, such a relatively small amount should not be considered the basis for a significant change in policy.

Conditionality under the special facilities had already been tightened, Mr. Malhotra remarked, thus weakening the argument that there had to be a balance between conditional and unconditional facilities. Given that the financial implications of the various access levels were relatively small, there was every advantage in maintaining the present level of 100 percent because, if the level was reduced, it would be extremely difficult to raise it again in the future. The staff had suggested that the need for financing in the years after 1984 might be higher, and in such circumstances an access level of 85 percent might be inadequate. Directors should not be overly concerned about maintaining "parallelism" between the Fund's various facilities. Finally, he favored the retention of the threshold of 50 percent to divide the lower and upper tranches of the compensatory financing facility.

Mr. Laske recalled that he had on previous occasions stated his views on the functions of the special facilities, on the combination of conditional and unconditional Fund financing, on the desirable relationship between access limits under enlarged access policy and those under the special facilities, and his concerns with regard to the Fund's liquidity. His chair continued to favor a reduction of access under the compensatory financing facility and the other special facilities. The limits should be adjusted roughly in proportion to the reduction in access under the enlarged access policy, i.e., to 70 percent for each of the components of the compensatory financing facility, with a combined limit of 90 percent. He would not rule out a degree of upward flexibility in his position, provided that the basic considerations that he had referred to on previous occasions were not compromised. For example, a "safety margin" might be allowed for in the combined limit, perhaps by setting that limit at 100 percent. The threshold between the lower and the upper segments of the compensatory financing facility should continue to be the midpoint between zero and the ceiling, or about 35 percent if his proposal was accepted. He could support an access limit of 40 percent of quota with regard to the buffer stock facility, thereby permitting access at a higher level than strict proportionality would warrant.

Mr. Alfidja stated that his chair's position in favor of the maintenance of the present limits for the special facilities remained unchanged.

Mr. Senior, noting that his remarks were preliminary, said that the quota limits applicable to the special facilities following the coming into effect of the new quotas should remain unchanged. The present discussion could be regarded as another step in the struggle between two different views of the role of the Fund in the 1980s that had been initiated with the Eighth General Review of Quotas. Like many other Directors, and the staff, he would have preferred a larger quota increase than that which was about to take effect. However, the view that the Fund should have a minimum size of SDR 100 billion had not been accepted. As a result, the Fund had had to face liquidity problems and painful discussions on the level of access to its resources, a situation that could have been made easier, or perhaps even avoided, if there had been agreement on an adequate increase in quotas.

In an attempt to correct what events had shown to be an inadequate increase in the size of the Fund, Mr. Senior recalled, his authorities had sought to retain the 150 percent annual limit on enlarged access or at least, in light of liquidity considerations, 125 percent. However, the outcome had been the two-tranche system agreed to by the Interim Committee, which would lead to careful case-by-case considerations with the ensuing risk of breaking the principle of uniformity of treatment. It was now being suggested that there should be a substantial reduction in the access limits under the special facilities on the basis of an alleged relationship between enlarged access and access under those facilities.

The special circumstances of the world economy demanded a strong compensatory financing facility, the access limits of which should not be reduced below 100 percent of quota, Mr. Senior considered. As other Directors had pointed out, conditionality under the compensatory financing facility had been hardened, and, therefore, the maintenance of the current limits would not mean an increase in unconditional financing. He also supported the retention of the present 50 percent threshold dividing the lower segment from the highly conditional upper segment.

The compensatory financing facility was the only bridging facility currently in place within the Fund, Mr. Senior continued, and, given the financial strains that continued to threaten the world economy, such a facility would have to be able to cope with the initial phase of a financial crisis in any country. The point was all the more important if account was taken of the fact that the Bank for International Settlements had already indicated its uneasiness about continuing to supply bridging finance in the event that a further financial crisis should arise. The financial implications of maintaining the current limits provided no justification for a reduction in access. As the staff had indicated, a country-by-country analysis of expected drawings under the compensatory financing facility suggested that relatively small amounts would be drawn in 1984 and the years beyond. The number of countries experiencing balance of payments problems of the kind qualifying for compensatory financing was likely to be smaller as the world economy recovered. In addition, many other countries that might have sought the highest level of access under the compensatory financing facility had already done so.

Mr. Sangare observed that, in EBS/83/232, the staff set out the different positions of Executive Directors when they had discussed access on earlier occasions, and it went on to provide factual information on the evolution of access limits. The staff then examined the impact of alternative quota limits on absolute access to the special facilities, pointing out that the lowest limit at which no country would suffer a loss in absolute access was 82 percent of the new quotas. Although aggregate absolute access for the 120 "core" users of the compensatory financing facility would be preserved with a limit of 72 percent, such a situation would result in a reduction in absolute access for 76 of those users. With an access limit of 68 percent, as proposed by a number of Executive Directors, the number of countries that would experience a decline in their absolute access would rise to 107 out of the 120 "core" countries. With regard to the threshold between the lower and upper tranches of the compensatory financing facility, the staff suggested either the midpoint between zero and the ceiling, or retention of the present 50 percent of quota. Finally, the staff provided a rough estimate of the financial implications of alternative access limits to the special facilities, indicating that annual drawings would range from SDR 2 billion with a limit of 68 percent to SDR 2.5 billion with a limit of 85 percent. Total drawings would increase by SDR 30 million for each percentage point increase in access limits.

During the previous discussions on access limits, Mr. Sangare recalled, his chair had argued in favor of retaining the present access limits for the special facilities, and he continued to maintain that position. He could not countenance any limit that would involve a loss in absolute access to any of the Fund's members. An access limit set at 72 percent would result in a loss in absolute access for 15 of the 17 countries in his constituency. He favored the retention of the present 50 percent of quota as the limit for access under the lower segment of the compensatory financing facility.

Mr. Zhang said that he also believed that the level and structure of the present special facilities ought to be maintained. There was no historical or logical link between changes in the special facilities and other Fund facilities. The former facilities were important for the poorest countries and for single commodity exporting countries. Conditionality under the compensatory financing facility had already been tightened. The financial implications of maintaining the present level of access to the special facilities were relatively small.

Mr. Yamashita stated that his authorities continued to believe that a reasonable balance between access under the special facilities and under the other Fund facilities had to be struck in order to use the Fund's resources most effectively. Therefore, a new quota limit of 68 percent for access under the compensatory financing facility after the Eighth General Review of Quotas came into effect would be reasonable, as it would correspond to the reduction to 102 percent in the annual limit under the enlarged access policy. However, in a spirit of compromise, he could go along with an access limit of about 80 percent, if it commanded the support of a majority of the Executive Board. He was interested in Mr. Wicks's point that the access limits should be reviewed annually. With regard to the threshold between the lower and upper segments of the compensatory financing facility, he favored the continuation of the midpoint of the ceiling. Such a solution would be straightforward and would preserve equality of access under the two segments. He noted the staff analysis with regard to the new quota limits for drawings under the buffer stock financing facility, and he could support a reduction that was in proportion to the reduction in the limit on drawings under the compensatory financing facility.

Mr. Polak remarked that he favored an access limit of 75 percent for the compensatory financing facility. Such a solution would involve a proportional adjustment in the other access limits, although it would be reasonable to round up the relevant numbers, i.e., a limit of 100 percent under the two components of the compensatory financing facility, and a limit of 40 percent for the buffer stock financing facility. He favored the retention of the midpoint between zero and the ceiling as the threshold between the lower and the upper segments of the compensatory financing facility. While agreement had been reached in the Interim Committee that there should be annual reviews of access, it did not follow that, if access under the enlarged policy were reduced in the next review, there would be implications for access under the special facilities. He hoped that Directors would be able to act in a spirit of compromise and that agreement could be reached at the present meeting.

Mr. Joyce observed that his original position had been that he could accept some reduction in access at present, given that an increase in quotas was about to take effect. However, he agreed with Mr. Malhotra that there was no clear or firm link between the limits on overall access and the limits on the special facilities. While excessive use of the special facilities could have an adverse impact on the Fund's liquidity, such a situation did not exist at the moment. His previous position had been that he could not accept a reduction, even at present, more than proportionate to whatever reduction was agreed upon for access under the enlarged access policy. At that time, discussion had focused on an overall access level of 150 percent of quota as a minimum, not the level that his authorities would have preferred. Since then, the Interim Committee had come to conclusions on access limits and had also urged the Fund to be particularly mindful of the difficult circumstances faced by small-quota, low-income countries.

In light of the changed circumstances, Mr. Joyce continued, his position was that access limits under the compensatory financing facility should be set at between 80 percent and 85 percent. He strongly supported Mr. de Maulde's suggestion that, at a minimum, the limits for small-quota countries should go as high as 100 percent. Such limits should apply under both the cereal decision and the export shortfall decision, and there should be a combined limit of 100 percent. With regard to the threshold between the upper and lower segments of the facility, a level of 50 percent was preferable, especially given the de facto tightening of conditionality that appeared to have occurred recently. He could accept a limit of 40 percent for access under the buffer stock financing facility; if the UNCTAD Common Fund came into effect, the limit under that facility should be reviewed.

Mr. Suraisry commented that the compensatory financing facility was important and had served members well in the past. There were several reasons why the current limits should be maintained. The facility was quick disbursing, and it was the closest form of assistance that the Fund had to a bridging facility. For that reason, it had been extremely useful to many members, and it had provided a breathing space until they could negotiate a program with the Fund. The distinction between the Fund's "conditional" and "unconditional" facilities had become increasingly blurred. Conditionality had been tightened on the use of the compensatory financing facility during the past year. It was difficult if not virtually impossible, at present, to make a drawing in the upper segment of the facility unless the member had a program with the Fund. The difference in the conditionality between the upper and lower segments had also been regrettably diluted. Therefore, there was no reason why access under the special facilities should be reduced along with the expected reduction in the enlarged access limits.

As indicated in Table 1 of EBS/83/232, Mr. Suraisry continued, members' access under the compensatory financing facility had declined significantly in relation to their access under the tranche policies. The relative decline had started in June 1969 and had accelerated after December 1975. Keeping the present quota limits for the facility in place for 1984, while the quota limits in the tranche policies were being reduced, would go only part of the way toward restoring the relative importance of the facility. Earlier calculations by the staff had shown that, under various plausible assumptions, the assistance provided by the facility would be lower in 1984-88 than in 1976-82, even at the present 100 percent quota limit. There was no justification for reducing further the assistance provided through the facility, particularly as there continued to be considerable uncertainty regarding the course of the world economic recovery.

The latest country-by-country estimates indicated that use of the facility could be expected to be SDR 1.2 billion in 1984, Mr. Suraisry noted, an amount lower than that previously projected on an annual basis for 1984-88. Furthermore, those estimates showed that drawings under the facility in 1984 were not likely to be greatly sensitive to the access limits selected. In light of the forthcoming enhancement of the Fund's ordinary resources from the quota increases, the Fund could afford such a level of use of the facility in 1984.

He also favored the retention of the present access limits for the cereal component of the compensatory financing facility and for the buffer stock financing facility, Mr. Suraisry stated. Past evidence suggested that those facilities were not likely to be used nearly as frequently as the export shortfall component of the compensatory financing facility; the Fund could afford to keep the present limits for 1984. The compensatory financing facility, as currently structured, was useful and had provided effective assistance to member countries. He hoped that the Executive Board would agree to maintain the present limits. However, it was equally important to reach consensus soon on the issue so that the facility would continue to play its valuable role.

Mr. Prowse remarked that the authorities in his constituency held a range of views on the issue under discussion, not dissimilar to the differences in views in the Executive Board, but his authorities were also willing to compromise. He hoped that a compromise solution could be reached quickly in the Executive Board. There was no evidence in EBS/83/232, or in other sources, to suggest that there had been in the past a close link between access under the special facilities and overall access policy. There was no logical reason why there should be such a link, although the possibility of considering the various sets of facilities together had been acknowledged by the Interim Committee.

In considering the scope for compromise, Directors should note that the projections of demand on the Fund's resources were very uncertain, Mr. Prowse continued. However, the effect on the Fund's liquidity of varying assumptions about demand on the special facilities was not large; in other words, the impact on the Fund's liquidity was less important in terms of the Fund's financial operations. In light of such considerations, it could be seen that the outcome of the Interim Committee's discussions had reflected a willingness to compromise that had focused on the maintenance of absolute access for each member. Thus, given the various uncertainties, it was not clear that much would be achieved by restricting access to the special facilities severely.

He could support an access limit for the compensatory financing facility in the range of 80-85 percent under each component of the facility, with a combined limit of 105 percent, Mr. Prowse stated. Given that small-quota countries ought to receive special consideration, as some Directors had already suggested, the limit for those countries could perhaps be set at 100 percent rather than 80 percent, with a combined limit of 125 percent rather than 105 percent. With regard to the buffer stock financing facility, it was important to be consistent, and for that reason he could accept a reduction in access under that facility proportionate to the reduction in access under the compensatory financing facility. In light of the refinement of conditionality, particularly with regard to the test of cooperation, under the compensatory financing facility, he could support the retention of the 50 percent figure as a threshold between the lower and upper segments. However, if a majority appeared to be favoring the midpoint between zero and the ceiling, he could accept such a solution in a spirit of compromise. The Interim Committee had concluded that access limits to the special facilities should be reviewed at the time of each review of the enlarged access policy; nevertheless, it was important to bear in mind the lack of a historical link between the special facilities and the general facilities, and a decision on the former should not be seen as establishing a principle of proportionality or "parallelism" between the two sets of facilities.

Mr. Malhotra commented that the information in Table 1 of EBS/83/232 should be considered in light of some Directors' remarks about the link between the special facilities and the general facilities and the supposed need to reduce access proportionately. The table showed that, in December 1975, access under the special facilities had been 75 percent of quota, while access under the tranche policies had been 165 percent. In August 1979, access under the special facilities had risen to 100 percent and under tranche policies to 305 percent. It had remained at 100 percent in May 1981 under the special facilities, whereas under tranche policies it had risen to 600 percent. If indeed there were a link between the two sets of policies, access under the special facilities should have been raised to 200 percent in 1981. Directors should consider the so-called linkage issue in light of that background.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/162 (11/23/83) and EBM/83/163 (11/28/83).

4. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 83/90 and 83/91 are approved. (EBD/83/289, 11/17/3)

Adopted November 23, 1983

b. The minutes of Executive Board Meetings 83/92 and 83/93 are approved. (EBD/83/290, 11/18/83)

Adopted November 25, 1983

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/285 (11/23/83), and by an Assistant to an Executive Director as set forth in EBAP/83/284 (11/23/83) is approved.

APPROVED: March 30, 1984

LEO VAN HOUTVEN
Secretary