

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/95

3:00 p.m., July 9, 1982

J. de Larosi re, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors

R. D. Erb

T. Hirao

J. C. Iarezza

R. K. Joyce

A. Kafka

B. Kharmawan

S. Nana-Sinkam

M. Narasimham

A. R. G. Prowse

J. Sigurdsson

Zhang Z.

Alternate Executive Directors

O. Kabbaj

C. Taylor

M. A. Senior

O.  ger, Temporary

A. Le Lorier

S. R. Abiad, Temporary

T. Yamashita

R. T. Salazar

J. R. Gabriel-Pe a

V. Supinit

F. Sangare

G. Winkelmann

C. P. Caranicas

A. Alfidja

S. El-Khoury, Temporary

T. de Vries

B. Legarda

A. Wright, Acting Secretary

J. A. Kay, Assistant

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Arrangement, and Purchase Transaction - Compensatory
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Also Present

Administration Department: M. Russo, Deputy Director; W. Bier, A. Goltz, G. E. Gondwe, J. G. Keyes. African Department: O. B. Makalou, Deputy Director; S. E. Cronquist, D. J. Goldsbrough, J. W. Kratz, M. Reichardt, M. Sidibe, K. Yao. Asian Department: Tun Thin, Director; P. R. Narvekar, Deputy Director; U. Baumgartner, U. R. Gunjal, I. S. Kim, B. J. Smith, D. Villanueva. European Department: W. L. Hemphill. Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; H. Hino, S. Kanesa-Thanan, M. R. Kelly, C. M. Loser. External Relations Department: C. S. Gardner, Deputy Director; A. M. Abushadi. Fiscal Affairs Department: M. J. Fetherston, J. C. Tavares. Legal Department: G. P. Nicoletopoulos, Director; A. O. Liuksila, J. M. Ogoola. Research Department: K.-Y. Chu, N. M. Kaibni, B. R. H. S. Rajcoomar. Secretary's Department: J. C. Corr. Treasurer's Department: A. G. Chandavarkar, H. Flinch. Advisors to Executive Directors: C. J. Batliwalla, A. B. Diao, P. Kohnert, Wang E. Assistants to Executive Directors: H. Alaoui-Abdallaoui, L. Barbone, L. E. J. Coene, T. A. Connors, M. K. Diallo, I. Fridriksson, F. G. Guena, A. Halevi, Jiang H., M. J. Kooymans, W. Moerke, J. A. K. Munthali, V. K. S. Nair, J. R. Novaes de Almeida, Y. Okubo, J. G. Pedersen, G. W. K. Pickering, C. N. Pinfield, E. Portas, J. Reddy, J. Schuijjer, D. I. S. Shaw H. Suzuki, J. C. Williams, J. F. Williams, A. A. Yousef.

1. INDIA - EXTENDED ARRANGEMENT - PROGRAM FOR SECOND YEAR

The Executive Directors continued from the previous meeting (EBM/82/94, 7/9/82) their consideration of a paper on the program for the second year of the extended arrangement for India, together with a draft decision (EBS/82/102, 6/11/82).

The staff representative from the Asian Department, continuing his replies to questions posed at EBM/82/94, commented on the position of the States. Consolidated public accounts, including a consolidated statement of state finances, were expected to be available in November 1982, even though amounts for one or two States might not be available by then. However, at the time of the review of performance, only partial information would be available, and it was unlikely that the staff would be able to provide a broad range of quantitative information on public savings and budgetary developments. It should, however, be possible to provide a qualitative assessment of changes in the public finances of States at the mid-term review.

Although no consolidated statement of state finances existed at the present time, the staff representative went on, a considerable body of information was available on the States' financing plans for 1982/83, and the staff had drawn on them in constructing the program with the authorities. There was a continuing dialogue between the Central Government and the States on the financing plans for the year; plan financing was an integral part of the budgetary preparation by the Central Government and the central government budget did include details of state plan financing. Nevertheless, detailed information was not available to the staff on such matters as the specific price adjustments in electricity, water, and road transportation tariffs that the States would implement in 1982/83. The state authorities had made commitments to the Central Government to raise financial resources that would involve price adjustments in those fields, but the specific details, which would vary from State to State, were not available to the staff.

The question that seemed to have been exercising many Executive Directors, the staff representative went on, was whether savings at the state level would be adequate to provide the investment needed in the critical sectors. The World Bank seemed to have similar concerns. In fact, the volume of spending that could be undertaken by the States with the current level of savings was well short of what the authorities themselves had anticipated in the Sixth Plan. Naturally, some shortfalls should be expected, and the authorities probably had not envisaged that they would meet all their targets in real spending, especially at the state level. However, the shortfalls that were beginning to emerge were substantial, and the authorities would probably be unable to protect real investment in the two critical state sectors of irrigation and electric power, because those comprised roughly 60 per cent of the planned state spending. Some speakers had asked whether the authorities could offset the shortfall in state savings by transfers from the Central Government. It did seem that in 1982/83 the Central Government would have funds available to finance some additional transfer of resources to the States.

However, the Central Government had no intention of bailing the States out of their difficulty. The authorities had made it clear to a number of States that had not been as forthcoming in resource mobilization as necessary that if the States could not contribute the resources they needed, the Central Government would provide no more than its agreed minimum. Under the circumstances those States would be forced to accept a cut in the level of their plans, which was politically unpalatable. Naturally, the Central Government also had to fight to raise the necessary resources, but its difficulties were less than those of some of the States.

A number of speakers had remarked that still further investment would be required in the railways, the staff representative recalled, as the real level of annual plan expenditures on the railways over recent years had been only about half the expenditures undertaken during the period 1956-66. Consequently, the railways had been starved of investment for a considerable time. While the authorities had been the first to recognize the need, it would be quite unrealistic to believe that a long period of underinvestment could be compensated for at all rapidly. During the first three years of the plan, they had however made very great efforts to increase the level of real investment in the railways which, in India, were very extensive and required a very large volume of resources.

Taking up other comments on the budget, the staff representative remarked that the performance of the authorities in reducing subsidies had been quite impressive. In 1979/80 subsidies had amounted to 1.7 per cent of GDP; the figure had fallen to 1.4 per cent in 1980/81 and to 1.2 per cent of GDP in 1981/82. The authorities would probably feel it unwise to eliminate the subsidies on some of the items. By reducing subsidies as a percentage of GDP, the authorities had also reduced the burden on total expenditure, and had therefore achieved at least a modicum of success.

The shortfall in project implementation in the steel sector had arisen from developments in past years, the staff representative considered; it was not directly related to the adequacy of funding in the current year. It was, however, true that the adjustments to steel prices that had been implemented as a result of deregulation would provide the industry with additional resources and should take some of the strain off financing-capacity increases in the future. Mr. Hirao had raised the more general question of whether further liberalization of industrial policies could be looked for in 1982/83. The authorities would probably emphasize that there was a need for continuity in policy; any given policy had to be in existence for a considerable time to achieve the desired effect. It was probably better to change policies periodically rather than to introduce a continuing flow of alterations in industrial regulations. At the time of the mid-term review the staff would wish to see how the recently introduced policies relating to the more liberal industrial licensing arrangements were being implemented. It was difficult to foresee in advance the effect of all policy changes and India still had a considerable way to go to overcome some of the unnecessary constraints on industrial activity. Nevertheless, the changes already introduced were of major significance.

In reply to Mr. Zhang, the staff representative explained that the difference between net savings and gross savings in India amounted to about 6 percentage points of GDP. Consequently, if gross savings were about 24 per cent, net savings would be in the neighborhood of 18 per cent. As to the distribution of savings, the household sector accounted for about 80 per cent and the corporate sector for about 5 per cent. The circumstances were rather special, however, because the household sector included a very large number of household enterprises, which included most farm operations.

Replying to questions regarding the relationship between gross capital formation and the rate of growth, the staff representative explained that in the particular circumstances of India over recent years, there was little discernible connection because the severe drought in 1979/80 had affected both the level of output and the level of savings and investment. More generally, in India the capital/output ratio had been tending to rise over time, something that was a matter of concern. The cause of the increase seemed to be related to the pattern of investment; in particular, it seemed unlikely that the capital/output ratio would fall at a time when investment was being concentrated on infrastructure, an area in which immediate returns in terms of output were likely to be small.

Taking up the question of the terms of trade, the staff representative explained that the staff had provided what it believed to be the best possible estimates although those were, of course, subject to much uncertainty. The terms of trade for India had been worse than expected in 1981/82 because, first, India's export prices rose by some 3 percentage points less than had been expected, and second, the rise in the oil import price had been more than expected. For 1982/83 the staff had drawn heavily on the work performed in preparing the World Economic Outlook, and the suggestion was that India, like all non-oil developing countries, would benefit from a fall in oil prices from 1981/82. The most recent projection was that oil import prices in India would fall by 3 per cent in U.S. dollar terms, although they would rise slightly in SDR terms. The staff assumption that there would be no change in India's terms of trade in 1982/83 did imply faster growth in the price for non-oil imports as against export prices. India exported a great diversity of products; indeed some two thirds of India's exports were manufactures, thus setting the country apart from many non-oil developing countries, whose exports were largely commodities at the mercy of world market prices. There was some hope that the nature of India's exports would provide it with more stability in the terms of trade than experienced by many other developing countries. Although the staff expected India's terms of trade to change broadly in line with the path that had originally been projected for the coming few years, the terms of trade would nevertheless remain less favorable than envisaged throughout the rest of the program period.

By offering higher interest rates to nonresident Indians, the authorities were certainly showing a greater flexibility in the use of the interest rate tool, the staff representative from the Asian Department considered. The purpose of raising interest rates for that category

of persons was to increase the attractiveness of deposits and savings within India for the very large number of Indians abroad who could contribute to the national savings. More generally, however, if the rate of price increases remained around 8 per cent, it seemed unlikely that interest rates would move downward. Interest rate policy could contribute very greatly to the accumulation of private savings, and the staff would not wish to see any changes to upset the balance in the coming period.

A Deputy Director of the Exchange and Trade Relations Department started by assuring Mr. Nana-Sinkam that it was understood that the staff would regularly place any one-year stand-by arrangement within a medium-term context. Another general question, which had been raised by Mr. Abiad, was whether the judgment of the World Bank staff had any impact on Fund decisions regarding individual programs. The topic had been discussed by Executive Directors in April 1981 (EBM/81/61 and EBM/81/62). On that occasion the Managing Director had said that the Fund's lending potential should not be subject to the veto of the World Bank, and he assured Executive Directors that management would not support any notion of cross-conditionality. He had gone on to say that the Fund would, whenever relevant, wish to take advantage of the advice of the staff of the World Bank, and in appropriate cases, of the World Bank's management. In brief, the World Bank would often provide very important inputs for the Fund's thinking, but it would certainly not provide the only input, and in some cases not the critical input.

Taking up matters directly affecting India, the Deputy Director assured Mr. Taylor, first, that in connection with the mid-term review, the phrase "all aspects of export development" encompassed a continuing review of exchange rate policy. Second, the review would take up the progress under the external borrowing program. If there was new information it would be brought to the attention of the Executive Board, and there might be a need to propose some increase in the ceiling at that time.

Responding to comments on India's debt service ratio, the Deputy Director remarked that India was a low-income country. In 1982, the average debt service ratio for low-income countries had been about 14 per cent, while the figure for India was currently between 10 per cent and 11 per cent. However, the staff had always made it clear that it was not as concerned with the absolute debt service ratio for any given country as with the direction and speed of change. In that sense, the projected 4 percentage point increase envisaged for India could not be taken lightly. Indeed, in view of the rather poor outlook for concessional aid in the second half of the 1980s and the generally gloomy prospects for the longer-term debt outlook, the Indian authorities were certainly correct to pursue a cautious debt management policy.

Some Executive Directors had expressed continuing doubts about the extent of India's need to draw on the Fund's resources, the Deputy Director went on. While it was true that the projected outturn showed a moderately smaller aggregate deficit over a four-year period, India would still

experience a considerable loss of reserves. The management and staff had taken very seriously the Executive Directors' concerns that India should make adequate use of the commercial borrowing capacity available to it. In practice, during 1982/83 India would probably borrow in the neighborhood of at least SDR 2 billion, partly public and partly private; and two additional large loans would probably be undertaken. It was expected that the disbursement of the bulk of the loans would take place after the conclusion of the extended arrangement. Nevertheless, the staff considered that the authorities were undertaking a sensible financing pattern. For the shorter term, what Executive Directors were being asked to agree to was a scheduling of disbursements that in total amounted to 95 per cent of quota for a 12-month period, compared with the 150 per cent of quota that might be drawn by members under the enlarged access policy in a single year. Bearing in mind the very substantial drawdown of reserves that had occurred and the prospect for a substantial balance of payments deficit, India's proposed drawings from the Fund were well within the normal criteria.

Commenting on Mr. Kharmawan's observations regarding the need for the Fund to devise programs that would enable countries to combine adjustment with growth, the Deputy Director of the Exchange and Trade Relations Department explained that there was no difference of view between Mr. Kharmawan and the staff. Unfortunately, the Fund often found that members' economic circumstances were such that once arrangements were undertaken for the necessary adjustment, there was little margin for growth. In his view, the Indian authorities had been able to design an extended arrangement that did provide for considerable growth in the early years because, first, the authorities had come to the Fund before they had encountered a balance of payments crisis; second, through prudent policies in the past they had built up considerable reserves, which they had been able to use during 1981/82; and third and most important, the Indian authorities had decided that if the program was to succeed, they would have to take major actions at the outset of the program to ensure adequate resource mobilization, both in the public and in the private sectors. It was those actions that had provided the sound financing for the stepped-up program of investment. Unfortunately, the combination of circumstances was not always available to other countries.

Mr. Narasimham thanked Executive Directors for their unanimous support for the second-year program under the Fund stand-by arrangement for India. He would communicate the observations they had made to his authorities in New Delhi.

Regarding the achievement of targets in the key sectors, Mr. Narasimham reiterated that the Government was fully committed to the achievement of those targets; it was the firm belief of the Government that both the growth of the Indian economy and the medium-term adjustment of its external account depended crucially on their achievement, especially in the area of nontradables, such as power and transport. The Government of India stood ready to reallocate expenditures if the need arose to ensure that the investment was made and that the targets were met. The targets

themselves were admittedly rather ambitious. Consequently, it was likely that there would be some slippages; but the program would be fulfilled in the core sectors.

Some Executive Directors had wondered whether there was to be sufficient investment in the railway sector, Mr. Narasimham recalled. Even after the budget for 1981/82 had been formulated, the authorities had decided to step up outlays in that sector by Rs 2 billion, representing a 17 per cent increase in the original budget for the year. Meanwhile, operational improvements had led to the railways operating at nearly full capacity. The World Bank, in its report for the India Consortium, had commented on a number of innovations that indicated a dramatic improvement in the performance of the Indian Railways.

Some Directors had expressed apprehension that there would be a lag in investment in the power or energy sector, Mr. Narasimham said. It was true that there had been a lag in power capacity installation, amounting to some 20-25 per cent in the first two years. Those lags, however, were due not only to financial inadequacy on the part of the States or the Central Government, but also to other reasons. The sheer magnitude of the investment itself, compared to earlier years, had caused difficulties, and the authorities had run into problems of design and, even more, land acquisition and civil works construction, all of which had caused delays. Nevertheless, in the first two years of the current plan, some 4,000 megawatts had been installed compared to a target of 5,000 megawatts. In the current year an extension of 3,500 megawatts was being planned, and the World Bank had indicated that the target, while ambitious, was feasible both physically and financially. In the first six months of 1982, the authorities had in fact increased capacity by 1,900 megawatts, or 54 per cent of the 1982 target.

Taking up comments about investment under the control of the States, Mr. Narasimham remarked that, on a constitutional point, power was on the concurrent list, so that both the States and the Central Government could undertake investment in that field. The Central Government, through two agencies, the National Thermal Corporation and the National Hydroelectric Corporation, had undertaken massive investments, setting up very large thermal power stations with capacities of 1,200 megawatts and even 2,000 megawatts each. In a deviation from established policy in the power sector, the authorities intended to purchase three turnkey projects with external assistance and were negotiating for them with the United Kingdom, Japan, and the U.S.S.R.

Irrigation, unlike energy, was a matter entirely for the States, Mr. Narasimham continued. It was therefore noteworthy that the development of irrigation represented one of the high points of India's development program. At the time of independence, under 20 million hectares of land had been irrigated in the whole of India, and irrigation works at that time were mostly protective irrigation. There were currently 61 million hectares under irrigation, most of the increase having taken place during the past 10 or 12 years, and the emphasis was on productive irrigation.

The current annual rate of growth of irrigation was about 4 per cent on an expanding total. In 1981/82, some 2.5 million hectares had been brought under irrigation, with the same area expected for 1982/83. As a result, the plan target of 13.6 million hectares was being expanded to 14 million hectares. It therefore seemed unlikely that the irrigation sector would be starved for funds. Many Executive Directors had commented that India's agricultural performance had been strong in the past two years and that the weather-induced decline in output of 1979/80 had been overcome. One of the main causes of that success had been the spread of irrigation, and the World Bank itself had said that the rates of return on irrigation in India were above the conventional standards. It was true that the charges for irrigation were still low and that they could certainly be raised. However, that was a matter on which the Sixth Plan was very explicit, and it was a repeated theme in the various resource mobilization discussions in India.

So far as the other sectors were concerned, Mr. Narasimham recalled that the World Bank had characterized the manner in which the output of coal had been increased as "an astonishing performance." There had been a steady increase in output of fertilizer. With regard to steel, there had been a slight setback because of a delay in commissioning. Instead of a capacity of 14.1 million tons being reached in 1981/82 the authorities hoped that it would be reached in the next 18 months or so. The most dramatic increase in the key sectors had taken place in that of oil. In November 1981 (EBM/81/138 and EBM/81/139), he had stated that by 1984/85 the authorities expected to have an output equal to half of total requirements. However, only seven months later he was in a position to state that by 1984/85 India would be able to meet two thirds of its requirements from domestic production because of an acceleration of investment. The investment allocations in all sectors could certainly be altered as the program developed. In any event, it was customary in India to hold a review midway through a development plan. The review would take place toward the end of 1982 and would cover sectoral priorities, the implementation of projects, and the financing involved.

Replying to Mr. Abiad's point, Mr. Narasimham agreed that the average capital/output ratio had been 3.37 during the 1950s and 4.13 during the 1970s. In the power sector it had risen from 15.2 to 16.02 and in transport from 12.49 to 12.63. However, the overall capital/output ratio had been higher in the 1970s than in the 1960s because of changes in the power sector, which was traditionally capital intensive. In manufacturing, the present figure was 5.5 because of the heavy investment in steel and petrochemicals that was required. According to the World Bank, the capital/output ratio in India had fallen during the past three years largely because of the commissioning of new capacity and the increased production of plants reaching stable output.

Taking up the topic of resource mobilization, Mr. Narasimham recalled that the authorities in India had raised the target for public savings from 4.8 per cent to 5 per cent for 1981/82, and that the staff had characterized the resource mobilization measures that had been adopted as

"aggressive." The staff had also mentioned that there would be full funding for the central plan, and the importance attached by the authorities to public savings was clear from the language used in paragraphs 8 and 9 of the Statement of Policies attached to the letter from the Finance Minister of India dated June 8, 1982. Regarding saving in the States, while the Central Government could not dictate to the State Governments, it could influence the states in their actions, and the importance of additional resource mobilization by the States had been recognized at all levels. The States were fully represented on the National Development Council, which was chaired by the Prime Minister, which had chief ministers of states as members, and which was the final deliberative body taking broad policy decisions with regard to resource mobilization. It had been the National Development Council that had taken the decision that the various resource mobilization targets would be met. The Prime Minister herself had made a strong statement on the urgent need for real resource mobilization to fulfill the plan. The States had agreed to raise the resources required, and they were thoroughly aware that if they did not do so each of them would have a smaller plan.

The States had a vested interest in having a larger plan, especially for irrigation and power, because a great deal of state revenue, and indeed the development of the States themselves, depended on advances in agriculture and small-scale industry, both of which were in turn dependent on the extension of irrigation and the expansion of the power sector, Mr. Narasimham explained. When the Indian authorities said that they would take steps to protect investments in those sectors, they were being very serious. There was scope for reallocation of investment within the state plans, and it would certainly be undertaken if necessary, even at the expense of the social sectors. In the circumstances, he would not agree with the Director of the Asian Department that state financing constituted a weak link in the performance of India under the extended arrangement. In 1981 some Executive Directors had expressed misgivings because the States had been asked to raise Rs 5 billion; they had in fact raised Rs 8.3 billion.

Regarding the provision of a consolidated statement of accounts for the States, Mr. Narasimham said that the States' accounts would normally have been available about November 1982; however, there had recently been elections in four major States, which had in consequence not prepared full budgets. Nevertheless, adequate qualitative information was available. It was true that in 1981/82 there had been some central bank financing of the state deficits. However, during the present week, the Government of India had announced the method of dealing with the overdrafts of State Governments. In brief, any State that overstepped a reasonable margin was likely to find itself refused funds by the Reserve Bank, which was certainly a more brutal way of imposing discipline on the States than merely reducing the amount of financing for development projects. One way in which the Central Government could influence the States was by providing assistance for States to carry out their individual plans. The present formula placed a great deal of emphasis on resource mobilization by the states in determining eligibility for central government assistance.

As to whether the Central Government should transfer its own funds for the States, Mr. Narasimham continued, it might be worth recalling that even before independence the Central Government used to provide funds to the various entities then existing in India. At present there were a number of ways in which the Central Government transferred funds to the States, but under the constitution every five years a finance commission was appointed to examine the distribution of resources. One topic on which the most recent commission was to report was the possibility of overcoming a complaint sometimes voiced by some of the States that their revenue base was inelastic compared to that of the Central Government. An attempt would be made to see whether under the provisions of the Indian constitution the Central Government could raise taxes and assign the proceeds to the State. While still on the question of resource mobilization, Executive Directors might wish to know that if domestic savings and capital formation seemed to be lagging, it was because of the effect of a statistical aberration. Base figures for 1980/81 had been revised, so that in fact there was no real lag.

Regarding the money and credit situation, Mr. Narasimham recalled that those who had spoken seemed to have found that the aggregates were consistent with financial stability. Mr. Joyce had proposed the theory that the ease with which India had met the criteria indicated that the criteria should have been tougher. He could not share such a view, which implied that the Fund was always right and the country wrong. The authorities had in fact had considerable difficulty in meeting some of the ceilings. During 1982/83 the Government would be absorbing only 40 per cent of total expenditures, compared with 48 per cent in 1981/82. In other words, the rate of growth of the private sector would be substantially higher than in the previous year, and credit to the Government would be lower. Moreover, the authorities expected the commercial sector to expand more rapidly, not merely because the economy was operating at a higher level of activity, but also because of the restocking that would be required. In passing, the restocking would be made out of domestic production rather than imports. Purchases by the Food Corporation of India were running well ahead of purchases at the same time in 1981, and considerable amounts of finance might be needed. The figure might indeed exceed the Rs 5 billion that had been mentioned. Fortunately, too, India expected to produce 8.3 million tons of sugar in 1982/83 compared with 5.1 million tons in 1981/82. Exports were restricted by international agreement and much of the sugar would have to be stored. Consequently, the authorities would be ready to re-examine the adequacy of the level of commercial credit in relation to stocks at about the time of the mid-term review.

He agreed with Mr. Kharmawan, Mr. Narasimham said, about the dubious advantages of holding quarterly reviews of ceilings. As far as India was concerned, the country consisted of 23 States, 400 districts, several thousand points where government expenditure was committed, and 35,000 branch banks. Monitoring outlays continuously was therefore very difficult; in their anxiety not to go beyond the ceilings, the authorities set levels that were effectively much lower than the nominal ceiling, a

circumstance that introduced another very real constraint. Indeed, there had been protests not only from the commercial sector but also from the government sector and various spending departments about the squeeze that the authorities were enforcing as the result of their intention to live within the Fund's credit ceilings. While it was true that there had been special circumstances in 1981, prices continued to remain moderate. Indeed, at one point in May 1982 the wholesale price index had been below the figure for May 1981. However, the index had begun to climb once again, largely because of the impact of the coal price increase, together with increases in the prices of steel and cement. Moreover, in 1982 the monsoon had begun very badly, with the result that the market had begun immediately to mark up a number of prices for commodities.

On the export side, Mr. Narasimham reaffirmed that the Indian authorities would watch carefully the competitiveness of exports. As Executive Directors had noted, the authorities would continue to use the exchange rate in a flexible manner and to pursue a realistic exchange rate policy. The assumptions made by the Indian authorities regarding the terms of trade were neutral because of their concern with the international economic environment and growing protectionism. The thrust of policy would, of course, continue to be on export promotion. The authorities hoped that the worsening of the terms of trade in 1981/82 would be reversible, as distinct from the irreversible shift that had occurred in 1979/80 and had caused the authorities to apply for the extended arrangement with the Fund.

The liberalization of imports into India had been carried out against the tide, in the sense that the authorities had a genuine fear of dumping in India as the result of the new policy, Mr. Narasimham observed. That dumping did exist could be evidenced from the prices charged for soda ash: the cost in India was Rs 1,500 a ton and on the international market Rs 1,400 a ton. But one country had been selling soda ash to India at Rs 300 a ton, namely, one quarter of the international price. Similar practices had been found occasionally with aluminum. Nevertheless, the authorities had held fast to their policy of providing liberal access to imports. While the import regulations set out in Appendix IV certainly appeared cumbersome, they were much less inconvenient in practice. It was difficult to sweep away regulations that had accumulated over many years from one day to the next. India was opening up its industry to foreign competition, but the Executive Board should bear in mind the strength of the argument about infant industries, especially at a time when the larger industrial countries were taking steps to protect their aging industries against imports from less wealthy countries. In a similar vein, the Indian authorities permitted the import of such products as vegetable oils and, when necessary, of foodgrains. They still reserved the right to prevent the import of such luxury items as caviar and champagne, particularly in view of the grinding poverty that still persisted in India.

India was undertaking commercial borrowing, but with a keen eye on the debt profile, Mr. Narasimham explained. At a time when the international aid climate was deteriorating, when India was in danger of being unable to obtain equitable treatment, and when interest rates abroad had

become exceptionally high, the authorities had aimed to keep the debt service ratio at under 10 per cent. The 4 per cent increase in the space of 3-4 years was not to be taken lightly. The authorities believed that commercial borrowing should not be overdone, and that it should be undertaken only as part of a judicious blend of various types of financing. In 1981/82 India had drawn down its reserves, which had the same effect from a financial standpoint as commercial borrowing.

Taking up the comments on India's balance of payments needs, Mr. Narasimham observed that in 1981/82 and 1982/83 together, India was liable to have a balance of payments deficit of SDR 3.85 billion, against a combined total drawing from the Fund for those two years of SDR 2.4 billion. For the whole program period the drawdown on reserves might well be SDR 4.6 billion on a net basis against the total drawing from the Fund of SDR 5 billion. Reserves had been drawn down partly because of the back-loading of the extended arrangement; indeed, the World Bank's view was that India had already drawn down its reserves too far. It had suggested that the authorities should rebuild reserves to a level equivalent at least to three months of imports plus nonsector payments.

Speaking more generally, Mr. Narasimham explained that while the changes that India had embarked on were perhaps not dramatic, they were nevertheless very significant. It would be unwise of the Executive Board to expect major changes of policy in India in a short time. The present short-term economic management had improved the medium-term prospects, and the strategy had been to place increasing emphasis on the external sector. But the external front would continue to be uncertain, and if the climate for assistance from abroad continued to be clouded, there would be an increasing emphasis of policy on efficient import substitution in all those fields where India had economic advantages and comparative costs showed the way. India had accepted the challenge of undertaking the adjustment program while maintaining its rate of growth. Consequently, the extended arrangement for India might provide some lessons about how to adjust without giving up the growth objective. While it might be difficult in later years to keep up with the achievements of 1981/82, given reasonable weather and some improvement in the international economy the Indian authorities believed that they could do so. They certainly had the determination to carry the adjustment program to a successful conclusion.

He was speaking on behalf of India before the Executive Board for the last time, Mr. Narasimham mentioned. It was a matter of great satisfaction that he had been able to show that the deeds of the Indian authorities had answered the doubts expressed by some of the Directors in November 1981.

The Chairman made the following concluding remarks:

First, the Board has noted with great satisfaction that the implementation of the program during the first year of the extended arrangement has been on track, and that all the performance criteria have been respected and almost all the targets met. The results in the real economy have been good.

I was particularly impressed to hear that during 1981/82 India had increased its crude oil production by some 6 million tons, thus reducing dependence on imports from two thirds to one half. That is balance of payments adjustment.

I was also interested to hear that, after years of stagnation, India had increased its production of coal by 11 million tons a year. That is intelligent balance of payments adjustment.

I understand that India has increased the land under irrigation by 2.5 million hectares. That too is intelligent balance of payments adjustment.

So these results in the real economy are heartening; and I thank Mr. Kharmawan for having said that the Fund and India had put together an extended arrangement that yielded an effective positive adjustment policy.

In the financial sphere, the Board noted the slowdown in inflation, the rapid increase in public sector savings, and the prudent management of fiscal monetary policies. But the balance of payments has deteriorated, essentially for reasons outside the control of the authorities.

Second, the Board unanimously approved the second year of the program because it felt that the quality of implementation during the first year and the substance of the measures and the objectives set for the second year justified it in doing so. The Board has shown exceptional fairness during this discussion, and the impartiality of the judgments that have been expressed today shows that when actions live up to expectations, positions can change.

Third, it is important, nevertheless, not to become complacent. I would like to say a few things that are not intended to cast gloom on the discussion, but to convey to Mr. Narasimham some of the thoughts and concerns of the Fund that may help him in the post he is soon to assume.

1. It is important for India to consolidate the favorable results of the first year, and to keep the program on track. All criteria are important; all targets are important; and the Fund should strongly encourage the authorities to maintain their efforts to achieve the planned results.

2. The Executive Directors expressed some concern regarding the capacity of the States to increase resource mobilization. While their success is probably greater than we had thought, there is a potential weakness in this sector. Anything that can be done to strengthen the financial position of the States and enhance their ability to increase savings through charges, taxes, and the like will be a step in the right direction.

3. A high level of investment in the key sectors is obviously fundamental in a structural program of this type. Executive Directors have commented on the adequacy of investment in some sectors like railways, power generation, and irrigation; not that there have not been successes in the last year, but every year requires a further victory in such matters as imposing economic charges on consumers, and the like, things that are often difficult for the States to carry out.

4. India must keep a close watch on its balance of payments. The figures are very large, and there has been a deterioration in the position. Although we do anticipate some stability in the terms of trade, no one can really be sure; the authorities must therefore be ready to take further measures if necessary, and to keep the exchange rate flexible for use as an instrument of adjustment, something that they already intend to do.

5. The authorities should continue work on the host of measures destined to increase the efficiency of the supply side of the economy, including the liberalization of trade. The results so far have been good, but more must be done in spite of the unfavorable external circumstances.

6. A great deal still needs doing in connection with the deregulation of prices. The authorities should be encouraged by the swift results brought about by the partial liberalization of prices in the cement and steel industries to go still further. Investment policies must be broadened, and there is considerable scope for ameliorating the incentives for private investment.

The Executive Board then took the following decision:

1. India has consulted with the Fund in accordance with paragraph 4(d) of the extended arrangement for India (EBS/81/198, Supplement 3, November 13, 1981 and Supplement 4, February 24, 1982), in order to reach understandings with the Fund regarding policies and measures that India will pursue through March 31, 1983.

2. The letter dated June 8, 1982 from the Minister of Finance of India, together with the annexed Statement of Policies shall be attached to the extended arrangement for India, as amended, and the letter dated September 28, 1981, together with the annexed Statement of Policies, shall be read as supplemented and modified by the letter dated June 8, 1982, together with the annexed Statement of Policies.

3. Accordingly, India will not make purchases under the extended arrangement from July 9, 1982:

(a) during any period in which the data at the end of the preceding period indicate that:

(i) the ceiling on domestic credit of the banking system as specified in paragraph 14 of the Statement of Policies annexed to the letter dated June 8, 1982; or

(ii) the ceiling on the net credit to the Government of the banking system as specified in paragraph 14 of the Statement of Policies and annexed to the letter dated June 8, 1982 is not observed; or

(b) if India fails to observe the limits on official contracting and guaranteeing of nonconcessional loans as specified in paragraph 17 of the Statement of Policies annexed to the letter dated June 8, 1982; or

(c) during any period after January 30, 1983, until the midyear review with the Fund contemplated in paragraph 3 of the letter dated June 8, 1982 has been completed, or if following that review, any performance criteria established by the Fund pursuant to the review are not observed.

4. Paragraph 4(a) of the extended arrangement for India shall be modified by the substitution of "through October 30, 1982" for "through June 30, 1982" in order to permit India to observe performance criteria specified in that subparagraph until October 30, 1982.

5. Paragraph 4(d) of the extended arrangement for India shall be amended to read as follows:

"(d) for the period from April 1, 1983 to March 31, 1984 and from April 1, 1984 to the end of the extended arrangement, if before June 30, 1983 or June 30, 1984, respectively, suitable performance clauses for these periods have not been established in consultation with the Fund or if such clauses, having been established, are not observed; or...."

6. Purchases under the extended arrangement for India shall not, without the consent of the Fund, exceed the equivalent of SDR 900 million until July 9, 1982; the equivalent of SDR 1,500 million until October 30, 1982; the equivalent of SDR 1,800 million until January 30, 1983; and the equivalent of SDR 2,400 million until April 30, 1983.

2. MADAGASCAR - 1982 ARTICLE IV CONSULTATION, STAND-BY ARRANGEMENT,
AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1982 Article IV consultation with Madagascar, together with a request by Madagascar for a stand-by arrangement and a draft decision concluding the 1982 Article XIV consultation (EBS/82/103, 6/11/82; Cor. 1, 7/2/82; and Sup. 1, 7/2/82). The Executive Directors also took up a request by Madagascar for a purchase equivalent to SDR 21.8 million under the compensatory financing facility (EBS/82/109, 6/21/82). They had before them a report on recent economic developments in Madagascar (SM/82/127, 7/2/82).

Mr. Nana-Sinkam made the following statement:

On behalf of my Malagasy authorities and myself, I wish to thank the Fund management, the staff, and the World Bank for their patience, understanding, and timely coordination, without which the present program would never have come into being. Through the Executive Directors concerned, I wish also to extend to the various delegations at the Paris Aid Coordination Conference for Madagascar our deep appreciation for their crucial contribution to the successful setting up of the Malagasy adjustment program. There is no doubt at all that, without this well-organized cooperation, it would have been nearly impossible to bring this stand-by arrangement to the Executive Board for discussion.

The set of documents under consideration gives a clear and balanced analysis of the economic and financial situation of Madagascar for the past two years. The details of the stand-by program are contained in EBS/82/103. My authorities concur with the staff conclusions and recommendations.

For the past two years, Madagascar has been incurring severe external payments arrears, which is only one sign of the serious deterioration of the country's economic and financial situation. Among the factors that led to this downturn, some were internal, but others were external and/or beyond the control of the Malagasy authorities.

Internally, there is no doubt that one of the fundamental causes of the present crisis has been the pressure exerted on internal resources by public expenditure, and particularly the overexpansionary policy (with a very high level of investment) launched by the Government in 1979.

To understand the reasons that led the Government to this policy it might be useful to recall what His Excellency President Didier Ratsiraka has often said, namely, that the investment policy followed by the Government in 1979 was conceived under conditions which appeared favorable at that time.

In fact, in 1978-79, the current account balance was positive, the inflation rate was running at 7-9 per cent, and the real growth rate was 9-10 per cent. In addition, Madagascar's external debt ratio was still one of the lowest among the developing countries, and the different projects involved in the investment program were intended to meet fundamental needs, such as infrastructure, agricultural and export diversification, import substitution, industrial integration and regionalization.

Nevertheless, it is clear that the authorities did not take into account either the technical and financial constraints or the absorptive capacity of the country. When the Government found that the use of taxation to mobilize internal savings has limits, the major solution became foreign borrowing, on terms and conditions (maturity and rates) that were not compatible with the country's prevailing economic and financial circumstances. Consequently, the external debt burden increased considerably. Moreover, the period was one of tremendous increases in the interest rate on the financial markets: the deterioration of the terms of trade was so pronounced that there was little the country could do to curtail its internal impact. The world price of coffee fell from \$1.80 a pound in 1980 to 75 per cent a pound by the end of 1981. The prices of vanilla and cloves (the two other major export products of Madagascar) followed the same trend. On the other hand, the cost of energy went up and the costs of agricultural and industrial inputs were increasing very rapidly.

The outcome has been:

(a) a more or less permanent external payments crisis, which has led the Government to build up considerable amounts of external arrears and the reduction of imports;

(b) stagnation and slowdown in economic activity because of the impact of the compression of imports on agricultural and industrial output;

(c) an increase in the rate of unemployment and a scarcity of consumption goods, which in turn has led to an acceleration in domestic price increases, the development of a parallel market, increases in taxes, and an increase in corruption;

(d) a decrease in budget receipts due to the reduction in imports and the stagnation of exports in a country whose budget receipts largely depend on customs duties. Consequently, despite the authorities' efforts to reduce the level of expenditure, the overall deficit of the Treasury has remained at a level incompatible with internal monetary stability;

(e) monetary deficit financing, which has led to a sharp increase in internal demand and pressures on the balance of payments and prices, thus fueling the inflationary process;

(f) finally, these difficulties have been compounded by a succession of prolonged droughts and cyclones that have devastated the island. The tremendous impact on agricultural infrastructure (including dams), on road infrastructure, and on private property (houses, fruit trees, etc.) is such that the Government cannot tackle the rehabilitation program unaided.

In the face of these difficulties, the Malagasy authorities have taken different adjustment measures. However, although the internal price level no longer represented actual costs and was unrelated to world prices, thus helping to perpetuate an over-valued exchange rate, the Government persisted in using fiscal proxies to replace a straightforward modification of the exchange rate. They thought that the market effects of an exchange rate modification could be duplicated exactly by explicit fiscal proxies.

The authorities have found that fiscal proxies based on partial equilibrium analysis and restricted to transactions in the market for goods are not alternatives to straightforward exchange rate modifications, either in the short run or in the long run. The country's experience has shown clearly that

(a) even for current account transactions, the fiscal proxy, only covered a subset of marketable goods;

(b) they have not been able to apply the schemes on a uniform basis even to current account transactions;

(c) the administrative costs of implementing the scheme have been significantly greater than those involved in a straightforward exchange rate change;

(d) the scheme has led to the development of corruption, evasion, and/or misuse.

Having discovered these shortcomings in the use of fiscal proxies, the authorities wisely and courageously decided to set up a comprehensive adjustment program which--provided the basic assumptions hold--could go a long way toward reducing the pressures and bringing the economic and financial situation on the right track within a medium-term framework.

The principal elements of this program, which the authorities consider a first step toward their medium-term adjustment objectives, are described in the staff papers and can be summarized as follows:

1. Supply-side measures

A reorientation of the investment program toward the agricultural sector with the assistance of the World Bank, in order to help fulfill the objective of better allocation of resources;

increases in the producer and consumer prices of rice by 27 per cent and 87 per cent, respectively, which will lead to the elimination of subsidies; an increase of 26 per cent in the producer price of cotton and more flexibility in the setting of domestic ex factory prices.

2. Exchange rate

The Malagasy franc, which has been pegged to a basket of several currencies since April 1982 has been devalued by 15 per cent in terms of local currency, and the authorities will keep the exchange rate policy under constant review.

3. Wage policy and public finance

The authorities have decided to limit the cost of living increase to 4.5 per cent. The 1982 overall budget deficit will be reduced to 9.4 per cent of GDP from 14.7 per cent in 1981 and a target for 1983 has been set at 7 per cent. There will be a reduction in the internal arrears equivalent to 0.7 per cent of GDP within the same period.

4. Monetary policy

The Malagasy authorities have decided to limit the growth of the domestic credit in the banking system to 20.5 per cent in 1982. The central bank discount rate has been increased by 4.5 per cent to 12.5 per cent, with a similar adjustment for other borrowing and lending rates.

5. External sector

The authorities have decided to reduce, in a nondiscriminatory fashion, arrears other than those related to dividends, by SDR 49.1 million at end-1982 on a net cash basis (excluding consolidations). The arrears on dividends and transfers will be reduced by FMG 1 billion during the same period. New commitments with maturities of one to ten years will be limited to the French franc equivalent of the SDR 24.8 million line of credit already agreed upon with the French authorities in 1981.

Despite these courageous measures and other discretionary actions to be taken in case of need, there will still remain a financing gap which, the authorities sincerely hope, will be covered following the forthcoming meetings of the Paris Club meetings and the London banks to discuss the rescheduling of Madagascar's external debt.

This is a very courageous program, well worked out and backed by strong political will on the part of the authorities. I warmly recommend its approval to my colleagues, the Executive Directors.

In concluding, allow me to extend to Mr. Kratz and his team the special appreciation of my Malagasy authorities and myself for their dedication and a job well done.

Mr. Erb remarked that Executive Directors had before them a proposal for the third stand-by arrangement for Madagascar in the space of two years. His chair had criticized both of the two previous arrangements for the overall quality of the program; in particular it had questioned the credibility of the measures that were to be taken. Despite the doubts of his authorities, they had approved the previous programs in the hope that they would in fact be successful in laying the groundwork for long-term growth and a sustainable payments position. Unfortunately, the earlier skepticism had been justified. The proposed stand-by arrangement and purchase under the compensatory financing facility would together provide an additional 100 per cent of quota before the midyear review that was to take place in December 1982. He was disturbed by the proposal for such a substantial amount of front-loading in view of Madagascar's previous performance, especially as the current adjustment program did not provide satisfactory assurance that meaningful progress would be made toward a sustainable balance of payments position, even if it was successfully implemented. While the staff had made an excellent analysis of the current situation in Madagascar, and Mr. Nana-Sinkam's statement had been illuminating, both of them had stressed that, given the difficult medium-term outlook, a sustained adjustment effort would be required. The recent policy decisions affecting the exchange rate, interest rates, and consumer prices--in particular the price of rice--had been courageous in the circumstances, and seemed to support the staff view that the Malagasy authorities had come to the conclusion that a fundamental change in their policy approach was called for.

However, Mr. Erb went on, he strongly felt that much more vigorous action would be required over time if the economy and people of Madagascar were to receive the full benefit of the recent measures. While it was not his intention to undertake a detailed analysis of Madagascar's adjustment measures, he had serious difficulties with the proposed stand-by arrangement.

First, Mr. Erb explained, the economic and balance of payments projections provided by the authorities did not go beyond the first six months of the program. Second, although resources had been found to fill the balance of payments gap for 1982, the operation only covered the first six months of the program. Thus, a gap existed for the second six months of the program that would have to be filled rather soon. Third, the staff devoted very little space to medium-term adjustment requirements and prospects. The language used in the paper did seem to suggest that Madagascar would not achieve a sustainable balance of payments position within the medium term. In those circumstances it was difficult to see how the Fund could assure itself of future repayment without accelerating Madagascar's problems at the time. Fourth, the Malagasy authorities needed to undertake major structural adjustments to the economy in order

to make better use of the relatively rich resource base. It was for that reason that the staff attached so much importance to such matters as changes in the interest rate, producer prices, consumer prices, and the exchange rate. Naturally, such adjustments would not have any very great impact unless prices were allowed to respond. The implication was that the World Bank should play a more active role in providing assurance that investment flows, both multilateral and bilateral, would contribute to the larger adjustments that would be needed in the economy of Madagascar in the coming years.

In the circumstances, Mr. Erb said, he would prefer the stand-by arrangement to be for a period of six months. He would reserve his position regarding a stand-by arrangement for a full year until he heard the staff's comments. He was particularly interested in hearing a description of the proposed midyear review. At that time the staff should prepare a more detailed analysis of the second half of the stand-by arrangement, together with an extensive evaluation of the medium-term prospects for Madagascar. In other words, the preparation of needed adjustment measures for the second half of the stand-by arrangement should take account of the adjustments that were likely to be needed over the near future if the country was to achieve a sustainable balance of payments position. The Fund and the World Bank should work closely together in making the medium-term assessment.

Regarding the compensatory financing facility, Mr. Erb went on, he noted that the swings in exports had been quite large, and that at the time of the previous request for a purchase under the compensatory financing facility Madagascar had in fact not had a shortfall in the relevant year.

More specifically, Mr. Erb explained, he would like more detailed information regarding the treatment of cloves in the request for a purchase under the compensatory financing facility. The growth of exports of cloves in 1981 had contributed to making the shortfall smaller than it would have been otherwise. But the volume of exports might have been even larger had it not been for what the staff referred to as the existence of clandestine exports. If the inclusion of the clandestine exports in the total would result in a smaller shortfall, perhaps some effort ought to be made to make the adjustment. His feeling was that the volume of clandestine exports was probably related to the way in which consumer prices were controlled, or perhaps to the exchange rate; and that there was a great incentive to export the cloves clandestinely.

Miss Le Lorier stated that she supported the two requests. The proposal for the stand-by arrangement seemed to contain major adjustment measures, and rightly so, given the difficulties facing Madagascar in the years ahead. Although the past record of Madagascar in implementing programs supported by the use of Fund resources might look rather poor, significant progress had been made. There had, of course, been very serious adverse external developments leading to a sharp decline in real GDP. In those circumstances, fiscal performance had been rather poor, but a substantial effort had been made to improve the tax system and

contain certain categories of expenditure. The introduction of a large new tax upon petroleum products, and the lower growth of personnel expenditures than allowed for in the program were both commendable policy adjustments. The nonobservance of performance criteria and the significant deviation from the main targets of the program did not mean that no progress at all had been made toward adjustment.

Commenting on the program for 1982, Miss Le Lorier said that she welcomed the recognition by the authorities that a fundamental change in their policies was warranted. The increase in the debt service ratio from less than 6 per cent in 1978 to some 54.3 per cent in 1982 clearly called for strong and sustained corrective action; and it was only one example among many. The steps already taken, which had required considerable determination on the part of the authorities, were evidence of their willingness to address the severe difficulties facing the country.

So far as the supply side was concerned, Miss Le Lorier noted, all subsidies had been eliminated as a result of what could only be called shock treatment. Many prices had been adjusted upward by large amounts; indeed, the authorities had gone even further than their undertaking to the Fund required. The impact of the exchange rate depreciation had been fully passed on to the price of products, including petroleum products, which had already been subject to substantial tax increases in 1981. It was of crucial importance that the benefits of such a major effort should not be eroded by future price controls; and she shared the view of the staff that a move toward greater flexibility should be continued. Shock treatment did not mean that gradual adjustment should not take place thereafter. She had noted that special attention was to be devoted to raising the producer price for coffee in light of world market conditions. According to the staff, any change in producer prices during 1982 would have virtually no impact on the receipts of the Fonds National Unique de Péréquation (FNUP) in view of the time lag with which products were exported. However, any adjustment in producer prices would have an impact on FNUP accounts in the following year, and she was sure that the point would be taken into account during the midyear review. The investment program for 1982-84 was certainly a key element in the long-term adjustment effort that was undoubtedly needed. The close cooperation between the authorities, the World Bank, and the Fund was very welcome.

Apart from the reallocation of priorities, a number of measures taken by the authorities appeared to be completely appropriate, Miss Le Lorier stated. The strengthening of the planning office and the emphasis on the monitoring of all external borrowing, the inventory of all projects covered by allocations transferred to the reserve fund and the commitment to cancel credits to projects that had not been started within two years, and the restriction of new locally financed investment to the provision of local counterparts of foreign financed projects, were all well conceived.

In the fiscal field, the undertaking to reduce the government deficit from 14.7 per cent of GDP to 9.4 per cent at the end of the year seemed ambitious, especially as the attempt would have to be made in seven months, Miss Le Lorier commented. Moreover, even though rice

subsidies had in theory been eliminated, there would still be a subsidy cost in the 1982 budget, which meant that an even greater effort than appeared on the surface--i.e., in the evolution of the deficit--had been undertaken. The containment of the wage bill through wage and salary policies, and a gradual reduction in the growth of the government labor force would certainly be key elements for medium-term adjustment.

On the revenue side, Miss Le Lorier inquired how much would be gained by cutting down the delays in recovering payments for the sale of imported rice to distributors, a point that had apparently been omitted in forecasting receipts in the public sector. She wholeheartedly endorsed the proposal to make a complete list of internal arrears, in order to avoid the problem of faulty data that had arisen in 1981 and, more important, to lead to the elimination of arrears.

The adjustment of interest rates had been substantial, Miss Le Lorier noted; on the occasion of the midyear review, an attempt should be made to decide whether any new adjustment was needed not only in line with the underlying rate of inflation but also in the light of the possible effect of further increases on the situation of enterprises. It was always difficult to forecast the outcome of a major government borrowing operation. Clearly, the authorities must have assumed a certain order of magnitude in order to be able to estimate the amount of bank financing needed by the Government. Should the operation outcome be different from that forecast, the relevant credit ceilings should be adjusted accordingly.

On the external side, it seemed reasonable to be satisfied with a rather small reduction of the current account deficit during 1982 in order to allow imports to grow at a pace consistent with an orderly functioning of the economy, Miss Le Lorier observed. Whether Madagascar would be able to meet its debt service obligations had been a matter for grave concern. She was greatly in favor of the proposal to establish a centralized debt management unit in the Central Bank that would be responsible for closely following movements in arrears and for devising a method of gradually repaying them on a nondiscriminatory basis. She had been rather puzzled by the staff observation on page 8 of EBS/82/103 to the effect that external arrears, other than those relating to dividends, that had emerged since the beginning of 1980 had been reduced by some SDR 71 million during 1981, but that the achievement was entirely due to the success in negotiating agreements for their consolidation, at the cost of increasing the future debt service burden. Her understanding was that any rescheduling operation was bound to increase the debt service burden in the future. However, the utmost priority was to be given to paying off existing arrears, while avoiding the accumulation of new arrears or rescheduled debt.

As to the exchange rate, Miss Le Lorier considered that the adjustment of May 16, 1982 had been significant; during the midyear review due consideration should be given to the nature of the Malagasy economy: the country was an exporter of primary products, the demand for which was not always as elastic as could be desired, and its economy was agricultural.

The midterm review would certainly be of major importance to the future of Madagascar, Miss Le Lorier considered. It was true that little detailed information was available for 1983, and that too little was known about the external financing arrangements for that year to establish detailed balance of payments forecasts. However, a major safeguard had been built into the program by the specification that the fiscal deficit should not exceed 7 per cent of gross domestic product in 1983. Perhaps the lack of detailed projections for 1983 was not serious, as it seemed particularly difficult to decide what additional adjustment measures could be introduced on top of those already taken by the authorities. The staff had chosen to rely heavily on a review, which seemed to her to be the corollary of taking an earlier starting point for the adjustment process than might have been justified if more detailed medium-term projections had been available.

It would certainly take some years before Madagascar was likely to have a viable balance of payments position, Miss Le Lorier commented. With the debt service ratio expected to be over 50 per cent of exports in 1986, there was clearly a strong case for international cooperation from multilateral institutions as well as from creditors and from donor countries. But there was an even stronger case for a sustained effort by the Malagasy authorities to pursue their adjustment goals. She hoped that the outcome of the requested stand-by arrangement, pursued with determination by the authorities, would be in due course an extended arrangement for Madagascar. The establishment of a consultative group would help to prepare a medium-term realistic development program and an extended arrangement might be an appropriate framework within which to work for the removal of structural deficiencies. The need for demand management policies would not disappear, but those policies were far from being incompatible with an extended arrangement. Quite recently, the Executive Board had agreed on the merits of the extended Fund facility and the enlarged access policy, and it had also agreed that a series of stand-by arrangements, even with midterm projections, was not a substitute for an extended arrangement. The obverse was, of course, that concluding an extended arrangement with the Fund required the country concerned to design and adhere to a medium-term strategy that might be more demanding than a one-year program. At present it would be quite impossible to decide whether a series of stand-by arrangements or an extended arrangement would be more suited to the special case of Madagascar; but an extended arrangement ought not to be eliminated from possible future consideration.

Mr. Taylor stated that he could endorse the recommendations made by the staff; he supported Madagascar's request for a stand-by arrangement and could agree to a purchase under the compensatory financing facility.

The authorities were to be commended for their courageous prior actions, including the devaluation of the currency and the elimination of the rice subsidies, Mr. Taylor observed. The considerable political risk inherent in the actions that had been taken was a strong indication of the authorities' commitment to a sound relationship with the Fund, and more generally to the objective of realigning their economic policies.

The early implementation of the new policies would prepare the way for further measures that would have to be introduced throughout the program period. The vigor of the prior actions also justified the front-loading of the disbursements under the arrangement. The program to be followed in the coming year was well designed in that it would address some of the underlying weaknesses of the economy. As the authorities must recognize, imbalances at the levels projected for the present calendar year could hardly be considered sustainable; indeed, the forecast current account deficit, amounting to 13 per cent of GDP at the end of the program period, remained alarming. Because the starting point was so unsatisfactory, the amount of adjustment to be achieved under the present arrangement would be relatively limited, and the outlook beyond the program period seemed rather gloomy both for the balance of payments and for the level of arrears.

Consequently, it was imperative, first, that the authorities should fully implement the agreed program, Mr. Taylor went on. Second, policies of retrenchment and strong adjustment would have to be continued for several years beyond the program period. Indeed, the adjustment effort might need to be intensified after 1982-83. The room for maneuver over the medium term remained severely limited, and there could be no question of returning to the expansionary policies of the late 1970s.

Taking up more specific points, Mr. Taylor noted that the broad thrust of fiscal monetary policy was appropriate. The principal aim should be to carry out the program as specified. He hoped that the authorities would continue to monitor fiscal performance closely, paying particular regard to the need for stricter control over parastatal financing and public sector wages. He welcomed the recent substantial increase in the level of interest rates, although both borrowing and lending rates seemed to be significantly negative in real terms; the authorities should not rule out further increases when the subject was discussed at the midterm review. The authorities' intention to phase out domestic arrears was commendable, and he wondered whether technical assistance might be helpful in improving domestic debt management. Could the staff give some reassurance that the credit ceiling of the program would not effectively be relaxed by a slowing down or reversing of the rate at which domestic arrears were repaid.

On the supply side, Mr. Taylor welcomed the change in direction of investment expenditure and the preeminence being accorded to agriculture and transport. He hoped that those factors would be given priority allocations of foreign exchange. Improving the yield of the agricultural sector would be central to the task of adjustment, and it was vital that agricultural producer prices should provide adequate incentives while continuing to reflect world market prices. It would be valuable if the staff would say whether it thought that any further increases in producer prices were warranted.

In the external sector, Mr. Taylor welcomed the pegging of the Malagasy franc to a basket of currencies, although the persistence of complicated exchange restrictions did suggest that the exchange rate remained overvalued. A further depreciation might well be needed in the medium term if a competitive rate was to be established. While he could agree with Miss Le Lorier that primary products did not necessarily show large elasticities with respect to price changes, they were products in which incentives played an important role in the medium term, and it was most important that the exchange rate should be consistent with the provision of incentives in the major export sectors. A series of gradual exchange rate changes would perhaps be more appropriate than one large devaluation, if more action were needed in due course.

It was not clear to him, Mr. Taylor stated, that the supply side of the economy was sufficiently free of rigidities; therefore a series of exchange adjustments might be easier to implement than a major change at one time. In any event, he hoped that the exchange rate could be kept under close review and that it would be a major topic for discussion at the midterm review.

He had been disturbed by the staff projection of the debt service ratio, which was projected to be over 50 per cent of exports in 1986, Mr. Taylor observed. The figure would surely be unsustainable and he would be interested to know both whether the steps being taken to restore the Government's control over foreign debt management were likely to alleviate the external debt situation to any significant degree, and whether the proposed improvement would also apply to short-term debt.

Mr. de Vries stated that he could support the proposed stand-by arrangement. The authorities had already made important changes in policy in connection with the exchange rate, interest rate, and prices. Nevertheless, he was not entirely convinced that they were thoroughly committed to the success of the program. While it was clear that the authorities had made a major effort, he had the feeling that some of the measures taken could no longer be avoided, and that it was too soon to say whether the authorities would be able to follow through with the many difficult decisions that were still to come. In those circumstances, the midterm review would be very important. At present the authorities had too few external resources to finance a program through 1983. Moreover, the debt service ratio was so high that a major program would be required for a considerable period. Consequently, he attached great importance to the further measures that would have to be taken and to the maintenance of a flexible exchange rate system. It was clear that the exchange rate played a role in creating clandestine exports, particularly of cloves. More generally, Madagascar offered a clear demonstration that even in a country where the main exports were primary commodities, a correct exchange rate was a major part of any appropriate policy measures.

Commenting on arrears accumulated by Madagascar, Mr. de Vries stated that he wished to protest against the discriminatory manner in which the Malagasy authorities had dealt with creditors, and in particular with

Israel, at least before an agreement between the two countries had been reached. The accumulation of arrears by Madagascar went back to 1978; the Fund had been involved because the accumulation of new arrears constituted a payments restriction that members concluding a stand-by arrangement with the Fund agreed specifically not to impose. The accumulation of arrears on a large scale by Romania had been considered sufficient reason to interrupt drawings on its stand-by arrangement with the Fund. The accumulation of arrears in a discriminatory manner was still more serious because it constituted a discriminatory payments restriction. On October 16, 1978 the Deputy Managing Director had offered his good services to bring the matter to a satisfactory solution. In November 1981 a written agreement signed by both Madagascar and Israel established that the value of Israel's claim amounted to \$2.85 million, and that the claim was recognized by both parties. The agreement and the protocol thereto specified that 25 per cent of the agreed amount should be transferred to Israel in U.S. dollars before the end of 1981, and that all other payments should be executed in an orderly and nondiscriminatory manner on a proportionate basis with all other creditors. The last few words referred to agreements that might be reached within the Paris Club. Despite the signing of the agreement, however, no payment had been made by Madagascar to Israel. He would be interested to know whether the staff considered that the absence of payments from November 1981 to July 1982 constituted a discriminatory nonpayment or merely a payments restriction.

The Paris Club was to meet on July 12 and 13, 1982, and the staff representative from the African Department would be present, Mr. de Vries went on. The Israeli authorities would like to participate in that meeting, together with other creditors. However, as he understood it, the Malagasy authorities had objected to the presence of an Israeli representative. He had received cables on the subject from both the Netherlands and Israel, where the authorities felt that the Fund ought to be able to bring pressure to bear. At present the position was that an effort had been made to exclude Israel on technical grounds. However, after a full discussion, creditors other than Israel had asked the French chairman of the Paris Club to obtain the consent of Madagascar to Israel's participation in the meeting. If that consent were not forthcoming, the Paris Club might well meet on Monday, July 12, but adjourn without concluding its business. If that were to happen, the Fund program was unlikely to be fully financed, and the question would then have to be raised whether Madagascar would be able to adhere to the terms of the stand-by arrangement, and its provisions on arrears.

As to the arrears themselves, Mr. de Vries asked five specific questions. First, did the ceiling on arrears of SDR 144.8 million, mentioned in Section VI of Appendix III and included as a performance criterion in paragraph 4(a)(iii) include or exclude arrears due to Israel? Second, did the announced deduction in arrears through cash payments amounting to SDR 19 million by end-September 1982 and SDR 30 million by end-December 1982, include or exclude cash payments to Israel? Third, would the staff confirm that the ordinary and nondiscriminatory manner in which payments were to be carried out refer to the reduction in arrears as well as to

various transfers? Fourth, in making a review, would the staff assess not only whether the commitment to reduce arrears through cash payments had been met but also whether that reduction had been carried out in an orderly and nondiscriminatory manner, meaning that a proportion of payments would be paid to all creditors including Israel? Fifth, what would be the consequences if the staff were to find that the reduction had been carried out in a discriminatory manner?

Taking up the request for a purchase transaction under the compensatory financing facility by Madagascar, Mr. de Vries said that, like Mr. Erb, he had been troubled by the discrepancy between forecasts and actual figures in the previous agreement. There, a shortfall of some SDR 29 million had been projected for the calendar year 1979, when in fact the outcome had been a surplus of SDR 8 million. In the present proposal the staff had written, regarding cloves, that the volume of exports in the 1981/82 peak year of the cycle was substantially lower than the levels in the previous peak years, probably because of the existence of clandestine exports. In other words, the Fund might be accepting a shortfall because not all exports were being reported. That was hardly a satisfactory basis for a purchase transaction, and the same might be true with vanilla. Before deciding whether to give the member the benefit of the doubt and approve the purchase transaction under the compensatory financing facility, he would await the answers to his questions.

Mr. Sangare stated that he supported the two requests by Madagascar. There had been a decline in economic activity in 1981: inflation had soared to 30.5 per cent and export earnings had declined substantially. The authorities were also facing a large budget deficit and severe pressure on the balance of payments. Many of the problems had, however, been brought about by factors beyond the control of the authorities, including adverse weather conditions and a serious deterioration in the terms of trade. The staff had also indicated that there had been an increase in government expenditure at a time when revenue had been less than planned, so that the program that had been adopted in 1980 had deviated substantially from the objective.

He was pleased that the authorities had renewed their efforts to improve the economic situation, as evidenced by the new adjustment program that had been submitted to the Fund, Mr. Sangare commented. A number of steps had already been taken, including a depreciation of the Malagasy franc and increases in prices and interest rates. Those measures demonstrated the resolve of the authorities to implement the program in full. The most striking indication of their resolve was the intention to reduce the budget deficit as a percentage of GDP by one half between 1981 and 1983. Monetary policy was being recast in order to bring about a greater mobilization of domestic resources. He also welcomed the steps being taken to reduce both internal and external arrears. The thrust of the investment program had received favorable reaction from the World Bank staff. Nevertheless, the balance of payments situation would remain a matter for concern in 1982, the main features being an increase in the volume of imports following cyclone damage to domestic crops, as well as

large interest payments on the external debt. While the current account was apparently expected to improve in the longer term, external debt would remain a problem. Consequently, the decision by the authorities to refrain from short-term borrowing during the stand-by period was only prudent; it should help to ameliorate the situation.

Mr. Hirao stated that he could support the requests for the use of Fund resources under a stand-by arrangement and for a purchase under the compensatory financing facility. The Malagasy authorities had been following a conservative policy until late in 1978. At that time the foreign debt had been less than 4 per cent of GNP. A major expansion of public sector investment had been begun in 1979 and the overall fiscal deficit had started rising sharply. A number of domestic factors, especially fiscal policy, had led to a sharp deterioration in Madagascar's external position. It therefore seemed appropriate that special emphasis should be placed on reducing the overall deficit from 14 per cent of GNP in 1981 to 9.4 per cent in 1982. He was glad to see that steps had been taken to reduce subsidies, which had been having an adverse effect not only on the fiscal position but also on resource allocation.

It was encouraging, Mr. Hirao considered, that the authorities intended to keep the increase in the central government labor force to a maximum of 4 per cent in 1982 and to zero from 1982 onward. It was also helpful that the authorities meant to apply their policies in the public sector very strictly. Nevertheless, he shared the staff view that they could look for a more rapid reduction in the rate of growth of personnel.

He also shared the staff view that the authorities should raise prices for locally grown commodities to a level that would provide a greater incentive to production and help to correct distortions in the economy, Mr. Hirao stated. He welcomed the information that the authorities intended to continue devoting special attention to the exchange rate, and that it would be discussed at the midterm review. He agreed with the Malagasy authorities that a fundamental realignment of economic policy was required if their goals were to be achieved with progress toward medium-term balance of payments viability. They had already taken some important steps; he hoped that they would continue their efforts to achieve a viable balance of payments position in the near term.

Mr. Prowse stated that he could support the proposed decision in favor of a stand-by arrangement and could endorse the program on which it was based. He also supported the proposal for a purchase transaction under the compensatory financing facility.

Like other speakers, Mr. Prowse went on, he had noted the recent history of arrangements between the authorities of Madagascar and the Fund. He was always concerned by breakdowns in arrangements with Fund members, because a breakdown signified that the Fund had failed to achieve its purpose. After all, a breakdown in a program imposed no financial cost on the Fund. The burden fell on the member that needed assistance and was unable to qualify for it. He saw no a priori rule that stated

that the breakdown of an arrangement should imply that there was no way of reaching agreement quickly with the country concerned. What was needed in such cases was strong evidence of political commitment to an appropriate program. The Malagasy authorities had encountered considerable misfortunes recently; both their political effort and their submission of a practical program would warrant a decision by the Executive Board to proceed with the proposals set before it. Nothing positive would be achieved by rejecting the proposed stand-by arrangement. He welcomed the measures taken by the authorities as giving evidence of their resolve. The performance criteria were quite comprehensive and certainly adequate for the proposal.

Nevertheless, he wished to record his concern regarding the outlook for the balance of payments, Mr. Prowse stated. It was clear that there would be need for external adjustment long after the present arrangement came to an end. He therefore hoped that it would be possible to look forward to further arrangements, while increasing export diversification and paying close attention to the exchange rate.

He noted that the Malagasy authorities were recorded as saying that the new exchange regime and the real level of exchange rates were well adapted to Madagascar's needs, Mr. Prowse observed. He had not been able to ascertain from the papers whether that was also the view of the staff. He would therefore look forward to a reply. It was always a pity that the policy with regard to exchange rates could not be clarified at the beginning of a 12-month stand-by arrangement. While he understood the feeling that the course of the exchange rate and the exchange rate regime ought to be the subject of the midterm review, it was desirable that those arrangements should be quite clear when the Board was asked to make a decision. It would therefore be interesting to hear the staff comment on the exchange rate and on their satisfaction or otherwise with the present level of interest rates.

Mr. Suraisry stated that he supported both requests, for a stand-by arrangement and for a purchase under the compensatory financing facility. He also supported the proposed decision concluding the Article XIV consultation. The request for a purchase under the compensatory financing facility clearly met all the requirements of that decision. The calculation of the size of the shortfall also seemed appropriate, and the shortfall itself was well above the requested purchase. In addition, the calculations of the shortfall were based on actual data for the whole shortfall year, so that there was no risk of overcompensation.

Taking up the request for a stand-by arrangement, Mr. Suraisry commented that the program that the authorities were undertaking was impressive. On the supply side, measures included reorienting the investment program toward the agricultural sector, and increasing producer prices for a number of key agricultural items. The ratio of the budget deficit to GNP was being reduced sharply in 1982, and public sector wage increases would be limited to 4.5 per cent compared to a cost of living increase of 50 per cent in the capital.

In connection with monetary policy, domestic credit creation was being reduced significantly, and the credit program seemed to be appropriate, Mr. Suraisry stated. In the external sector, the Malagasy franc had been devalued by 15 per cent in local currency terms in May 1982. The backing had been changed from the French franc to a basket of currencies reflecting the distribution of Madagascar's trade. External assistance was also being reduced over the program period. He wished to commend the Madagascar authorities for the courage they had shown in having already adopted a number of difficult corrective measures. He agreed with the staff that the adjustment effort contained in the program for 1982 would contribute toward the restoration of domestic and external and financial stability in the economy. Naturally, Madagascar still had some way to go before achieving balance of payments viability, but that task could only be achieved in the medium term.

The staff representative from the African Department, replying to questions, remarked that by Madagascar's standards recent policy changes had been very substantial. Moreover, at the beginning of 1982 the country had been the victim of a number of severe cyclones, which had distracted the authorities from the review of economic policy that they had begun. In those circumstances, the negotiations had lasted somewhat longer than had been anticipated so that the stand-by arrangement that was before the Executive Board was now in support of a program for 1982 and 1983, although the program for 1983 still had to be negotiated. Consequently, the team that was to review the performance by the authorities under the 1982 program would also have the task of negotiating a new program for 1983. It was for those reasons that the staff had been less specific than usual for the coming year.

There had been a deliberate division of labor between the staff of the Fund and the staff of the World Bank, the staff representative continued. There had been very close cooperation between the Fund and the Bank and between the Malagasy authorities and the two institutions. A World Bank mission had arrived in March in Madagascar somewhat later than the Fund mission. It had been asked to help in the preparation of the new investment program, which represented a change in policy in Madagascar, where the authorities had previously only been interested in the World Bank's views on World Bank projects and not in its views on an overall program. The authorities had specifically asked the World Bank for help in designing an investment program for 1982 through 1984. Moreover, that program was to be substantially different from the six-year development plan approved by the National Assembly, only six weeks earlier, again indicating that the authorities had a serious intent to change their policy. The World Bank was undertaking the more detailed work on the medium term; therefore it would send a mission to Madagascar in August to finalize the public investment program for 1982-84, a program that might ultimately become an investment program for 1983-85. A second World Bank mission would visit Madagascar in October 1982 to concentrate on sectoral work in preparation for a structural adjustment credit that the World Bank staff hoped to be able to present to its Executive Board in early 1983. Consequently, the Fund review mission would have the benefit of the results of those two World Bank missions.

The staff had felt that the prior actions taken by the authorities in Madagascar warranted the use of Fund resources equivalent to 60 per cent of the amount of the arrangement during the remainder of 1982, the staff representative observed. The whole amount might not be drawn, though, before the review mission visited Madagascar in November 1982. Of course, the results of that mission's visit to Madagascar would not be known to the Executive Board before early 1983.

Taking up the various topics raised by Executive Directors, the staff representative remarked that he would have liked to see a larger increase in the producer price for coffee than had actually taken place. However, the staff had agreed with the Malagasy authorities on the need for caution in the light of the experience with world market prices for coffee during 1981. The matter would be discussed with the Malagasy authorities again, after consultation with the World Bank staff, which had hitherto concentrated more on the appropriateness of rice prices than coffee prices. The Fund staff was satisfied with the increases in the producer prices for rice and cloves. For cloves it was true that the prices paid to farmers were only 19 per cent of the world market price. Even there, however, it was possible to understand the caution of the Malagasy authorities; almost all Madagascar's exports of cloves went to Indonesia where they were used to perfume cigarettes. The Indonesian authorities had been making efforts in the past few years to encourage farmers to grow their own cloves, so that it might be unwise to persuade the Malagasy authorities to give incentives for the production of cloves that could not be marketed. There had been very substantial price increases for vanilla in the past two years, and the present price seemed about correct. Generally speaking, however, the staff wished to keep agricultural producer prices under close review on every occasion that they met the Malagasy authorities.

The adjustments in interest rates had also been substantial by Madagascar's standards, the staff representative commented. Nevertheless, as Mr. Taylor had said, the rates were negative both on the lending and on the borrowing sides. The staff would keep an open mind and would not hesitate to press for further increases if it felt that they were warranted at the time of the review. Much the same could be said about the exchange rate. The staff was satisfied with the exchange rate regime, but not necessarily with the level of the exchange rate, which was also something that would need careful watching. Naturally, any shift in the exchange rate would have to be undertaken in close coordination with any relaxation of the hitherto rigid internal price structure. Pressing unduly for a change in the exchange rate until sufficient progress had been made in formulating internal prices might not lead to the kind of success that exchange rate action was expected to bring. Mr. Taylor's suggestion of a series of small changes rather than one large one was certainly worth exploring.

Regarding the crop export figures, the staff representative commented that it was not his impression that smuggling was very extensive. The effect of smuggling cloves and, to a somewhat larger extent, vanilla and

the severe punishment pronounced against the smugglers had been rather played up in the Malagasy press in order to discourage such practices. It was, however, inevitable that in an economy with rather extensive exchange, import, and price restrictions, there should be a considerable temptation to smuggle commodities into neighboring countries with convertible currencies and an operations account with the French Treasury.

So far as the arrears were concerned, the staff representative remarked that it was self-evident that consolidating arrears would create a future burden on the external accounts. The staff had always considered that the economically more beneficial way to reduce arrears was through cash payments. It was rather premature to consider negotiating an extended arrangement with Madagascar. However, if the work undertaken by the World Bank proceeded satisfactorily and the World Bank offered a structural adjustment credit, an extended arrangement might be pursued later.

Taking up observations on the debt service ratio of Madagascar, the staff representative indicated that it was of grave concern to the Fund staff. However, apart from rescheduling there was little that could be done with regard to obligations resulting from the past. In order to ease the burden in the future, the staff and the Malagasy authorities had agreed that there should be no new debts with a maturity of less than ten years, except those under an overall agreement concluded in 1981.

Commenting on the relations between Madagascar and Israel, the staff representative from the African Department indicated that the ceiling on arrears of SDR 144.8 million mentioned as a performance criterion in paragraph 4(a)(iii) did include arrears owed to Israel. Consequently, the announced reduction in arrears through cash payments included cash payments to Israel. The Malagasy authorities had indicated in a policy memorandum that it was the intention to reduce arrears in an orderly and nondiscriminatory manner, so that the arrears owed to Israel would be reduced on a proportionate basis. Any deviations would be for administrative reasons, since it was sometimes burdensome to pay off small amounts in several installments. The staff could affirm that the orderly and nondiscriminatory manner in which payments were to be carried out referred both to the reduction in arrears and to the transfer of dividends. During the midterm review the Fund team would make it a point to find out whether the reduction in arrears and the transfer of dividends had in fact taken place in an orderly and nondiscriminatory manner. Payments by Madagascar in connection with arrears or the transfer of dividends had not been discriminatory because very few payments had been made by the authorities. Some countries had obtained payment by preempting receipts.

The staff representative from the Exchange and Trade Relations Department remarked that the phasing of purchases under the stand-by arrangement, which provided for 60 per cent of the amount to be drawn prior to the midyear review, was by no means exceptional. Moreover, in 1980 the Executive Board had adopted guidelines to the effect that the first purchase under a stand-by arrangement could by itself be as much as one third of the total when major policy adjustments had been put in place, as was the case in Madagascar.

Replying to Mr. Erb's questions regarding the nature of stand-by arrangements, the staff representative remarked that it was certainly true that the present program only contained details of balance of payments and economic projections for calendar year 1982. However, it should be remembered that in Madagascar the fiscal year coincided with the calendar year. Discussions with the Malagasy authorities had started early in 1982 with the intention of formulating a program for the present calendar year. However, discussions had become drawn out and the stand-by arrangement being proposed to the Executive Board was for the 12-month period running from July 1982 to July 1983. Nevertheless, the program was not entirely devoid of guidelines for 1983 since, among other things, the budget target provided for a further reduction of the ratio of the deficit to GDP from 9.4 per cent in 1982 to 7 per cent in 1983.

In the present circumstances, it was evident that the midyear review, which would take place by the end of 1982, would be crucial, the staff representative remarked. At that time, the staff and the authorities could look at the prospects for calendar year 1983 not only from the standpoint of the budget but also from that of the balance of payments. That the authorities acknowledged the importance of the midterm review was evident from the reference in the letter of intent, stating that the review would provide an occasion for agreement on performance criteria for the balance of the period covered by the arrangement, with specific reference to interest rate and exchange rate policies. Depending on circumstances, as the Malagasy authorities formulated policy on a calendar year basis, one possibility would be to conclude an entirely new stand-by arrangement covering the whole of calendar year 1983. As for the medium-term outlook, an important element of the midterm review would be to ensure that the program would not have an unfinanced balance of payments gap either in the first half of 1983 or for calendar year 1983 as a whole.

While the staff report did not contain detailed balance of payments projections, the staff representative from the Exchange and Trade Relations Department said, it had been candid in providing sufficient information to indicate that the situation would remain critical for several years because of the heavy debt service payments. It had also indicated that continued exceptional external support, similar to that obtained from the recent donors' meeting in Paris, as well as debt relief, would be needed, even if the current account deficit was reduced from 13.5 per cent of GDP in 1982 to 9 per cent in 1986 through domestic adjustment, as forecast in the paper.

The staff representative from the Research Department, commenting on the method of calculating the shortfall in cloves, indicated that the calculation had been made without any adjustment for unrecorded trade, quite simply because statistics were not available. Any attempt at making an adjustment would be purely arbitrary. Whether smuggling had had any effects on the shortfall could be determined by examining whether there had been an increase in the level of unrecorded exports in the shortfall year. For neither cloves nor vanilla was there any evidence that unrecorded exports had increased more sharply in the shortfall year than in any of the other four years of the trend period.

The Director of the Legal Department stated that the stand-by arrangement with Madagascar contained a provision under which if, during the period of the stand-by arrangement, Madagascar should impose or intensify restrictions on payments or transfers in current international transactions, further purchases would be interrupted until further understandings had been reached. Consequently, if the authorities of Madagascar were to introduce discriminatory treatment in respect of arrears vis-à-vis any member country, Madagascar would be unable to make further purchases under the arrangement.

Mr. Erb stated that in the light of the staff's explanation, and of the role to be assigned to the midyear review, he could support the proposed program. He took the fact that the authorities intended to reduce the government deficit to 7 per cent of GDP, rather than the higher figure proposed by the staff, as an indication of the political will to carry out further adjustment. He would, however, wait for an analysis of the 1983 program before deciding whether the 7 per cent figure itself was appropriate.

Miss Le Lorier informed Executive Directors that the Secretary of the Paris Club had indicated that Israel would be attending the meeting of the Paris Club to be held on July 13, 1982.

Mr. Nana-Sinkam, referring to the meeting of the Paris Club, recalled that the Vice President of the World Bank had said that the World Bank was in active contact with the Malagasy authorities with a view to supporting the structural changes needed to restore the economy. The World Bank would wish to consider supporting the economy financially by making investments appropriate to the situation in Madagascar. The implication was that there would be a second meeting of the Aid Coordination Group with donors on the possibility of financing the structural adjustment program to be set up by the World Bank. What the Malagasy authorities had done was to seek to overcome their urgent short-term needs by adopting an array of measures, including a public investment program that would serve as a basis for promoting more lasting adjustment of the economy. He would therefore not consider the program to be covering only the first six months of 1982. For instance, the authorities had decided to reduce government personnel by 6,000 persons, and that was clearly something that could not be undertaken in such a short time as six months. Similarly, although the authorities had made the decision to eliminate the subsidy on rice as part of the program, they would have to spread the effects throughout the whole year. It was perhaps worth noting that the decision to eliminate the rice subsidy had been taken even though the impact of devaluation would be to raise consumer prices by 6 per cent and wages were only to be increased by 4 or 5 per cent. All those prior actions taken together not only justified support from the Fund, but also the front-loading to which Mr. Erb had referred. The reference to the authorities' intention to limit the budget deficit to 7 per cent of GDP in 1983 was also an indication that the authorities were contemplating medium-term adjustment.

Several speakers had indicated that they considered that even after the actions taken by the authorities, the economy would contain an excessively large number of rigidities, Mr. Nana-Sinkam observed. The observation was probably correct; it was one of the major reasons why the authorities and the World Bank together were trying to establish an investment program to bring capital from the outside world for the operating sectors of the economy. The fact that the debt service ratio was considered likely to remain high even in five years' time was really due to the nature of Madagascar's exports. In the present circumstances, it would be unwise to project any large increase in the value of exports of coffee, cloves, or vanilla.

Regarding the compensatory financing facility and the export of cloves, Mr. Nana-Sinkam remarked that the description of unrecorded exports applied more accurately to vanilla than to cloves. There was in fact comparatively little unrecorded export of cloves. Vanilla was exported to the Comoros as a means of obtaining foreign exchange. The authorities' view on the exchange rate would have to be ascertained at the next midyear review; it might well be that the rate would have to be examined as part of that review, and some change made in the future. He was grateful to the Executive Directors for their comments, which would be found most useful by his authorities in Madagascar. They would certainly prepare for the midyear review taking account of the views that Executive Directors had expressed during the meeting.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the views expressed in the staff paper for the 1982 Article IV consultation with Madagascar. In recent years supply conditions in the economy had been weakened by a lack of real price incentives for producers, inadequate maintenance of existing infrastructure, particularly in agriculture and transportation, and poor management of state enterprises.

Concurrently, however, expansionary investment policies, a too rapid growth in government personnel, and the growing burden of rice subsidies had contributed to a drastic widening of internal and external financial imbalances. Although a number of commendable policy measures were adopted in 1981, the authorities were not successful in containing government expenditures, while the acute foreign exchange shortage led to a further sharp decline in economic activity and an increase in inflationary pressures.

The external debt accumulated by Madagascar and the debt service ratio that will absorb some 50 per cent of projected exports gave an idea of the unsustainability of the imbalances and of the course of policies that led to such results.

Directors commended the authorities for the courageous policy measures that they had recently implemented, notably the exchange rate action, the elimination of rice subsidies, and the increase in prices for petroleum products.

Noting the exceptionally large external imbalance of the country, however, Directors stressed the importance of continuing rigorous sustained implementation of all elements of the new financial program, and in particular the reduction in the fiscal deficit and the most rapid possible nondiscriminatory elimination of internal and external payments arrears.

Directors regarded the 7 per cent target in terms of GDP for the 1982 budget deficit as a manifestation of the authorities' commitment to further fiscal measures.

Directors also recognized that imbalances in Madagascar's economy were so wide, and projected debt service so large, as to require an intensified adjustment effort over several years, with close attention to fiscal, exchange rate, and domestic pricing policies, and a continued careful choice of investment projects.

In addition, strict monetary policy, along with an adequate level of interest rates and exchange rates, is required. It was suggested that further adjustment of interest rates and, perhaps, of exchange rates might be indicated. In this context, Directors expressed the view that the midterm review planned for late 1982 must play a crucial role in ensuring the continued application of viable adjustment policies.

This review should be set in the context of a medium-term viable balance of payments adjustment strategy. In particular, Directors agreed with the staff view that the authorities might need to consider a more rapid reduction in the proposed rate of growth of government personnel to bring about the required fiscal adjustment.

During the review a close look would have to be given to the interest rate, the exchange rate, the budget, and the elimination in an orderly and nondiscriminatory fashion of external arrears.

The Executive Board then took the following decisions:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision in concluding the 1982 Article XIV consultation with Madagascar in light of the 1982 Article IV consultation with Madagascar conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Madagascar maintains restrictions on payments and transfers for current international transactions as described in EBS/82/103 and in SM/82/127. The Fund notes the intention of the authorities to remove these restrictions as soon as possible. In the meantime, the Fund grants approval for their retention until June 30, 1983 or the completion of the 1983 Article IV consultation with Madagascar, whichever is the earlier.

Decision No. 7160-(82/95), adopted
July 9, 1982

Stand-By Arrangement

1. The Government of Madagascar has requested a stand-by arrangement for the period from July 9, 1982 to July 8, 1983 for an amount equivalent to SDR 51.0 million.

2. The Fund approves the stand-by arrangement attached to EBS/82/103 and waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7161-(82/95), adopted
July 9, 1982

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Madagascar for a purchase of the equivalent of SDR 21.8 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7162-(82/95), adopted
July 9, 1982

3. HOME CURRENCY OPTION

The Executive Directors considered the memorandum by the Managing Director containing a review of experience with the Home Currency Option and recommendations (EBAP/82/218, 6/23/82). They also had before them the report of the Bank/Fund Technical Committee on the Home Currency

Option (EBAP/82/197, 6/7/82) and EBAP/82/236 (7/6/82) containing the comments of the Staff Association Committee on the recommendations contained in EBAP/82/218.

The Deputy Director of the Administration Department reported that the Executive Board of the World Bank had discussed a similar proposal by the President of the World Bank earlier in the week. The Executive Board had approved the recommendation to discontinue the present scheme, and to review it at the next comprehensive compensation review scheduled for May 1984, or earlier if the dollar were to depreciate significantly. The decision of the Executive Board of the World Bank was subject to the Fund's Executive Board taking a similar decision.

Mr. Kafka referred to EBAP/79/110, Supplement 1 (4/25/79). In that paper the Managing Director had stated that the Home Currency Option scheme would become inoperative if salary levels were adjusted in the future so as to be competitive with those prevailing in higher paying countries. Such an adjustment had been made, so that discontinuance would be entirely appropriate. He was slightly disturbed that whatever action was taken by the Fund and the World Bank in such circumstances might send a signal to the markets that could be misunderstood. If the two institutions decided to discontinue the Home Currency Option, they might be interpreted as feeling that the U.S. dollar would depreciate below the level at which it had stood at the beginning of the original period. If the institutions retained the scheme with the original base period, they could be interpreted as feeling that the U.S. dollar would not depreciate below the original level. He was prepared both to retain the scheme, but with the original base period, and to discontinue it.

Mr. Winkelmann recalled that when the Home Currency Option had been proposed in the committee chaired by Mr. Kafka, it had been strongly endorsed. The Managing Director was now proposing to terminate it for the time being and to review it on the occasion of the next major compensation review in May 1984, or earlier if the dollar should depreciate substantially. At present, the nominal exchange rate for the dollar was such that only a few participants would, presumably, again opt into the scheme. However, many participants appeared to appreciate the scheme, not only because of the maintenance of purchasing power provided by transfers to the home countries, but also because of the convenience of being able to make such transfers regularly. The regular transfer feature should be maintained, especially as the cost to the Fund did not appear to be excessively high. His own preference would therefore be to maintain the scheme, but in a more flexible form.

He would agree that the option should not be reversible for the lifetime of the scheme, Mr. Winkelmann continued. However, in view of the present pattern of exchange rates, he would advocate making it possible to enter the scheme not only at inception but at six-month intervals. In origin, the scheme had provided for transfers to home countries at the prevailing market rate, with a guarantee referring to a base period. He had never been convinced that it had been desirable to adjust the market

rate to take account of changes in the inflation differential. Exchange movements in the past two years had amply demonstrated that exchange rates and inflation differentials could move in a perverse fashion. Consequently, the purpose of the scheme had been distorted by market reactions that had not been in conformity with so-called economic fundamentals. Hence, if the scheme were to be continued, he would propose eliminating the inflation differential when calculating the nominal exchange rate. If the majority of the Board wished to discontinue the scheme, he could go along, with the understanding that in the event of any sharp appreciation of currencies like the deutsche mark vis-à-vis the U.S. dollar, the scheme would be reconsidered with a view to reactivating it.

Mr. Kharmavan said that he had been convinced by the Managing Director's statement, and that he would fully support his recommendation.

Mr. Taylor paid tribute to the Bank/Fund Technical Committee on the Home Currency Option for the thoroughness of its analysis. The Committee had been correct to emphasize that the purpose of the scheme had been to provide staff members with a degree of insurance against large changes in purchasing power. It had not been and should not be to provide a vehicle for currency speculation. Consequently, in assessing the impact of the scheme, the relevant question was not how much better off, with hindsight, participants had become compared with nonparticipants, but how well participants had been protected against the real losses that could have arisen from exchange rate changes and changes in the relative rates of inflation. There was also a nonmonetary benefit in the form of a certain added security.

Table 8 on page 19 of EBAP/82/197, Mr. Taylor went on, suggested that experience had been very diverse for different nationalities, a clearly unfortunate result. Such an outcome could presumably be avoided by giving full compensation for differences in inflation rates, a change that ought to be given serious consideration if the scheme were revived, rather than leaving the compensation at 50 per cent of the difference in inflation rates, as at present.

On the question of whether to discontinue the scheme, Mr. Taylor stated, he would support the Managing Director's proposal to allow the scheme to lapse and to review it at the time of the next major compensation review. The reasons put forward by the Managing Director for not adopting any of the options put forward by the Bank/Fund Committee were persuasive. In particular, the recovery of the U.S. dollar in the past two years had eliminated many of the concerns that had given rise to the scheme. The prospects for the dollar remaining strong suggested that even fewer staff members would be interested in protection than had been in 1979. He had no strong views on the matter and, if at any time there were a wish to revive the scheme, Executive Directors should consider it on its merits. However, at that time he hoped that proposals arising from the work of the Bank/Fund Committee would be brought forward.

He noted that the Managing Director had said that steps were being taken to retain the facility for regular low-cost foreign exchange transactions by staff members, Mr. Taylor stated. He was sure that the arrangement had been much valued by many of the staff members who had participated, and that its value far outweighed the relatively small administrative cost. He therefore hoped that the staff would bring their negotiations with the local banks to a satisfactory conclusion, so as to retain that element of the scheme.

Mr. de Vries stated that he could accept the recommendations by the Managing Director, especially if they were supplemented by the qualifications adopted by the World Bank Executive Board. The purpose of the Home Currency Option had been to cover one specific risk to which expatriates were subject, but they were really subject to risks that were very much larger. At some time in the future, therefore, Executive Directors might wish to provide against them by granting an expatriation allowance. At present, while the U.S. dollar was strong, there was an implicit expatriation allowance, and no action was needed. However, when the U.S. dollar had been weaker, he did hear a number of complaints, perhaps indicating that the exchange rate for the U.S. dollar was more important to staff members than statistical studies sometimes indicated. For the time being, however, he could accept the Managing Director's recommendations.

Miss Le Lorier stated that she could accept both the Managing Director's recommendations and the idea of negotiating with the banks for low-cost transfers of funds.

Mr. Erb stated that he would support the proposal to terminate the Home Currency Option on June 30, 1982; he had no objection to reviewing the need for such a scheme in May 1984. However, if there were a move to reintroduce the scheme in the interim simply on the grounds that the U.S. dollar was beginning to weaken, account would have to be taken of the gains made by the staff between July 1982 and the reintroduction of the scheme in order to preserve its symmetrical nature. Hence, in his view, exchange rates would have to move substantially below those prevailing at the present time for the international competitiveness of staff salaries to be brought into question. On general principles, his authorities' position was that any scheme must contain uncertainty of gain and should not be interpreted as a guaranteed supplement to income.

Mr. Prowse stated that he was rather openminded about continuing the scheme. If the staff had wished to maintain it, he could probably have been convinced of the desirability of doing so. He could not accept Mr. Winkelmann's proposal that, in any variant of the scheme, there should be provision for opting in and out as frequently as every six months. Nor would he be keen on an arrangement by which the scheme would be introduced at a time when the U.S. dollar was beginning to depreciate against other currencies. Indeed, if that was the intention, he would be strengthened in his stand in favor of retaining the scheme in operation. To reintroduce the scheme at the beginning of a decline in the value of the U.S. dollar would not only cause a "signal" problem; it would also involve the Fund in expenditures.

The intention to re-examine the scheme at the time of the next major compensation review, Mr. Prowse considered, implied that it would be re-examined in its present form. In other words, the justification would be that at that time Fund salaries would be found to be uncompetitive compared to salaries in the OECD countries. He found that approach unsatisfactory. If Fund salaries became uncompetitive with those in particular countries from time to time, and it was desired to deal with that problem once and for all, perhaps something along the lines of an expatriate allowance might be worth looking at. But to reintroduce the scheme at a moment when the U.S. dollar looked like it was falling would be profoundly unsatisfactory. The Staff Association Committee, in EBAP/82/236, had stated that it would rather see the scheme continued in the form set out under Section 2(b) on page 26 of EBAP/82/197--A Scheme to Provide Stability in the Real Purchasing Power of the Transferred Portion of Participants' Salaries--but that it would agree to discontinue the scheme if it was clear that it would never be introduced as a means of avoiding setting Fund salaries at competitive levels. While it would be impractical to set Fund salaries in such a way that they were competitive in relation to every single country at any given point in time, the Staff Association Committee seemed to have taken a valid position. He wondered why the Executive Board should not simply say that it would discontinue the scheme, and that it would not reintroduce it when salaries became uncompetitive.

Naturally, Mr. Prowse went on, the views of management carried great weight, and if the majority of the Executive Board wished to accept the Managing Director's recommendations, he would not object. He hoped that the Executive Board would take a moment to decide between agreeing to review the matter again at the time of the major compensation review in May 1984, and dropping it pure and simple.

The Deputy Director of the Administration Department commented that the intention had not been to suggest that the scheme might be reintroduced in lieu of a salary increase; the purpose was to state that a judgment would be made at the time of the compensation review in May 1984 regarding the competitiveness of Fund salaries by using appropriate exchange rates. Those rates could be guaranteed in real terms to the staff through the reintroduction of a Home Currency Option scheme. It would be quite unwise to try to decide at the present time on a scheme that might be applicable only in 1984.

Mr. Prowse commented that, despite any explanation that might be offered, he feared that many staff members were likely to think that management had retained the right to reintroduce the scheme as a way of avoiding making salaries competitive.

The Chairman suggested that the Executive Board should agree to allow the Home Currency Option to expire on June 30, 1982 and to consider a possible case for reintroducing a similar scheme at the time of the next major compensation review, scheduled for May 1984. Meanwhile, the Fund could try to preserve the low-cost transfer to home countries that had

been one of the benefits of the present scheme. He agreed with Mr. Prowse that the Home Currency Option was not intended to avoid setting salaries at a competitive level. On the other hand, he was reluctant to adopt a decision saying that the matter would be reconsidered if the U.S. dollar were to depreciate seriously against other major currencies. After all, staff members had been benefiting from the unexpectedly high exchange rate achieved by the U.S. dollar. His proposed decision was perhaps not exactly in line with that of the World Bank, but there was no reason why the Fund should not give exchange rate matters closer scrutiny than did the World Bank.

Mr. Winkelmann suggested that the Executive Board might decide to undertake a review of the Home Currency Option earlier than the major compensation review in May 1984, and to make no mention of exchange rates.

Mr. Caranicas suggested that it might be better simply to allow the Home Currency Option to lapse without undertaking to reconsider the case for it at the time of the compensation review in 1984. After all, any member of the Executive Board was free to raise the matter at any time, as were management and staff.

Mr. Kafka supported Mr. Caranicas on the grounds that the matter might have to be discussed in connection with expatriate benefits later in 1982.

After further discussion, the Executive Board agreed that the following language should be circulated for approval by lapse of time on Wednesday, July 14, a date that would allow for concertation with the World Bank.

The Home Currency Option, which expired on June 30, 1982, will be discontinued. The possible case for the reintroduction of a Home Currency Option scheme will be reviewed, normally, at the time of the next major compensation review scheduled for May 1984. 1/

APPROVED: January 11, 1983

LEO VAN HOUTVEN
Secretary

1/ The World Bank having been consulted and made no objection, the decision was approved on a lapse-of-time basis at the close of business, July 14, 1982.