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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/103

10:00 a.m., August 9, 1982

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

Executive Directors	Alternate Executive Directors
	F. Sarraf, Temporary
	C. Taylor
	E. M. Ainley, Temporary
	J. F. Williams, Temporary
	J. L. Feito, Temporary
	H. G. Schneider
B. de Maulde	
R. D. Erb	C. Dallara
M. Finaish	T. Alhaimus
	T. Yamashita
J. C. Iarezza	
R. K. Joyce	M. Casey
A. Kafka	J. R. Gabriel-Peña
	F. Yeo T. Y., Temporary
	J. A. K. Munthali, Temporary
G. Laske	
G. Lovato	
	A. Alfidja
	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	
	B. Legarda
J. Sigurdsson	
Zhang Z.	

L. Van Houtven, Secretary
S. Fennell, Assistant

Also Present

Asian Department: I. Zaidi. Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; D. K. Palmer, Deputy Director; M Guitian S. Kanesa-Thasan. External Relations Department: A. M. Abushadi, H. P. Puentes. Fiscal Affairs Department: A. M. Abdel-Rahman. IMF Institute: M Al-Jaser, O. N. Alotabi, S. K. A. Noori, Participants. Legal Department: S. A. Silard. Middle Eastern Department: A. S. Shaalan, Director; A. S. Ray Deputy Director; F. Drees, S. H. Hitti, J. Prust, B. K. Short, G. Tomasson, S. von Post, M Yaqub. Research Department: W C. Hood, Economic Counsellor and Director; C. F. Schwartz, Associate Director and Director of Adjustment Studies; G. I. Brown, K.-Y. Chu, E. A. Milne, B. R. H. S. Rajcoomar. Treasurer's Department: A. M. Al-Samarrie. Western Hemisphere Department: E. W. Robichek, Director; S. T. Beza, Deputy Director; H. Arbulu-Neira, J. E. González, Z. Hodjera, E. S. Kreis, E. V. Zayas. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, S. El-Khouri, L. Ionescu, M. A. Janjua, G. Jauregui, P. D. Péroz F. A. Tourreilles. Assistants to Executive Directors: L. Barbone, T. A. Connors, M. K. Diallo, A. Halevi, M. J. Kooymans, W Moerke, J. R. Novaes de Almeida, Y. Okubo, J. G. Pedersen, G. W. K. Pickering, C. N. Pinfield, D. V. Pritchett, J. Schuijer, D. I. S. Shaw, O. Üçer, J. C. Williams, Zhang X.

1. REPORT BY MANAGING DIRECTOR

The Chairman stated that he had attended the BIS meeting in Basle on July 11 and 12, 1982. Under the chairmanship of Mr. Leutwiler, the governors had discussed a number of matters, including particularly the question of the Hungarian debt. In addition, he had had the opportunity to explain the Fund's views of the recent developments in the world economic outlook at a meeting of the Governors of the Group of Ten. He had also given them the most recent available figures. On July 13 he had delivered a speech in Geneva at the meeting of the Economic and Social Council of the United Nations, and also in Geneva he had given a working luncheon for a number of ambassadors of the United Nations, where he had made a few informal remarks on the world economic situation and the role of the Fund. On August 3 he had discussed interest rates and the general world economic situation with Mr. Delors, Minister of Economy and Finance of France.

The Executive Directors took note of the statement by the Chairman.

2. HAITI - STAND-BY ARRANGEMENT

The Executive Directors considered a request from Haiti for a stand-by arrangement equivalent to SDR 34.5 million (EBS/82/120, 7/7/82; and Cor. 1, 7/14/82).

Mr. Kafka remarked that in many respects Haiti represented a rather special case; it was the poorest country in the Western Hemisphere even though it had achieved respectable growth rates during the period 1970-80 under extremely difficult circumstances. Those difficulties had been accentuated over the past three years both by internal events and by developments in the world market. A major natural disaster had increased the problems. It was therefore wrong to emphasize that Haiti's difficulties stem largely from expansionary policies--as the staff had done on page 3 of its report.

The financial program proposed by the Haitian authorities was extremely rigorous, Mr. Kafka noted. Structural adjustment was necessary and the contributions by the multinational financial institutions, the Fund, and private investors and lenders were essential. However, better demand management was a necessary condition.

Since March 1981 the authorities had adopted a series of revenue measures, Mr. Kafka observed, and their effects had already begun to show; despite the recession, revenue collections in 1982 were running no less than 20 per cent ahead of 1981. Nevertheless, expenditure cuts were unavoidable and would have to fall largely on public sector investments until concessional credits could be increased. The authorities hoped that they could identify, in agreement with the Fund, socially beneficial products that would be financed with commercial credit. Although exports could be expected to be stronger in 1983, it was wise of Haiti to formulate its financial program in terms of monthly ceilings for credit, treasury expenditures, and the public sector deficit.

Speaking as an Executive Director of the Fund and not as Haiti's representative, Mr. Kafka went on, it was clear to him that it would not be wise of the Fund to transform those monthly ceilings into monthly performance criteria. Excessive precision in phasing was bound to cause difficulties that might lead to an interruption of drawings, increasing problems for Haiti and perhaps for the Fund. A more traditional type of phasing would be in the Fund's own interest. Similarly, he doubted whether commercial borrowing should have been subjected to a qualitative rather than a quantitative limitation by the Fund. Increased technical assistance would have been the proper way to ensure the necessary tight control, both of expenditure and of borrowing.

Haiti had fulfilled the preconditions that were inherent in the performance criteria, Mr. Kafka concluded, and the authorities had assured him that they would not falter in the execution of the financial program. He hoped that Directors would give their full support to the proposed arrangement and that they would see that the nature of the performance criteria, and particularly the phasing, did not create a precedent.

Mr. Laske remarked that Haiti had experienced an extended period of unsatisfactory economic development, and was once more confronted with a severe financial crisis. The adverse effects of several successive years of falling terms of trade had been one factor contributing to that unfavorable development. However, the authorities had pursued inadequate policies, in particular an unduly expansionary fiscal policy, which had been an even more important factor than the weakening external position.

The program presented to the Board for the requested stand-by arrangement demonstrated a determined effort by the authorities to apply more reasonable economic policies and to pursue more efficient financial management in the future, Mr. Laske noted. If that program was fully implemented and the results were as projected, donor countries and international development agencies might consider increasing their financial assistance to Haiti; in addition, capital inflows might come from private sources.

With regard to the performance criteria, Mr. Laske commented that he was particularly impressed by the combination of criteria that the authorities had agreed to. After the Fund's experience with previous stabilization programs with Haiti, the extended list of performance criteria was certainly justified. It could also serve as an early warning system for the authorities if developments threatened not to go along the envisaged adjustment path. He fully agreed with the authorities and the staff that a severe fiscal imbalance was at the root of the current financial crisis, Mr. Laske continued. The scope for additional revenue measures was limited--at least in the short term--and it was inevitable that the bulk of the adjustment would have to be achieved by expenditure cuts. That unfortunate situation was a consequence of past delays in implementing corrective action. A larger slice of the projected increase in bank credit would be made available to the private sector under the envisaged program, thus enabling that sector to play an increased role in the economic development of the country. Interest rates had remained maladjusted for an extended period of time and had become negative in real terms, but a more flexible policy would ensure that the program targets for financial savings would be met.

He welcomed the authorities' intention to eliminate recently imposed import restrictions, Mr. Laske said. Could the staff state when that action would become effective?

In sum, while the program was strict and demonstrated the determination of the authorities to attack the problems of the economy in a more organized fashion, it would not produce a sustainable balance of payments position until the end of the arrangement, Mr. Laske noted. Restrictive demand management and well-structured development policies over a much longer period than 12 to 15 months would be required to set the Haitian economy on a sound footing. It was particularly important that all levels of public administration should be determined to stick to the course that had been adopted; only in that way could Haiti expect to restore the confidence of foreign donors and creditors.

Mr. Ainley indicated his support for the proposed decision; in the case of Haiti he felt that the performance criteria were appropriate. Haiti faced serious economic and financial problems that were the result of a combination of adverse external developments and overexpansionary fiscal and monetary policies in the past three years. Performance under the recently expired extended arrangement had been disappointing, and the emergency program implemented in early 1981 had been insufficient to halt the deterioration in the public sector accounts. The overall balance of payments deficit was clearly at an unsustainable level, and confidence in the private sector and on the part of the foreign investors was very low.

Against that rather somber background, it was encouraging that the authorities had maintained contact with the Fund and had recognized the need for drastic action, Mr. Ainley continued. Indeed, in the present situation, they had little alternative. He shared Mr. Laske's view that by delaying the implementation of corrective measures the effects would inevitably be more severe, and the extent and the rate of the adjustment that was required would be much greater. The staff report left no doubt, and the authorities' letter of intent acknowledged, that the greatest difficulties had been caused mainly by weaknesses in fiscal policy. Sound fiscal management was the key to securing internal and external equilibrium in both the short and the medium term.

He agreed with the staff that the immediate burden of adjustment had to fall on expenditure rather than on revenue, Mr. Ainley stated. The targeted reduction in the public sector deficit appeared reasonable, but the margin for error in reducing expenditure was very limited. He therefore welcomed the steps that had been taken to improve and to centralize the system of expenditure control. In addition, he endorsed the important role that Fund technical assistance could play in overhauling the tax system, and he hoped that progress could be made soon toward introducing a general sales tax and assessing import duties on an ad valorem basis.

With regard to monetary policy, close adherence to the fiscal targets should ease the credit squeeze in the private sector, Mr. Ainley noted. He agreed with the authorities' declared intention of following a more flexible interest rate policy since interest rates were still negative in real terms--even though the differential between Haitian and international rates was small. Periodic reviews of interest rates could be one way of boosting confidence and of helping the authorities to meet their target of raising public and private sector savings.

On the external side, the imposition of trade restrictions and the accumulation of arrears were most disheartening developments, Mr. Ainley went on. The efforts to dismantle the system of import controls and the proposed elimination of external arrears by September 1983 were therefore very welcome; they should contribute to greater confidence on the part of Haiti's trade and investment partners.

He would have liked the staff report to have included more discussion on the exchange rate, Mr. Ainley remarked. Perhaps the staff could have included some analysis of the appropriateness of pegging the gourde to the U.S. dollar or have given an opinion on whether there might be advantages in alternative policies? He hoped that the mid-term review would give the staff an opportunity to appraise the exchange rate fully.

In sum, a short sharp period of stabilization seemed unavoidable, Mr. Ainley concluded. The proposed program should achieve that aim, but even if the authorities were successful in meeting their immediate targets, a sustained adjustment effort would be required over the medium term. Like Mr. Kafka, he believed that the structural adjustment was required in order to reduce the economy's dependence on coffee exports.

Mr. Lovato indicated his agreement with the staff that the economic situation in Haiti over the past three years had been difficult--due largely to extremely lax fiscal management, but also to the deteriorating external situation and the problems of the international coffee market. However, it was comforting that the authorities were aware of the seriousness of their situation, and of the need to address the fiscal imbalances in a decisive way. It was encouraging to note that the proposed one-year stand-by arrangement might lead to a longer-term program with the Fund.

He had some reservations concerning the present arrangement and he would like to hear comments from the staff on a few points, Mr. Lovato commented. First, as the adjustment that was envisaged under the program was substantial and the past experience was not very positive, he was surprised that there were no preconditions for the stand-by arrangement. Although the "shadow program" that had been requested by the authorities and that had been discussed at the most recent Article IV consultation might have served that purpose, no mention of the program had been made in the staff report. The staff had merely said on page 8 (EBS/82/120) that once again the authorities had not been able to carry out the intended 20 per cent cut in expenditure. It would be useful if the staff could elaborate on that issue.

Second, there was no suggestion in the paper that a review would be needed during the course of the arrangement, Mr. Lovato went on. Given the seriousness of the situation, the Executive Board should have a chance to assess the progress under the program. While he recognized that performance criteria were set for the whole year and that they were extremely detailed both for expenditure and for the deficit of the public sector, he wondered whether a mid-term review might not be useful for both the Board and the authorities.

Third, Mr. Lovato inquired whether the staff was satisfied with the measures that had been undertaken to curtail extrabudgetary expenditures. Those expenditures were, in fact, one of the elements that had been responsible for the collapse of the extended arrangement, and measures should be taken to ensure that they would not recur.

With those comments and reservations, Mr. Lovato stated, he could support the proposed decision. Haiti was facing a difficult future and he hoped that Fund resources could help redress the critical situation and put the country on the path of development once more.

Mr. Feito indicated his support for Haiti's request for a stand-by arrangement. Over the previous two years the Haitian economy had undergone serious financial difficulties due to expansionary fiscal policies and the sharp deterioration in the terms of trade. Due to the country's narrow export base, the economy had been very sensitive to external developments in general, and to fluctuations of the world coffee market in particular. Thus, during 1981, following the setback in the world coffee market, export and fiscal receipts had experienced a sizable decline. At the same time government spending, both current and capital, had grown rapidly, thereby raising the overall public sector deficit to almost 9 per cent of GDP in 1980/81 from 4 per cent in 1979/80. Not only the public sector deficit but also the portion of that deficit financed by the monetary system had continued rising over the previous two years.

The authorities had been increasingly forced to resort to foreign savings to finance their fiscal deficit, Mr. Feito went on. The current account deficit of the balance of payments was currently of the order of 10 per cent of GDP. The poor economic situation was further compounded by the accumulation of external arrears and by the erosion of the private sector's confidence. The authorities should take action to improve the confidence of any future lenders.

Although he would like to commend the staff for its summary of the financial program, set out in Appendix III of the paper, Mr. Feito observed that he would have found it even more useful if the assumptions on net capital flows had been made explicit and had been incorporated into the text. In addition, it would have been useful if the assumptions and estimates regarding the demand for money that were embodied in the program had been made explicit.

The financial program, which aimed at reducing the imbalance between aggregate demand and supply, went to the root of the problem, Mr. Feito considered, and the planned pace of adjustment took into account the main constraints on the economy. The Haitian authorities had recognized that fiscal imbalance was a major problem; consequently, their adjustment effort was rightly aimed at improving the public finances. Although the fiscal program seemed strict, it was difficult to see alternative courses of action, given the rigidity of the tax system and the need to effect a major adjustment in a short period of time in order to restore confidence in the economy. He wished to endorse Mr. Kafka's remark on the scheduling of the credit ceilings and the number of performance criteria.

With regard to monetary policy, he assumed that it had been formulated assuming a constant velocity of circulation throughout the program's implementation period, Mr. Feito said. From the table on page 24, Appendix II, it was evident that velocity, given as a ratio of GDP to M-2, remained practically constant at 4.4 for the duration of the program. Was that assumption compatible with the estimated figures given for prices, output, and interest rates? According to the projections, interest rates were going to increase considerably in real terms during the course of the program, and that must surely have a negative impact on velocity. In addition, the stand-by arrangement might reduce price expectations even more than the actual reduction in prices; in other words, individuals would find it more profitable than before to increase their monetary holdings if they rationally associated a fall in the inflation rate with the monetary and fiscal discipline traditionally attached to a stand-by arrangement, thereby reducing velocity. Considering that private savings had decreased over the previous two years, they could be quite responsive to improvements in real rates of interest. Even if financial savings were not responsive to improvements in real interest rates, in a developing economy the income elasticity of the demand for money must be greater than one; therefore, under a program that projected an increase in real income over the period the velocity of money should decline, assuming that other factors remained constant.

If the velocity of money turned out to be significantly lower than estimated, the proposed ceilings on the rate of growth of net domestic assets would be insufficient to finance the expected rate of real growth, Mr. Feito concluded. On the other hand, the improvement in prices and the balance of payments situation would be greater than expected. Could the staff comment on those points and more specifically on the assumptions behind the projections made for velocity and for the demand for money?

Mr. Polak stated that he was disappointed because both the Fund's and donors' experience with Haiti over the previous years had been far from satisfactory. More recently, an Article IV consultation with Haiti following the expiration of the three-year extended arrangement had concluded that "the economic and financial situation of the country is now significantly more serious than it was at the inception of the extended Fund facility program." External factors, such as declining terms of trade and a decline in bauxite exports, had contributed to the authorities' problems, but the primary cause had been the unsatisfactory management of the domestic fiscal sector. The crucial question about the present arrangement was whether the basic weakness of Haitian management had been overcome. Could the staff assure him that it was convinced that Haiti was seriously entering a phase of recovery? Could it also comment on the fact that the Minister of Finance who had signed the letter of intent no longer held his position in the Government.

In the circumstances, did it seem sensible to include treasury expenditure as a performance criterion? Mr. Polak inquired. How did the staff intend to monitor extrabudgetary expenditure, and was it sure that there was no possibility of evading the performance criterion by short-term financing from the National Credit Bank, for example? Was it advisable, considering the circumstances, to allow higher treasury outlays once more concessional assistance became available?

Mr. Joyce considered that Haiti was facing a very difficult economic situation, although the problems were due, in part, to developments in the world economic situation, particularly with respect to coffee and bauxite. There was some hope that the volume of coffee production might increase in 1983. However, it was clear that the lack of adequate control over public expenditure and over the monetary situation had been the major cause of Haiti's current difficulties. The authorities had now understood that fundamental changes would need to be made in order to improve Haiti's economic situation. Their determination was welcome and he supported the program that had been proposed.

He was somewhat worried about the authorities' ability to carry out that program, Mr. Joyce continued, since Haiti's previous record under the Fund programs had not been good. It was clear that developments in the current fiscal year had not gone as well as had been originally anticipated. Revenue shortfalls had caused a much higher than expected deficit in the current account. However, treasury expenditures had been held down to the planned levels, and the authorities had taken steps to enable them to control expenditure better, namely, the withdrawal of the automatic overdraft facilities of the central bank for the state agencies, and the consolidation of much of government spending into the Treasury.

The 1982/83 program provided for only a moderate reduction in the public service deficit, Mr. Joyce noted. However, it was the staff view that little progress could be expected on the revenue side in the immediate future, which meant that it would be more important to ensure that expenditure was tightly controlled.

Like Mr. Ainley, he welcomed the authorities' decision to seek technical assistance for reforming the tax system, Mr. Joyce went on. A more broadly based tax system would be more appropriate and would reduce the dependence on excise taxes and import duties. Was the staff convinced that the automatic overdraft facilities could not be restored without Fund approval?

With regard to monetary policy, he agreed with the staff that capital outflows were occurring mainly as a result of lack of confidence in the economy and the administration, Mr. Joyce remarked. He agreed with previous speakers that the maintenance of a negative interest rate differential vis-à-vis the United States did not improve the situation. The program aimed at increasing domestic savings, and it would therefore be desirable for the authorities to increase real interest rates. He noted that the authorities had decided to re-establish periodic reviews of interest rates to ensure that the savings target was achieved; but were they willing, in fact, to increase interest rates?

Discussing external policy, Mr. Joyce remarked that the quotas imposed in 1981 on a large number of items would be eliminated or replaced by selective tariff increases. Had any consideration been given to the devaluation of the gourde? Although such a devaluation would probably only have minimal effects on the country's export revenues, it could have a significant impact upon imports. The perseverance of the authorities and their ability to execute the program would be the determining factor in restoring confidence. He wondered whether the staff had held discussions with the new Minister of Finance about his views of the economic program.

In the particular case of Haiti, he would be inclined to support the reporting of monthly data, Mr. Joyce observed. On the other hand, to make the figures criteria could lead to great uncertainty with respect to the execution of the program and the disbursement of Fund resources. He suggested that the Executive Board should indicate to the authorities that any request for a modification or waiver of the criteria would not be well received.

His main concern was with the authorities' ability to implement the program, Mr. Joyce concluded. Haiti remained one of the poorest countries in the hemisphere; it was therefore one of the countries most deserving of help and assistance.

Mr. Iarezza expressed his support for Haiti's request and his broad agreement with the staff appraisal. Haiti demonstrated the case of a less developed country that had been affected by the external economic environment; after a period of high investment, the external economic conditions had deteriorated sharply, and the lack of elasticity in the authorities' policies had caused the fiscal sector and balance of payments deficits to increase. However, the authorities had decided to take the necessary adjustment measures to correct the situation, and they should be commended.

While the fiscal policies appeared appropriate in the short run, he hoped that with the benefit of Fund technical assistance a more elastic tax system would increase the public sector revenues, allowing the authorities to increase the level of investment expenditures, Mr. Iarezza remarked. In addition, he welcomed the authorities' commitment to pursuing a more flexible interest rate policy, which, together with the restoration of confidence, would help to increase the demand for money and would allow the authorities to fulfill the projected growth targets for broad money.

With regard to the external sector, the authorities' intention to dismantle recently imposed restrictions was welcome, Mr. Iarezza concluded. More generally, he wondered whether the use of monthly ceilings was appropriate, and he hoped that such a decision would not be considered as a precedent.

Mr. Dallara said that he considered that the adjustment program, supported by the stand-by arrangement, was well designed; the phasing of purchases, the program objectives, and the policies were particularly appropriate. He welcomed the authorities' unwavering commitment to the program, and on that basis he was prepared to support the proposed stand-by arrangement. Given Haiti's recent economic history and, particularly, the poor performance of the most recent two years of the extended arrangement, there was undoubtedly a need for strict compliance by the Government of Haiti with its commitments.

Fiscal policy was of central importance, Mr. Dallara commented. First, in view of the excessive levels of government expenditure during the previous two years, and the need to ensure expenditure reduction if the program was to succeed, he supported the views expressed by other Directors that the performance criteria--including those directly related to treasury expenditures and the public sector deficit--were appropriate. The authorities should continue to monitor costly government expenditures.

Second, although he believed that Haiti's problems had been fundamentally caused by excessive growth of expenditure, he noted with interest the intent of the authorities to pursue a reform of the tax system, Mr. Dallara commented. He encouraged them to act promptly in order to broaden the tax base. He was pleased that the Fund was providing assistance in that effort. Third, in the light of Haiti's past use of short-term commercial credit he was pleased to note that the Government had agreed to consult the Fund before contracting foreign credit, in order to assess the implication of the proposed financing arrangement on the balance of payments. Fourth, he strongly supported the efforts of the authorities to separate the accounts of the central bank from those of the state-owned commercial bank.

He believed that success in controlling the fiscal disequilibrium was a necessary prerequisite for sound monetary policy, Mr. Dallara explained. Credit to the private sector could be expanded at a slightly faster rate than nominal GDP growth; however, he wondered whether other government policies provided an appropriate context within which the private sector could respond. Could the staff assess Haiti's medium-term prospects, and suggest policy areas in which further adjustments were likely to be necessary? Should the Government be focusing attention on other structural areas in the future to provide the basis for stronger economic growth and a sustainable balance of payments position? Could the staff also provide an update on World Bank activities in Haiti?

The program called for substantial adjustment, the unavoidable consequence of long delays in applying meaningful corrective action, Mr. Dallara concluded. The disappointing performance under the recent extended arrangement underscored the critical nature of the current stand-by arrangement for the future of the Haitian economy and relations between Haiti and the Fund.

Mr. Legarda stated that Haiti's difficulties had been brought about by overexpansionary policies that had been triggered by the temporary export boom in 1979. However, after the boom had collapsed Haiti had suffered from mounting arrears, foreign exchange shortages, and a general deflation of confidence, and the authorities had had to seek Fund support.

He supported the request, Mr. Legarda indicated, and the authorities should be commended for moving decisively to overcome their problems and also for recognizing that fiscal policy should be the cornerstone of the adjustment effort. The Haitian authorities had asked for Fund assistance in reforming the tax system. Budget cuts would be necessary to ensure fiscal relief, and he noted that the program aimed to ensure that cuts would not fall disproportionately on public investment. In addition, the activities of public enterprises would be kept under close scrutiny. Provided that the program's fiscal and monetary policies were rigorously implemented, there could be some improvement in the difficult economic situation.

He wondered whether previous stand-by arrangements had included monthly performance criteria on treasury expenditure, the public sector deficit, and the net domestic assets of the monetary authorities, Mr. Legarda mentioned. Since purchases were to be made at quarterly intervals and only the immediately preceding monthly ceiling would be relevant, what was the operational significance of the criteria? He also wondered if the staff considered that the exchange rate was at least broadly appropriate.

Mr. Zhang inquired in what ways the performance criteria and the content of the economic program under the stand-by arrangement differed from those under the previous extended arrangement?

The staff representative from the Western Hemisphere Department remarked that the Fund had been dealing with the Haitian authorities for the past 30 years. Never before had it faced problems that were beyond the scope of its functions to solve.

The staff believed that the balance of payments difficulties had at their roots the extremely lax fiscal management that had begun during the 1979-80 coffee boom, the staff representative continued. During that period, government revenue had increased rapidly but government expenditure had risen twice as fast. Very large projects had been carried out, including a sugar mill that had cost close to $100 million but had so far not yielded any returns. The Government had also bought a fishing fleet that had gone into bankruptcy, not only losing the initial capital but also having to pay $8-10 million to creditors. When the coffee boom ended, government revenue had declined sharply but government expenditure had continued rising rapidly, and the central bank had found itself in a precarious foreign exchange position. Needless to say, the extended Fund facility program had not come to fruition.

The present arrangement had been negotiated when Mr. Bazin was Minister of Finance, the staff representative explained. His presence in the Ministry had been a decisive factor in leading to the speedy conclusion of the arrangement. His resignation, however, was a strictly political matter unrelated to the determination of the Government to carry out the Fund arrangement. Fortunately, the new Minister of Finance, Mr. Frantz Merceron, was a very able man who had assured the staff of the authorities' commitment to the program.

Concerning the establishment of monthly ceilings, it was not intended to set a precedent for future programs, the staff representative observed. However, it was a necessity in the case of Haiti in view of the disappointing performance of previous programs and the possibility of monitoring--thanks to the progress achieved with the fiscal reform--treasury expenditure almost on a day-to-day basis.

In regard to the observance of the shadow program established in 1981, the staff representative remarked that the authorities were not able to observe it in the first half of the fiscal year. However, the shadow program had been reformulated in the second half so as to limit the fiscal deficit to G 225 million in FY 1981/82. To conform with that limit, monthly government expenditures had been cut to G 70 million. Since May the ceiling had been strictly enforced. The observance of the monthly ceilings until the end of July had been in fact a prior condition for the discussion of the arrangement by the Executive Board.

There had not been any reason to advise changes in the exchange rate for the gourde, the staff representative from the Western Hemisphere Department stated because it could have serious destabilizing repercussions in a country, like Haiti, which had one of the lowest per capita incomes in the hemisphere. Besides, there was no indication that the price relationship between the U.S. dollar and the gourde had been out of line. As to Haiti's medium-term prospects, they were very much related to the Government's development program and the restoration of confidence. It was hoped that once Haiti re-established a viable balance of payments position the private sector would find profitable investment opportunities in Haiti; the inflow of both fiscal and foreign capital would have the effect of alleviating the unemployment problem substantially.

The staff representative from the Exchange and Trade Relations Department stated that the two main purposes of performance criteria in Fund arrangements were to ensure, first, that adjustment was being effectively made, and second, that the use made of Fund resources by a member was appropriate in the sense that their revolving character was safeguarded. He was not aware of any precedent in which monthly performance criteria had been used, but the record could be examined to ascertain that question. The staff had always argued that a degree of flexibility was necessary in phasing ceilings to suit the particular needs of different countries. In the case of Haiti it was believed that monthly performance criteria would help the authorities in implementing their policies. The ceilings were cumulative, so that nonobservance of a particular monthly ceiling would not necessarily preclude a purchase, as long as by the time of the quarterly drawing the subsequent monthly ceiling was being met. However, if the authorities, having observed all the performance criteria, decided not to make a quarterly drawing on schedule, they could not make that drawing at a later date if a subsequent monthly performance criterion was not observed.

Although a case could be made for both quantitative and qualitative ceilings, in its periodic reviews of the subject the Executive Board had come to the conclusion that quantitative performance criteria would be the best way to safeguard the Fund's resources, the staff representative commented. An Executive Director had raised a question regarding the excessive precision of the criteria; although valid, the objection was not related in any way to the frequency or periodicity with which the criteria had been phased.

With regard to the question about the need for a review clause, the staff representative explained that all arrangements contained a clause under which either the Fund or the member could request a consultation. In addition, a review clause was often included to enable the staff to set particular ceilings at a later date, or to reach understandings on certain policies for which performance criteria had not been formulated. Since, in the case of Haiti, there was an appropriate list of performance criteria it did not seem necessary to include a specific review clause. However, the staff could still consult with the country if it seemed appropriate to do so.

In response to a specific question on the assumption made in the program regarding the velocity of circulation of money, the staff representative from the Exchange and Trade Relations Department remarked that velocity would decline if the demand for money in Haiti increased more than the staff had anticipated. Ceteris paribus such a change would improve the situation and prospects of Haiti more than had been expected. For example, it could allow the existing payment arrears to be eliminated faster, thereby perhaps encouraging an increase in flows of concessional assistance from abroad.

The staff representative from the Fiscal Affairs Department stated that since 1979 the Fund staff had been extensively involved in Haiti. On the expenditure side, earmarking and multiple taxation had been eliminated, thus broadening the coverage of the central government budget, increasing its efficiency as the most important fiscal instrument, and improving control over expenditure.

On the revenue side a number of structural reforms covering taxes on incomes and profits, duties and taxes on imports, and sales taxes had been undertaken, the staff representative went on. The reform on taxes on incomes and profits had been completed in 1980. It had reduced the administrative complexities of those taxes, accelerated the payment of corporate profits tax, and minimized external indicators as a basis of taxing some categories of profits. Following that reform, revenue had increased by about 30 per cent. The reform of duties and taxes on imports had been completed in September 1981; it had consolidated the many duties and taxes that had previously been levied on the same products. The consolidation was in conformity with and in support of the budgetary and accounting reform that had eliminated earmarking. In the process of consolidation, the valuation of imports had been verified; ad valorem rates for the tariff posts for which only specific rates had existed were incorporated, and the anomalies stemming from the many ad hoc changes in the tariff had been removed. In the area of sales taxes, a general sales tax would replace the majority of remaining excise duties, the commissions levied by the tobacco monopoly, and the tax on luxury foods. The sales tax would be levied on imports and manufactured goods; it was expected to broaden the aggregate tax base and improve the overall elasticity of the tax system.

Mr. Kafka stated that he had never objected to quantified performance criteria, but rather to the monthly ceilings. If the authorities became entitled to draw at the end of August 1982, for example, but decided to wait a month only to find that they had exceeded the ceiling by 1 gourde, they would have to ask the Fund for a waiver. If the ceilings had been quarterly, a waiver would not have been necessary. After all, he did not wish to encourage countries to draw as soon as they were entitled.

It was true that Haiti had been experiencing serious economic problems over the past three years, Mr. Kafka concluded. However, it seemed clear to him that if a country had maintained a stable currency in terms of the U.S. dollar without exchange restriction for 30 years, as Haiti had done, the management of the economy could not have been as bad as some speakers seemed to imply.

Mr. Feito said that he agreed with the staff representative from the Exchange and Trade Relations Department that, other things remaining constant, the velocity of circulation would certainly decrease over the course of the program. However, other factors were not likely to remain constant. The economy was expected to improve and interest rates were expected to become positive; the demand for money would therefore increase and velocity would be reduced. If velocity turned out to be lower than had been expected, both the balance of payments position and prices would be better than had been forecast. But if in fact the scenario unrolled in the way both he and the staff representative had suggested, the credit ceilings imposed by the Fund would be insufficient to finance the expected growth. That was his point.

The staff representative from the Exchange and Trade Relations Department agreed with Mr. Kafka that there was an operational difference between a monthly and a quarterly ceiling: monthly ceilings were stricter than the quarterly ceilings. But the question of the degree of precision of the ceilings was independent of the period for which they were set.

As for the velocity of circulation, it was true that a program that would eliminate negative interest rates could, in the abstract, bring about a decline in velocity, the staff representative noted. However, in Haiti's economic situation it would seem most reasonable to assume that velocity would not change. He was not convinced that if the demand for money turned out to be higher than forecast, a credit ceiling that brought about an improved balance of payments position would also necessarily result in a lower growth rate, because the relationship between credit flows and growth was neither very well established nor very direct.

The Executive Board then adopted the following decision:

1. The Government of Haiti has requested a stand-by arrangement for the period from August 9, 1982 to September 30, 1983, for an amount equivalent to SDR 34.5 million.

2. The Fund approves the stand-by arrangement set forth in EBS/82/120, Supplement 1.

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

Decision No. 7180-(82/103), adopted August 9, 1982

3. URUGUAY - PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered a request by Uruguay for a purchase equivalent to SDR 55.3 million under the decision on the compensatory financing of export fluctuations (EBS/82/124, 7/13/82; and Sup. 1, 7/26/82).

The staff representative from the Research Department made the following statement:

I would like to inform the Executive Board of the latest export data the staff has been provided.

In EBS/82/124, the value of Uruguay's exports for the period of May-September 1982 is estimated at SDR 67 million a month. The staff now has actual export data for May and June and preliminary data for July. On this basis, the value of exports for the May-June period is estimated at SDR 70 million a month--SDR 3 million a month higher than the original estimate. This implies that the value of exports for the remaining two months should be SDR 62 million a month for the staff's estimated of exports given in the paper to be correct.

> The main reason why the May-June exports exceed the estimate given in the paper is unexpectedly large bulk shipments of rice and wheat made in June; the June exports, at SDR 80 million, were unusually large. The staff does not expect that additional shipments of this nature will occur in August or September, and therefore would propose that the original estimate of exports given in EBS/82/124 be maintained.

Mr. Iarezza stated that the Uruguayan authorities had requested a purchase of SDR 55.3 million, equivalent to 45 per cent of quota, under the compensatory financing facility with respect to a shortfall in merchandise export earnings for the year ending September 1982. The projected shortfall in export earnings was largely attributable to external circumstances beyond the control of the authorities, in particular, the weak world demand that was caused by a decline in economic activity in industrial countries, the austerity measures introduced in neighboring countries, and the political disturbances in the South Atlantic. The authorities were in close contact with the Fund staff to find appropriate solutions for their balance of payments difficulties. Several measures had already been introduced: a wage freeze in the public sector through end-1982, public expenditure cuts, tax increases, and an acceleration in the rate of exchange depreciation through the remainder of 1982.

Mr. J. F. Williams stated that he had no difficulty with Uruguay's request for a drawing under the compensatory financing facility and that he supported the proposed decision. He was concerned about the deteriorating balance of payments situation in Uruguay. Were the authorities proposing to enter into an arrangement with the Fund to correct the widening external imbalances? If so, it would be useful to conduct an Article IV consultation with Uruguay before any arrangement was finalized.

Mr. Gabriel-Peña expressed his support for the request by Uruguay. It was clear that Uruguay met the requirements for compensatory financing; the shortfall was due mainly to the slowdown in world demand and to declining prices for Uruguay's agricultural exports and traditional and nontraditional manufacture exports.

The overall balance of payments deficit was expected to be approximately SDR 400 million in 1982, Mr. Gabriel-Peña noted. Had the balance of payments projection for 1982 taken account of the fiscal and external policy changes?

Mr. Legarda indicated his support for the proposed purchase by Uruguay. It was evident that the reasons for the shortfall were beyond the control of the authorities. Despite a 15 per cent decline in imports, the current account deficit had increased, in part because of weak world demand for Uruguay's exports. Austerity measures that had been introduced in neighboring countries and the political disturbances in the South Atlantic had also affected the volume and price of exports of agricultural and manufactured goods.

He was confident that there would be a recovery in the postshortfall period, Mr. Legarda remarked; there would be some degree of restoration of economic growth in industrial countries, and some strengthening of international prices for agricultural products. In addition, the ending of hostilities in the area and the opening of the Brazilian market for beef meant that the volume of Uruguay's exports would increase.

Mr. Feito indicated his support for Uruguay's request. The Uruguayan economy was experiencing serious balance of payments difficulties, primarily due to the sharp deterioration in the international economic environment. The recession in the industrial countries and a tightening of economic policies in neighboring countries had negatively affected the volume of Uruguay's exports. In addition, the recent hostilities in the region had seriously affected the balance of payments position, partly because of a disruption of normal shipping, but also because of the interruption of direct capital inflows from Argentina. The export shortfall was largely attributable to circumstances beyond the authorities' control.

The authorities had been closely cooperating with the Fund over the previous years, Mr. Feito remarked, and they were now holding discussions with the staff about the possible use of additional Fund resources. The authorities had recently introduced new measures, including a wage freeze, an acceleration in the pace of exchange rate depreciation, and imposition of a 10 per cent export subsidy and 10 per cent import surcharge. Those measures would undoubtebly alleviate some of the balance of payments difficulties.

Mr. Dallara stated that he had no difficulty with the request and that he supported the proposed decision. Uruguay's external position had deteriorated markedly since 1980 due largely to problems with public sector finances as well as to weak foreign demand for its exports. The introduction of a number of measures by the authorities, aimed at improving the fiscal and external imbalances, was welcome. He shared Mr. William's view that an in-depth analysis of the economy and the authorities' policies in the context of an Article IV consultation would be useful.

Mr. Nimatallah expressed his support for Uruguay's request for a purchase equivalent to SDR 55.3 million under the compensatory financing facility.

Mr. Polak indicated his support for Uruguay's request. Could the staff comment on the progress of its study of compensatory financing drawings based on estimated data for export shortfalls? He noted that in EBS/82/124, Supplement 1 the staff retained the original estimates of Uruguay's shortfall.

Mr. Casey indicated that he could support Uruguay's request since there was certainly a balance of payments need, the shortfall was temporary in nature, and the authorities had fulfilled the condition of cooperation.

The shortfall had been caused largely by factors beyond the authorities' control, Mr. Casey considered, although a part of the shortfall could probably have been avoided by domestic action, for example, the avoidance of production bottlenecks in the area of nontraditional manufacture exports and perhaps also a smoother growth of the national cattle herd. There was no evidence of above-normal stock-building during or after the shortfall year, although it was clear that stocks of many products had been reduced before the shortfall year and that the reduction had had the effect of increasing the size of the calculated shortfall. Nevertheless, there seemed to be no serious problem in the present case, and he was more concerned with the possibility of overcompensation. The staff had not included a table indicating estimated exports for the five months for which actual data were not available. Although the staff representative had provided some figures for May and June and preliminary figures for July, there was a strong possibility of overcompensation. For example, there might be a marked recovery in exports of fish because of the cessation of hostilities in the South Atlantic; exports of younger cattle could resume suddenly; and the slaughter of cattle that were unfit for export could quickly alleviate the shortage of leather. For those reasons the actual shortfall might be less than had been projected.

If a repurchase was necessary, it could probably be made promptly, since the gross official reserves of Uruguay were about SDR 250 million, Mr. Casey said. Nevertheless, any repurchase would cause problems for the authorities because it would arise "out of the blue" and not be budgeted for, and that was an important consideration to bear in mind. What was the staff view on the possibility of overcompensation?

The staff representative from the Western Hemisphere Department indicated that the staff would conduct an Article IV consultation with Uruguay during late September or early October 1982, and it would discuss the extended Fund facility with the authorities at the same time. He hoped that the staff would be able to talk about the general economic situation of Uruguay with the Executive Board before the end of 1982. The staff had taken into account the recent measures that had been introduced by the authorities when making the balance of payments projection. The fiscal measures that had been introduced would only begin to have an impact at the end of August 1982, when taxes were collected.

The original projection for the export shortfall would hold for two reasons, the staff representative explained; first, exports in June would be much higher than had been projected, due to the larger shipments of rice and wheat. Therefore stocks of those commodities available for export would be lower in the following two to three months. When taking the average for May and July, exports were somewhat lower than the staff had projected. The Uruguayan authorities were well aware of the possibility of overcompensation, and they had committed themselves to repurchase if that was required.

The staff representative from the Research Department stated that the staff paper on reducing the risk of overcompensation in early drawings under the compensatory financing facility would be finished by October 1982. The staff had not been able to obtain reliable data on stocks of commodities in Uruguay, with the exception of rice. According to that information, rice stocks had declined from 17,800 metric tons at the end of 1979/80 to 100 metric tons at the end of 1980/81; during the shortfall year they had remained at the depressed level of 100 tons.

Mr. Iarezza commented that the authorities intended to reach an agreement with the Fund concerning a purchase in the upper credit tranches. Although he did not believe that the case of overcompensation would arise, his authorities would be ready to make a repurchase if necessary.

The Chairman remarked that, as the shortfall was largely estimated and the drawing was equal to the shortfall, there was clearly a risk of overcompensation. It was satisfactory to learn that the Uruguayan authorities would make a prompt repurchase if necessary. One Executive Director had been reassured by the fact that the gross reserves of Uruguay were rather high in relation to any probable overcompensation. However, if the Executive Board were considering a country with a much lower level of reserves, would the staff still be inclined to make a proposal based on a drawing equal to the shortfall? While there was no way to answer the question on the spot, it was a point worth considering.

The Economic Counsellor remarked that when the drawing was equal to the shortfall there was indeed a risk of overcompensation, but under the compensatory financing decisions the amounts were fully compensable. The staff would therefore have made similar proposals even in the case of a country with a much lower level of reserves. Mr. Polak had, however, asked when the staff would give Executive Directors a chance to change the decisions in that respect. The staff hoped to bring a paper to the Executive Board in October 1982.

The Deputy Managing Director stated that Mr. Polak had explained the issue correctly; there was a choice between risking overcompensation on the one hand and making a country wait longer before making drawings under the compensatory financing facility on the other.

The Executive Board then adopted the following decision:

1. The Fund has received a request from the Government of Uruguay for a purchase of the equivalent of SDR 55.3 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund notes the representation of Uruguay and approves the purchase in accordance with the request.

Decision No. 7181-(82/103), adopted
August 9, 1982

4. SAUDI ARABIA - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with Saudi Arabia (SM/82/131, 7/7/82; and Cor. 1, 8/2/82). They also had before them a report on recent economic developments in Saudi Arabia (SM/82/145, 7/22/82; and Cor. 1, 8/2/82).

Mr. Nimatallah made the following statement:

I would like to start by thanking the staff for the valuable set of papers they have prepared in connection with the 1982 Article IV consultation with Saudi Arabia. My authorities are in general agreement with the staff's appraisal of the economic and financial situation in Saudi Arabia.

Oil policies

As the staff paper has clearly indicated, Saudi Arabia's policies with respect to oil production and prices are guided by long-term international and domestic considerations. In general, these considerations are based on the following main objectives: (1) to ensure adequate supplies of oil to meet the genuine requirements of consuming countries; (2) to maintain a unified and orderly oil price system and stable conditions in the world oil market to the extent possible; and (3) to secure optimal and reasonable revenue for the Kingdom in the long run.

Saudi Arabia has consistently endeavored to maintain stability both in the price and supply of oil. My authorities have cooperated with developed and developing countries toward that objective of stabilization. Saudi Arabia believes that maintenance of stable conditions in the world oil market is imperative, particularly in this period of international economic difficulties. My authorities believe that a decline in oil prices at the present time would have destabilizing effects in the medium and the long run. For one thing, the conservation efforts, which were very successful in many countries over the past few years, would be thwarted if the price of oil were to decline. Furthermore, projects aimed at oil exploration as well as the development of alternative energy resources all over the world would be threatened if not canceled altogether. Financial institutions that have loaned billions of dollars for that purpose might experience liquidity difficulties. Some of these are already hurting and are in serious trouble as we hear today. Moreover, any decline in the price of oil could only be temporary, given the long-term supply constraints. The best way to ensure that oil prices will be stable in the future is for them to be stable now. This is the main reason why my authorities, in cooperation with others, have acted to prevent a decline in international oil prices at the present time.

Development policies

Despite the substantial increase in its financial strength in the 1970s, Saudi Arabia remains, in many respects, a developing country. The economy also remains headily dependent on the oil sector. The two major objectives of development planning in Saudi Arabia have always been to raise the level of well-being of the population and to diversify the productive base of the economy.

The First Five-Year Development Plan, which covered the first half of the 1970s, stressed building up the basic infrastructure, especially public utilities, and improving government services. The Second Five-Year Development Plan, covering the second half of the 1970s, emphasized the development of the physical infrastructure and the expansion of social services. The implementation of these plans has been largely successful. The actual rates of increase of non-oil GDP during the period of these two plans were higher than the plans' targets. These rates averaged 11.6 per cent during the first plan and 14.8 per cent during the second plan. Furthermore, there are statistical indicators that show that the dependence of the economy on the oil sector has been reduced over time. As Appendix Table 17 of SM/82/145 shows, the contribution of the oil sector to GDP has exhibited a declining trend in real terms over the period 1975/76-1980/81. My authorities are determined to continue this trend of enhancing the contribution of the non-oil sectors to GDP.

The current Third Five-Year Development Plan, covering the period 1980/81-1984/85, stresses investments in productive sectors and domestic human resource development. As in the second plan, private sector participation in the development process is being greatly encouraged through the provision of financial and other incentives. My authorities continue to regard the objectives of the plan as being both appropriate and attainable. As such, the expenditure targets under the plan will not be affected by revenue considerations. Any revenue deficiencies will be compensated for by drawing on reserves, which are there fundamentally to maintain the development pace.

Demand management policies

The Government's operations play a dominant role in the Saudi Arabian economy. The Government's direct contribution to non-oil GDP averaged about 40 per cent over the past few years. Furthermore, net domestic spending of the Government has been a major factor influencing economic activity in the private sector, as well as the expansion of liquidity in the economy.

In the current budget, revenues and expenditures are balanced at SRls 313.4 billion. Revenues are projected to decline by 15 per cent and expenditures to increase by 9 per cent, as compared with the provisional actual figures for the previous year. The projected decline in revenue is mainly due to lower oil revenue, which is based on a lower average production and no change in the official sales price. On the expenditure side, project expenditures are budgeted at SRls 180 billion, which represents a 25 per cent increase over the provisional actuals for 1981/82. The other categories of expenditures are, however, projected to show only small changes from the provisional actuals of the previous year.

The staff has raised several fiscal issues with my authorities regarding the diversification of the revenue base, the reduction in budgetary subsidies, and medium-term fiscal planning. The staff report (SM/82/131) covers the views of my authorities on these subjects, but I would like to emphasize them briefly.

With respect to diversification of budgetary revenue sources, my authorities see some merit in this approach, which is in line with their stated objective of reducing the dependence of the economy on oil in the long run. However, the need at the present stage is not for raising other sources of revenue, but to develop mechanisms to raise them when it becomes appropriate to do so in the future. At this stage, my authorities are encouraging the private sector to divert most its savings to capital formation and to hold down consumption. They are using several means to encourage capital formation, including loans on easy terms through specialized development banks and funds. When firms in the industrial, agricultural, and services sectors have had time to establish themselves, the privte sector can be taxed appropriately.

On the reduction of subsidies in the budget, a ministerial committee is currently studying the question of subsidies and its recommendations are expected to be finalized in the near future. At the present time, the maintenance of food subsidies, for example, is an important social policy objective as the Government is committed to improving the living standard and well-being of the population. However, adequate food and agricultural prices are required in every country to maintain incentives for farmers. The conflicting objectives of controlling inflation on the one hand, and maintaining adequate prices in the agricultural sector on the other hand, can be compromised in most cases by subsidies given to the producers of food and agricultural products. Saudi Arabia provides such subsidies, as do many countries.

As far as the other subsidies are concerned, my authorities are convinced that developing human skills to earn higher income is a good way to distribute the oil wealth. Developing skills, however, takes time, and to avoid creating a wide gap between the more fortunate and the less skilled, and because the oil wealth belongs to all the Saudi Arabians, the Government is continuing with these subsidies for the time being.

As noted earlier, there will be an overall review of subsidies when the recommendations of the ministerial committee are completed. There will be no desire to continue subsidies when they are no longer required.

With respect to the establishment of a medium-term expenditures planning process, the investment program that is embodied in the Five-Year Development Plan does represent a medium-term program. Investment expenditures will continue according to that program. However, the oil market uncertainties make it difficult to forecast reliably the behavior of oil revenue. Thus, it is extremely difficult, at this time, to plan for budgetary current expenditures on a medium-term basis.

The main determinants of the extent of monetary expansion in Saudi Arabia are the net domestic expenditures of the Government and the balance of payments deficit of the private sector. Like many other countries, Saudi Arabia has faced the problem of private capital outflows because of the high interest rates on the dollar and the other key currencies. However, the gap between domestic rates of remuneration in financial assets and international interest rates narrowed somewhat in 1981/82 as a result of some decline in international interest rates, together with a significant increase in the return on riyal-denominated assets. Private capital flows, in and out, have obviously had an impact on credit availability for the private sector and caused fluctuations in domestic liquidity. My authorities are keen to keep monetary expansion within reasonable limits to maintain an inflation rate below 10 per cent. This is a ceiling that is carefully watched.

External sector policies

Because the value of oil exports is expected to decline, and imports of goods and services are projected to increase substantially, the surplus in the 1982 current account of the balance of payments is expected to decline sharply. However, this will not affect Saudi Arabia's policy of providing generous assistance to other developing countries. Over the past six years, Saudi Arabia provided about $28 billion in terms of official foreign aid to developing countries, which is equivalent to about 6 per cent of GDP. In 1982, official foreign aid is projected at $6 billion, which is considerably above the average of these past years.

The overall balance of payments position is projected to be in equilibrium in 1982. Saudi Arabia continues to adhere to the principle of freedom to make payments and transfers for international transactions, and imposes no restrictions on imports. My authorities will continue to manage foreign assets in a prudent and responsible fashion, not only in the interest of Saudi Arabia, but in that of the whole international community as well.

With respect to the exchange rate regime, the Saudi Arabian riyal remains, in principle, pegged to the SDR. In order to discourage speculation and to create an environment conducive to private sector confidence, my authorities also sought to preserve a fairly stable riyal-dollar exchange rate. Since late 1980, the riyal had been depreciated in a number of small increments against the dollar. However, given the sharp appreciation of the U.S. dollar against other currencies, the appreciation of the riyal against the SDR exceeded the 7.25 per cent margin.

Output and prices

The prudent policies, which my authorities are pursuing and which I have described above, had led to rapid economic growth in recent years, as well as to a decline in the rate of inflation. Real non-oil GDP rose by over 12 per cent in both 1979/80 and 1980/81, and preliminary data indicate that it grew by about 10.5 per cent in 1981/82. The growth rate in real non-oil GDP is projected at 9.5 per cent in 1982/83.

At the same time, the rate of inflation has been declining steadily. The rate of increase in the implicit non-oil GDP deflator declined from 8.9 per cent in 1979/80 to 7.6 per cent in 1980/81 and to an estimated 5-6 per cent in 1981/82. Furthermore, the two cost of living indices have risen by less than 2 per cent during the past year. These favorable price developments were due to several factors: first, the prudent fiscal policy, which limited increases in expenditures to levels consistent with the economy's absorptive capacity; second, the removal of supply bottlenecks in the economy, especially in the area of residential construction; third, the stability of import prices in riyal terms, reflecting a slowdown in international inflation, and the appreciation of the riyal against major currencies other than the U.S. dollar; and fourth, the continued absence of barriers to imports. Inflation is expected to remain low in 1982/83, and Saudi Arabia is expected to continue to enjoy a healthy economy.

Mr. Finaish stated that it was clear that Saudi Arabia had been playing a major role in the international adjustment process. That was amply reflected in its overall economic policy; its liberal trade and payments system; its continued high level of external assistance, which contained a very generous grant element; and the very substantial contributions to the resources of regional and international institutions, including the Fund and the World Bank. Saudi Arabia was also contributing to international adjustment by currently importing merchandise at an annual rate of almost $40 billion, as well as paying for services, effecting foreign workers' remittances of over $4 billion a year, and through private investments abroad.

On external assistance, Mr. Finaish noted that Mr. Nimatallah had indicated that, over the past six years, Saudi Arabia had provided about $28 billion of official foreign aid to developing countries, equivalent to about 6 per cent of GDP. In 1982, official foreign aid was projected at $6 billion--considerably above the average of those previous years. Some of the countries of his constituency were beneficiaries of the generous Saudi Arabian aid program. On their behalf, he expressed his appreciation.

The current circumstances would not affect the maintenance of the steady flow of aid to other developing countries, Mr. Finaish continued. Furthermore, the nature of Saudi Arabian aid--as Mr. Nimatallah had pointed out the previous year--was different in several respects. Moreover, it had a wide distribution and was not tied aid. It should also be remembered that Saudi Arabia was liquidating physical assets and, in that sense, there was no rationale for treating proceeds of those assets as current income.

The staff report again highlighted the key role that Saudi Arabia played as the world's principal oil exporter, Mr. Finaish observed. The oil production and pricing policies of such an important exporter deserved particular attention in the prevailing uncertain circumstances surrounding the oil market and the world economy. The staff paper indicated that the country's stated objectives of its oil policy had not changed. They were still based on the need to ensure adequate supplies of oil, maintain a unified and orderly price system, and secure optimum and reasonable revenue. He shared Mr. Nimatallah's view that a reduction in the price of oil could give wrong signals in current circumstances and adversely affect conservation efforts and the development of energy resources.

The authorities realized, Mr. Finaish continued, that the achievement of the stated objectives of oil policy was a difficult task. Those objectives might not always be mutually reconcilable and a decision might often be needed to determine which objective was to be given priority in any particular situation. Conflicting domestic and international considerations might complicate the implementation of an objective course of action, assuming that such a course could be easily defined. The balancing of supply and demand for oil would always face the often difficult task of defining the proper point of balance, given the numerous unsettled issues involved in both the short term and the long term. Those difficulties had contributed to the present uncertainties. They clearly indicated that the objective of maintaining stability of oil supply and price could be more effectively achieved by more concerted efforts among major exporters and greater international cooperation that would give due consideration to the long-term energy requirements of the world economy.

The domestic consideration in the Saudi Arabian oil policy, as stated before, was "to secure optimum and reasonable revenue for the Kingdom in the long run," Mr. Finaish went on. That was particularly needed to achieve the long-term objective of econommic strategy to diversify the economy through emphasis on investment in the non-oil sector. As that would remain the central theme of economic policy, one would expect more attention and analysis in the staff reports of the progress and conditions conducive to the achievement of this crucial objective. It might be noted that Mr. Nimatallah had mentioned that there were some statistical indicators of a trend to reduce dependence on oil, as reflected in the relative contribution of the non-oil sector to GDP in the years 1975-81. Some elaboration on the other indicators involved would be useful in that regard. It was also important to follow possible changes in the structure of the non-oil sector itself. It had been noted in the discussion of the previous year's report that economic policy under the Third Five-Year Development Plan had shifted emphasis from building the physical infrastructure to developing directly productive activities, a course of action that the Board had welcomed at that time. A closer analysis of the shifts in relative importance of the various components of the non-oil sector--i.e., construction, services, manufacturing, and other industries--was highly relevant to assessing progress made in achieving the major objective of economic policy.

It was encouraging, Mr. Finaish noted, that the authorities recognized the desirability of making a thorough review of budgetary expenditure and revenue policies, that reducing reliance on oil remained a major aim of the Government, and that the possibility of diversifying revenue resources would be considered. Given the uncertain revenue prospects and the relatively high rates of spending, it would be useful to know whether, in the staff's view, a more cautious expenditure policy in the future was advisable.

Returning to oil production and pricing policy, Mr. Finaish commented, one of the stated objectives of the policy was to secure optimal revenue. In assessing the optimality of extraction rates, oil exporting countries faced a number of difficult questions: they included whether the domestic investments being undertaken with the oil proceeds were fruitful; whether the external investments were secure and their yields compared favorably with the yield that would accrue to petroleum if it were left in the ground; whether the necessary infrastructure had been developed and remunerative lines of production had been chosen; and whether it was a fair exchange, liquidating petroleum to acquire those assets under current conditions. He was certain that Saudi Arabian planners were well aware of those considerations.

It was also clear, Mr. Finaish observed, that the authorities assigned a high priority to ensuring adequate supplies of oil to meet the requirements of consuming countries. It was worth noting that, while the staff had spoken of consumer requirements in general, Mr. Nimatallah had spoken of "genuine requirements." Indeed, that was an important qualification. Clearly, it was important for the long-term conservation of that scarce resource that its use be confined to genuine requirements. That would also contribute to the maintenance of stable conditions in the world oil market, which was the second stated objective of the Saudi Arabian oil policy. Accommodation of consumers' demand beyond genuine requirements could lead, for example, to destabilizing stocking and destocking of oil. The changes in the level of production also had implications for financial flows and investment decisions. They could also have technical implications, such as those impinging on the productivity and long-term capacity of the oilfields. It would be useful to know from the staff whether it had any useful information on the latter technical aspect.

Mr. Taylor stated that he endorsed the analysis and the conclusions in the staff appraisal and that he agreed that the authorities were to be congratulated on their economic and financial management, which had maintained a high rate of growth while reducing inflation. The fairly rapid growth in non-oil GDP was an admirable achievement.

The staff had not fully assessed the international implications of the authorities' policies, Mr. Taylor remarked. Such issues as the size of the current account surplus, the oil production and pricing policy, and the disposition of Saudi Arabian overseas assets clearly had major implications for global economic stability, and he would have therefore welcomed a fuller review of those aspects of policy by the staff. Mr. Nimatallah had dealt with a number of those questions, and he found his observations valuable and interesting.

In its exercise of surveillance, the Fund should give as much attention to the international aspects of policies of surplus countries as to those of deficit countries, Mr. Taylor went on; the policies of the major oil exporters were as significant with regard to the world economy and questions of surveillance as were those of industrial countries.

With regard to fiscal policy, he shared the staff view that budget revenue sources should be diversified and that the integration of expenditure and revenue plans should be pursued with more urgency than at present, Mr. Taylor commented. In that connection, he welcomed the authorities' recognition of the need for a thorough review of budgetary expenditure, and he was pleased to note that they also planned a review of subsidy policy.

Some of the arguments put forward by Mr. Nimatallah concerning the social objectives of subsidies were undeniable in Saudi Arabia's case, Mr. Taylor indicated. However, some prices--particularly in the energy field--had remained unchanged over a considerable period. The size of Saudi Arabia's oil reserves might reduce the need to economize in the domestic use of energy, but conservation should remain an important objective in Saudi Arabia as elsewhere. Under the present domestic pricing policy there was a risk of some misallocation of investment or distortion of industrial development. How far were the authorities intending to monitor the economic effects of social and welfare subsidies with those dangers in mind?

He would welcome some further comment from the staff on the reasons behind the slight deceleration in the growth of non-oil GNP and the nature of the constraints that impinged on growth in that sector, Mr. Taylor stated. The cautious demand management policy was appropriate in view of the wish to avoid regenerating inflationary pressures and of the expectation of somewhat lower revenues from oil exports. He fully recognized the uncertainties inherent in a heavy dependence on oil-related income and he had no reason to believe that the authorities had underestimated the growth potential of the non-oil economy. However, expenditure had frequently fallen short of budgetary projections even though there were large financial reserves on which the authorities seemed prepared to draw in order to finance their investment program. Could the staff comment on whether they felt the authorities had been slightly overcautious in trimming back their budget for 1982/83?

With regard to the external sector, a very large reduction in the current account surplus--to no more than about $10 million, after allowing for foreign aid--was being forecast for 1982, Mr. Taylor noted. Although that seemed likely judging by current trends, he would be interested to hear whether the staff would be inclined to revise the figure upward slightly--perhaps to reflect lower imports and possibly slightly higher than expected oil exports.

Like Mr. Finaish, he commended the authorities for continuing to provide high levels of aid to the developing countries, Mr. Taylor said; however, the external contribution of countries with a current account surplus could not be judged only by the level of their official development assistance. Other financial flows, and even the exchange and trade regime, were also important factors. For example, the flows of workers' remittances had been of great benefit to poorer countries. What were the prospects for a continuation of those flows? Furthermore, it was necessary to acknowledge the very vital role that capital outflows had played in recycling Saudi Arabian payments surpluses. In that respect Saudi Arabia's performance was exemplary.

More generally, policies of member countries with regard to the operation of capital markets--in particular, the promotion of liberal capital markets--did seem to be a subject that deserved more attention in Article IV consultations, Mr. Taylor considered. There was a tendency for Fund surveillance to focus traditionally on trade and aid policies, but policy in the area of overseas investment and the promotion of free and efficiently operating capital markets was a subject that should be discussed in staff papers. In addition, Article IV consultations might pay more attention to the strategic disposition of the official reserves of surplus countries. Substantial shifts in reserve holdings between major currencies could be destabilizing, and it would seem that a member's reserve management and the extent to which it promoted stabilization in the international economies was a legitimate topic for coverage in Article IV consultations. He had in mind the fact that the major reserve currency members of the Fund had committed themselves to maintaining the internal and the external value of their currencies at the Versailles summit meeting; other member countries might also feel an obligation to avoid destabilizing actions in the management of their reserves. He was not commenting on Saudi Arabia's reserve management, and he commended the authorities for following consistent and conservative official investment policies. He especially welcomed the authorities' willingness to hold SDR-denominated reserves--as exemplified by the Saudi Arabian Monetary Agency loan to finance the Fund's provision of enlarged access resources.

With regard to the external sector, the steps that the authorities had taken to maintain oil output at a broadly constant level and to adhere to a constant price for oil were very welcome, Mr. Taylor commented. The authorities had shown great concern for the effect of their pricing policy on the rest of the world economy. However, might it not be better to switch the method of pricing oil from one based on U.S. dollars to one denominated in a composite currency unit or in terms of SDRs? The maintenance of a constant price in dollar terms was useful up to a point, but it meant that the effective price fluctuated when the dollar moved against other currencies, and those moves could be significant in the short-term. Perhaps the staff might discuss that issue with the authorities.

Mr. Laske remarked that the Saudi Arabian authorities had continued to manage the country's economy in a skillful manner, and that success had not failed to come their way. Bottlenecks in infrastructure and transportation, which had hampered the development of the non-oil sector of the economy, had been largely eliminated. The growth rate of the non-oil sector, although somewhat smaller than in previous years, had been maintained at a rather high level, and the rate of inflation had been reduced. A well-considered development policy and prudent financial management had been the main causes of that success. The authorities should be commended for those achievements.

As the most important producer of crude oil, Saudi Arabia held a key position in the world economy, Mr. Laske noted. The authorities' production and pricing policies had demonstrated a high sense of responsibility for the needs of the international community. In the face of a slowdown of world demand, Saudi Arabia had reduced its oil production and pursued moderate pricing policies, thus helping to forestall extreme swings in oil supplies and oil prices. He shared the authorities' view that, given the present world economic situation--characterized by an extraordinarily high degree of uncertainty--a reduction in the nominal price of oil would not be helpful, especially in the long term. Such a reduction might increase the volatility of both the nominal and the real price of oil, which in turn would tend to intensify the disruptions in the world economy. Saudi Arabia was carrying a heavy responsibility for the oil markets, and it had lived up to the challenge extremely well.

With regard to fiscal and monetary policies, the non-oil sector continued to account for a very small share of the economy and that situation was likely to continue even though, over the previous decade, the growth rate in the non-oil sector had been impressively high, Mr. Laske continued. As in 1981, he approved of the shift in the authorities' development policy giving more emphasis to the non-oil sector; the infrastructure had been improved and appeared to be broadly adequate. In previous years expenditure had been largely determined by the flow of oil revenues and, thus, by the variations in that flow. The authorities intended to follow a steadier course of development expenditure and to use financial assets if revenues were insufficient to bring about a balanced growth and continued diversification of the non-oil sector.

Although the growth rate in the non-oil sector of the economy had declined slightly and was not expected to rise in 1982, monetary expansion had been considerable, Mr. Laske noted. The increase in domestic liquidity was expected to be 25 per cent in 1982--5 percentage points more than in 1981. That expansion, which had occurred despite a slowdown in non-oil growth and despite weak demand for bank credit to the private sector, was due to the substantial repatriation of financial assets that had taken place in 1982. Perhaps the resulting overliquidity was too great to ensure the maintenance of a low rate of inflation. At the time of the discussion for the 1981 Article IV consultation with Saudi Arabia, a number of Directors had suggested that the effectiveness of the monetary policy could be strengthened by employing a wider range of more sophisticated instruments. Had the authorities given further consideration to their monetary policy and to instruments that could be employed?

The large amount of aid made available by the authorities to developing countries was much appreciated, Mr. Laske concluded, as was their contribution to the financing of multilateral financial institutions, including the International Monetary Fund. He hoped that Saudi Arabia would be able to continue that policy even though its oil revenues had declined.

Mr. Schneider indicated his agreement with the staff assessment of the present economic situation and the future prospects of the Saudi Arabian economy. The authorities should be congratulated for the implementation of successful policies; their oil policy was highly constructive and stabilizing, and their determination to expand the economic base through productive non-oil investments should be commended. Saudi Arabia had made a significant contribution to the international adjustment process.

The country's acomplishments within the framework of the Third Five-Year Development Plan had been outstanding, Mr. Schneider remarked. Impressive improvements had been made in physical infrastructure--in particular in housing, transportation, communications, water supply, electrical distribution, and social services. It therefore seemed likely that the non-oil sector might soon become productive; the combined effects of establishing appropriate physical infrastructure, improving the skilled labor force, and using advanced technology would speed up the pace of the diversification process and provide a sound basis for an increase in absorptive capacity. He would have appreciated a brief analysis of the prospects for the infrastructure investments, compared with the magnitude of overall expenditure, in order to determine whether both the short-term and the medium-term needs of the Saudi Arabian population would be met.

The revenues from oil would continue to be the main determinant for achieving a fully diversified economic base, Mr. Schneider considered, since investment projects, both in infrastructure and in the productive sector, required the mobilization of all available resources. The growth rate figures given in Table 2 of SM/82/145 clearly indicated that the increase in non-oil GDP--especially within the private sector--was consistent with the overall objectives of the Government. Nevertheless, the difference between the planned growth figure of 6.2 per cent for the period as a whole and the first year's actual outcome of 12.3 per cent was rather surprising. Such a difference could not be expected in following years. It would be useful if the staff could comment on whether the difference resulted from reduced crude oil production or from possible increases in the investment expenditure. The authorities appeared willing to continue with the planned investment spending for developing the non-oil sector even if public expenditure had to be curtailed. They should be commended for their determination to control inflation at the same time.

With regard to fiscal policy, Mr. Schneider noted that the budget had been smoothly executed, and that the authorities had continued with their prudent management of domestic financial affairs, as well as of oil production and pricing policies. He welcomed the study on subsidies; while he agreed that subsidies had an important role to play in the context of social objectives, he hoped that a proper balance could be found between those objectives and budgetary considerations. The relative size and importance of the banking system had grown considerably as a result of modern management, and it played a leading role in both fiscal and monetary developments and as a depository for private savings.

The high level of development aid from Saudi Arabia to less developed countries was greatly appreciated, Mr. Schneider concluded. The authorities had maintained a policy of extending substantial aid to developing countries even though their oil revenues had declined.

Mr. de Maulde remarked that oil pricing and production policies were unavoidably woven into the country's overall development objectives. Saudi Arabia was not a unique case and other oil producing countries were faced with comparable problems; however, because of Saudi Arabia's weight within OPEC and also because of its commitment to maintaining stability within the oil market--which the authorities viewed as being an essential condition for optimizing revenues and fulfilling the long-term development goals--it presented a special case.

The authorities had been successful in achieving their goals, particularly with regard to economic growth and price stabilization, Mr. de Maulde considered. Non-oil GDP, which was a more adequate measure of the efficiency of economic policy, had grown at the very high level of 12 per cent a year in both 1980 and 1981, and it appeared that the growth rate in 1981/82 would be above 10 per cent. In addition, inflation had been reduced from 9 per cent in 1979/80 to 5 per cent in 1981/82.

Inflation could probably be maintained at its present low level over the medium term, Mr. de Maulde said. Domestic price increases in particular should not come under excessive pressure as long as international rates of inflation were moving downward and the domestic currency remained stable. There were two other reasons for expecting a continuation of the present stability of domestic prices: the conservative financial policies of the authorities, and the absence of any major imbalances between supply and demand in almost all sectors of the economy.

The capacity of the non-oil sector to maintain its present rate of growth over the medium term would be largely determined by future oil market conditions and prices, Mr. de Maulde went on. The extent of the cuts in production that had taken place in the previous months, within both Saudi Arabia and the OPEC group as a whole, gave some indication of the size of the present imbalances in the oil market. Although it was hazardous to forecast future demand for oil, it was likely that demand would be weak over the next few quarters. It could be assumed that since consuming countries had based their energy conservation efforts on developing alternative energy sources using new technology, demand for oil would not increase dramatically.

Growth prospects in the industrial world remained very bleak, Mr. de Maulde remarked, and he noted that for many importing countries the appreciation of the U.S. dollar had more than offset the recent weakening of oil prices. Therefore, there was an additional incentive to conserve energy and intensify substitution from domestic sources. In addition, with the reduction of OPEC production to 17.5 million barrels a day--from a peak of 31 million in 1979--non-OPEC producers accounted for about 60 per cent of the market and it appeared that they should be willing to continue to increase that share. In view of the considerable uncertainty regarding the future behavior of the oil market, the reduction in the projected growth rate of public spending in 1982 was entirely appropriate.

He appreciated the large amount of foreign aid that Saudi Arabia was extending in spite of the reduction in oil revenues, Mr. de Maulde stated. In addition, he was grateful for the high level and quality of the cooperation by the Saudi Arabian authorities with the Fund.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/82/102 (8/6/82) and EBM/82/103 (8/9/82).

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/82/288 (8/5/82), EBAP/82/293 (8/5/82), and EBAP/82/294 (8/5/82), by Advisors to Executive Directors as set forth in EBAP/82/291 (8/5/82) and EBAP/82/295 (8/5/82), and by an Assistant to Executive Director as set forth in EBAP/82/292 (8/5/82) is approved.

APPROVED: February 8, 1983

LEO VAN HOUTVEN
Secretary