Mr. Guetta

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/159

10:00 a.m., December 13, 1982

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

Executive Directors	Alternate Executive Directors
	M. K. Diallo, Temporary
	C. Taylor
	L. E. J. Coene, Temporary
	A. Le Lorier
A. Donoso	
R. D. Erb	C. Dallara
	S. R. Abiad, Temporary
	I. R. Panday, Temporary
T. Hirao	
R. K. Joyce	M. Casey
	C. Robalino
	G. Grosche
G. Lovato	
R. N. Malhotra	
	S. El-Khouri, Temporary
J. J. Polak	J. Schuijer, Temporary
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
F. Sangare	E. A. Ajayi, Temporary
M. Senior	J. L. Feito
	L. Vidvei
Zhang Z.	Wang E.

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

Also Present

African Department: J. B. Zulu, Director; E. L. Bornemann, F. d'A. Collings, M. E. Edo, W. J. Shields, A. C. Woodward. Asian Department: H. Neiss, Deputy Director; N. N. Choudhry, L. H. De Wulf, S. Kimura, K. Saito, J. Schulz, R. L. Sheehy. European Department: M. T. Hadjimichael, S. Mitra. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; S. Kanesa-Thasan. External Relations Department: C. S. Gardner, Deputy Director; A. M. Abushadi. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder. Middle Eastern Department: G. Tomasson. Research Department: W. C. Hood, Economic Counsellor and Director; G. I. Brown, N. M. Kaibni. Treasurer's Department: D. Williams, Deputy Treasurer; A. M. Al-Samarrie, D. Berthet, W. J. Byrne, D. S. Cutler, D. Gupta, A. F. Moustapha, M. Sami, G. Wittich. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: J. R. N. Almeida, C. J. Batliwalla, M. A. Janjua, P. Kohnert, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, T. A. Connors, R. J. J. Costa, G. Ercel, C. Flamant, G. Gomel, M. Hull, P. Leeahtam, W. Moerke, J. A. K. Munthali, V. K. S. Nair, Y. Okubo, J. G. Pedersen, G. W. K. Pickering, J. Reddy, C. A. Salinas, D. I. S. Shaw, J. C. Williams, A. Yasseri, A. A. Yousef.

1. REPORT BY MANAGING DIRECTOR

The Chairman said that the Chairman of the G-10 Deputies had sent him the main conclusions reached by the G-10 Deputies at their meeting on December 10, 1982. Copies were being distributed to members of the Executive Board (Attachment).

2. DESIGNATION PLAN AND OPERATIONAL BUDGET FOR DECEMBER 1982-FEBRUARY 1983

The Executive Directors considered the proposed designation plan for December 1982-February 1983 (EBS/82/220, 11/29/82) and the operational budget for December 1982-February 1983 (EBS/82/221, 11/29/82).

The staff representative from the Treasurer's Department explained that there had been very few changes in the original operational budget for September-November 1982, and the staff would circulate a table updating the use of currencies and SDRs in that period soon. 1/ As for the designation plan for September-November 1982, transactions amounting to nearly SDR 200 million above the originally expected amount had occurred. 2/

Mr. Abiad remarked that his authorities in the United Arab Emirates had informed him that there was a problem of reconciliation of statistics. The authorities were discussing the matter with the staff.

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

The decisions were:

Designation Plan for December 1982-February 1983

The Executive Board approves the designation plan for the quarterly period beginning December 13, 1982, as set out in EBS/82/220 (11/29/82).

Decision No. 7266-(82/159) S, adopted
December 13, 1982

1/ An updated table on the use of currencies and SDRs under the Operational Budget for September-November 1982 was subsequently circulated in EBS/82/221, Supplement 1 (12/14/82).

2/ An updated table on the use of SDRs under the Designation Plan for September-November 1982 was subsequently distributed in EBS/82/220, Supplement 1 (12/14/82).

Operational Budget for December 1982-February 1983

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/82/221, page 3, footnote 1, and the operational budget for the quarterly period beginning December 13, 1982, as set out in EBS/82/221 (11/29/82).

Decision No. 7267-(82/159), adopted December 13, 1982

3. ZAMBIA - PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered a request by Zambia for a purchase equivalent to SDR 34 million under the compensatory financing facility (EBS/82/212, 11/23/82; and Sup. 1, 12/10/82).

The staff representative from the African Department said that a staff mission had just returned from Zambia after conducting the 1982 Article IV consultation and holding further discussions on a financial program covering 1983. Although progress had been made in several areas during the discussions, it had not been possible to conclude the negotiations on a financial program, in part because the 1983 budget had not yet been finalized. The staff planned to have further contacts with the authorities.

No official balance of payments data for 1982 were available, the staff representative commented, but the external position had clearly remained under great pressure and the balance of payments outcome for 1982 was likely to be worse than that indicated in Table 1 of EBS/82/212. The overall balance of payments deficit in 1982 was now estimated at about SDR 350 million; it was to be financed largely by a further substantial accumulation of external payments arrears including, for the first time, arrears on the external public debt. Finally, in recent months Zambia had intensified its exchange restrictions on current international transactions.

Mr. Sangare made the following statement:

I should like to express my appreciation to the staff for its paper, which sets out in a very clear and objective manner Zambia's request to make a purchase under the compensatory financing decision.

In the last two years, the balance of payments situation in Zambia has weakened, as the current account balance moved from a surplus of SDR 103 million in 1979 to a deficit of SDR 596 million in 1981, reflecting mainly a shortfall in export earnings and an increase in payments on services, including interest payments on external debt. Despite significant capital inflows in 1981 associated with the mining industry, the overall position deteriorated further, from a deficit of SDR 173 million in 1979 to SDR 327 million. As a result, external reserves fell from SDR 60.7 million in 1979, the equivalent of 4.3 weeks of imports, to SDR 40.7 million in 1981, representing 2 weeks of import cover. The projected outturn for 1982 indicates that Zambia's balance of payments will remain under pressure. Although the current account position is expected to improve as a result of a reduction in imports, the overall position is again projected to show a substantial deficit, with external reserves remaining precariously low at only 2.5 weeks of imports.

Zambia's export earnings, particularly from copper and cobalt, the principal export commodities, have been falling steadily since 1979, mainly as a result of depressed world demand. In 1981/82, Zambian copper fetched on the London Metal Exchange an average price of 70 cents a pound, which was 12 per cent below the average price in the previous year. In the case of cobalt, the price fell from $25.20 a pound in 1979/80 to $7.30 in 1981/82. Meanwhile, production continued to expand with copper output rising by 1 per cent in 1981/82 and expected to increase by the same amount in 1982/83. Production of cobalt has also increased, and its accumulated stock reached the level of 2,700 tons at the end of June 1981, or three times the level held in the previous year, and remained virtually at that level by the end of June 1982, despite all efforts by the Zambian authorities to dispose of their cobalt even at considerably lower prices. It is therefore clear that the export shortfall was due to factors that were outside the control of my Zambian authorities.

Meanwhile, it is expected that the price of both copper and cobalt will improve somewhat in 1983. But the extent of this improvement will depend on the recovery of the world economy mainly in the industrial countries. In this connection, it may be noted that the Zambian authorities have been making efforts to increase the volume of cobalt exports and to obtain better prices.

With regard to cooperation with the Fund, it will be recalled that on May 8, 1981 Executive Directors approved an extended arrangement for Zambia. The objective of the program was to restore the financial balance while accelerating economic growth through, inter alia, diversification into the agricultural sector. In this regard, it may be noted that some significant strides had been achieved in diversifying the economy into agriculture and in meeting the fiscal targets. However, the program met with some setbacks in the first year, as the unfavorable external environment exerted renewed pressure on the balance of payments, as a result of which some of the performance criteria for December 1981 were not met and the program had to be canceled in July this year. The authorities are negotiating with the Fund with a view to concluding a new arrangement. Last month the staff held discussions on the 1982 Article IV consultation with my Zambian authorities, including further discussions on a financial program. I had the privilege of attending some of these discussions, and I can assure Executive Directors that they proved useful to my authorities in their further efforts to find solutions to the financial and economic difficulties. In connection with the new restrictions subject to approval by the Fund, it should be noted that the imposition of a 10 per cent foreign exchange levy on overseas travel and education was necessary because of the persistent and increasing pressure on the external payments position rooted in the continuing unfavorable external environment, which had compounded the problem of the payments arrears. The authorities will not hesitate to remove restrictions on external transactions and eliminate arrears as soon as the external payments position permits.

In view of the foregoing, it is clear that Zambia has a balance of payments need, and that the authorities are cooperating with the Fund in seeking solutions to their economic and financial difficulties. The Board should also note that the staff agrees that the Zambian request meets all the requirements of the compensatory financing decision. I therefore urge the Board to approve the decision on page 12 of EBS/82/212.

Mr. Dallara stated that he accepted the proposed decision, although only with serious reservations. As the staff had noted, Zambia's performance under the extended arrangement, which had recently been canceled, was mixed; and the inability of the authorities to formulate a comprehensive adjustment program since then, despite discussions with the staff lasting more than a year, led him to doubt whether the Government's policies were adequate to solve the balance of payments problems, as required by the test of cooperation applied to requests to use the compensatory financing facility. Nevertheless, since the discussions--which, he hoped, would lead to a comprehensive set of adjustment policies--were continuing, he was inclined to believe that Zambia's request met the minimum test of cooperation under the compensatory financing facility. As it had been traditionally interpreted, the minimum test of cooperation was meant to satisfy the Fund that a member country would cooperate with it in an effort to solve the country's balance of payments problems. Zambia's request raised the fundamental question of whether the traditional application of the test was sufficient to safeguard the Fund's resources in a case involving a country with a temporary shortfall in export earnings and more serious payments problems that clearly called for a major and comprehensive adjustment effort. The question was a general one and was meant to cover basic Fund policy; it was not limited to the present case of Zambia.

It was important to bear in mind, Mr. Dallara continued, that the test of cooperation, like all Fund conditionality, was designed to ensure that the Fund's resources would be used in accordance with the purposes of the institution and in circumstances that would preserve the revolving character of the resources. Decision No. 102-(52/11) on the use of the Fund's resources and repurchases, adopted February 13, 1952, contained the following statement:

> Considering especially the necessity for ensuring the revolving character of the Fund's resources, exchange purchased from the Fund should not remain outstanding beyond the period reasonably related to the payments problem for which it was purchased from the Fund. The period should fall within an outside range of three to five years. Members will be expected not to request the purchase of exchange from the Fund in circumstances where the reduction of the Fund's holdings of their currencies by an equivalent amount within that time cannot reasonably be envisaged.

In the case of Zambia, and in some earlier cases, it was difficult to conclude with much confidence that a repurchase could take place on the basis of the current policy stance. In September 1982 the Executive Board had been informed of significant arrears--about SDR 45 million--on Zambia's payments to the Fund. The arrears had subsequently been cleared up, but such arrears were a serious matter for the Fund. The record of repurchase was a central aspect of a member country's relationship with the Fund and was important for both the Fund's own operations and the broader perception of the Fund as an institution that could effectively perform its functions.

The staff could have usefully provided more information on Zambia's payments arrears, Mr. Dallara went on. As a rule, it would be appropriate and helpful for the staff to inform the Executive Board of a member country's recent financial relationship with the Fund and its obligations with respect to repurchases and charges in the coming period. Zambia's substantial repurchase and charge obligations to the Fund in 1983 added to his concern about the country's ability to meet its financial obligations. The staff had noted that the volume of Zambia's external arrears had grown in 1982--equaling about three quarters of total expected export receipts--and that the problem had become a serious one.

Mr. Salehkhou commented that the evolution of the domestic and external balances of the Zambian economy had paralleled the developments in the international copper and cobalt markets. In the year ended June 1981, copper exports had accounted for 90 per cent of total export earnings. As international demand for copper and raw materials had weakened in line with the intensification of the world economic recession in 1981 and 1982, and prices had fallen sharply, Zambia's trade balance had deteriorated markedly. At the same time, international interest rates had soared and the external debt burden had become heavy. As a result, the external current account balance had swung from a significant surplus, equivalent to 4 per cent of GDP, to a large deficit equivalent to 20 per cent of GDP; Zambia's reserves had fallen significantly; and there had been a large increase in external payments arrears despite an important rise in net capital inflows.

Zambia's request to use the compensatory financing facility clearly met all the relevant criteria, Mr. Salehkhou said. The authorities needed to act quickly to ameliorate the unfavorable effects of the world recession, and it would be useful to hear further staff comment on the difficulties that apparently had delayed the negotiations between the staff and the authorities on the resumption of Fund assistance. A speedy completion of the negotiations would have enabled Zambia to draw a much larger amount under the compensatory financing facility than was being requested; the compensable shortfall was substantially larger than the proposed drawing, which would increase Zambia's outstanding purchases under the facility to only 50 per cent of quota. Would Zambia be able to make a further purchase under the compensatory financing facility after an agreement on a new stand-by arrangement had been reached?

It was of course difficult to forecast exports for the coming two years, as they depended heavily on the behavior of the world economy, Mr. Salehkhou commented. The staff had projected a 20 per cent increase in Zambia's export earnings in the two postshortfall years and had assumed that there would be a significant recovery in the industrial countries. Although he did not wish to challenge either the staff's forecast or the finding that Zambia's export shortfall was temporary in character, the same assumptions had been made for Zambia's request to use the compensatory financing facility in 1981, and actual developments had been much different from the staff's expectations; the export position had continued to deteriorate and Zambia had felt the need to request another purchase under the compensatory financing facility.

Despite the failure of the ambitious extended arrangement in 1981 and the authorities' introduction of exchange restrictions in 1982, Mr. Salehkhou remarked, Zambia's record of cooperation with the Fund was good. The unfavorable developments in the economy had obviously been due to factors beyond the control of the authorities: the sharp deterioration in the terms of trade and the subsequent increase in the external imbalances. The proposed decision should be approved.

Mr. Schuijer noted that the authorities had been unable to make the ambitious adjustments that they had planned, and Zambia's extended arrangement had been canceled. In many cases involving a canceled extended arrangement, the next step had been to agree on a less ambitious, one-year stand-by arrangement. As he understood it, such an arrangement was being negotiated with Zambia, and any further comment on the status of the negotiations would be useful.

Zambia clearly had a balance of payments need to use the compensatory financing facility, Mr. Schuijer continued. For a number of years the current account deficit as a percentage of GDP had been in double digits and capital inflows had not come close to covering the deficit.

Moreover, reserves had declined to a dangerously low level, and the external payments arrears had continued to grow.

The problems facing the economy, Mr. Schuijer commented, had been caused in large part by the persistently depressed markets for Zambia's main export products. Zambia's purchase under the compensatory financing facility in 1981 had been based on the assumption that copper prices would increase in the postshortfall period, but that assumption had proved incorrect, thereby casting some doubt on the staff's estimates for the proposed purchase under the facility, especially as the assumed revival of the world economy might well take longer than the staff thought. Moreover, Zambia, a landlocked country, had suffered from transportation problems in neighboring Tanzania that had occasionally delayed Zambia's exports, and it seemed safe to assume that such difficulties would continue in the coming period. Still, he was fully willing to give Zambia the benefit of the doubt, especially as the estimates of future copper exports were on the conservative side. In addition, the export shortfall had been caused by factors beyond the control of the authorities, particularly the depressed world prices of copper and cobalt. The authorities had recognized that their continued high pricing of cobalt had caused substantial stockpiling in 1980-81, thereby adding to the calculated export shortfall in that period.

Zambia clearly met the minimum requirement of cooperation for a drawing up to 50 per cent of quota under the compensatory financing facility, Mr. Schuijer considered. However, he shared Mr. Dallara's concern about Zambia's ability to meet its obligations to the Fund in the coming period, especially as Zambia might well qualify to draw an additional 50 per cent of quota under the compensatory financing facility if a new stand-by arrangement was adopted.

There was obviously an urgent need for Zambia to make a strong and persistent adjustment effort, Mr. Schuijer stated. Ways should be found in the framework of a new stand-by arrangement to deal with Zambia's external payments restrictions. The exchange system had become increasingly restrictive in 1982 through the introduction of the levy on foreign exchange purchases for travel and overseas education and through the rise in the volume of external payments arrears. The approval of the exchange restrictions would expire shortly, and he would feel much more comfortable about extending the approval if the authorities were committed to making a serious effort to reverse the trend toward restrictions.

During the previous discussion on Zambia, Mr. Schuijer recalled, the question had been raised whether it was appropriate for a member country to use Fund resources to reduce its arrears. The staff had correctly argued that money was fungible, and that attention should be focused on the viability of a country's overall balance of payments position. However, Executive Directors had also agreed that the use of Fund resources by a member country to reduce its external arrears was consistent with Fund principles only if the level of the arrears did not rise soon after the use of Fund resources. The data supplied by the staff suggested that such an increase had indeed occurred in Zambia after the most recent use of Fund finances under the extended arrangement and the compensatory financing facility. Did the staff believe that the proposed purchase under the compensatory financing facility was compatible with the principle that a member country should not increase its arrears in the period after it used the Fund's resources? Finally, the proposed decision was acceptable.

Mr. Grosche stated that he accepted the proposed decision. All the criteria for using the compensatory financing facility had been met. The proposed purchase would raise Zambia's outstanding purchases under the compensatory financing facility to only 50 per cent of quota, but he shared the serious concerns that Mr. Dallara and Mr. Schuijer had expressed about Zambia's ability to meet its financial obligations to the Fund in the coming period.

Zambia seemed to be trying to solve its balance of payments problems by further tightening restrictions rather than by correcting the exchange rate in order to shift more resources to the export sector, Mr. Grosche remarked. An exchange rate adjustment would be an appropriate response to the shortage of foreign exchange and to the need to rehabilitate the capital stock and to improve the maintenance of mining and transport equipment.

The staff's estimates were realistic, Mr. Grosche considered. As for the issue that Mr. Schuijer had raised, during the previous discussion on Zambia the Chairman had stated that it would be appropriate for a member country to use Fund resources to reduce its arrears, but only if the country's economic program was designed to prevent arrears from further accumulating. He was convinced that Zambia's program had been designed to prevent such an accumulation, but the recent information provided by the staff suggested that the arrears had nevertheless begun to rise again. What did that development imply for the ongoing negotiations with the authorities on a new stand-by arrangement?

Mr. Taylor commented that Zambia's request met all the relevant criteria and should be approved, although he too had the kind of broad reservations that previous speakers had mentioned. Zambia clearly had an acute balance of payments need to use the Fund's resources, and the proposed drawing was small in comparison to the estimated export shortfall. The projected increases in the prices of cobalt and copper seemed realistic, although the stocks of both metals were above the normal levels and there were few signs as yet of the desired recovery in world demand. The recent increases in copper prices might be partially speculative, and copper substitutes were more readily available than they had been in the past. The projections for the volume of copper exports were suitably conservative, particularly as the shortage of foreign exchange limited the scope for modernizing Zambia's plant and equipment. The projected increase of 17 per cent in the volume of cobalt exports in the first postshortfall year was surprising, especially in view of the sharp fall in cobalt production in 1980-81.

Zambia met the test of cooperation for a purchase up to 50 per cent of quota under the compensatory financing facility, Mr. Taylor noted. The full discussion of the question of the test of cooperation in the staff paper was welcome and should become a standard feature of papers on member countries' requests to use the compensatory financing facility. In addition, the description of the exchange restrictions introduced since the previous Article IV consultation--restrictions that did not warrant Fund approval--was particularly useful.

Zambia's external payments situation in general, and the size and continuing increase in the external payments arrears in particular, were certainly worrying, Mr. Taylor said. Zambia's external debt and debt service ratio seemed to be rising rapidly, and he wondered how the country would be able to repurchase even the fairly modest proposed purchase if there was no change in policy and present economic trends continued. Did the staff feel that the proposed purchase was consistent with the basic requirement of the Articles that the Fund must be satisfied that a member country making a purchase was taking steps that would enable it to make the required repurchase over a period of three to five years?

Future staff reports on Article IV consultations with Zambia could usefully include a detailed assessment of the country's debt profile in keeping with the general objective of improving and extending Fund surveillance in the debt area, Mr. Taylor considered. Given Executive Directors' considerable concern about developments in Zambia, the staff could usefully comment further on the negotiations with the authorities on a new stand-by arrangement. That no tangible results were evident, even though the negotiations had been going on for nearly a year, was worrying.

The proposed drawing fully met the relevant criteria, Mr. Taylor said, but it was impossible not to be concerned about Zambia's ability to make the necessary repurchase. The drawing under the compensatory financing facility would at best provide a temporary respite for Zambia, and the authorities should be urged to reach an early agreement on an adjustment program that would address the need for fundamental improvement in the external payments position.

Mr. Vidvei stated that the proposed purchase met all the requirements and should be approved. However, he shared the concerns that had been expressed by previous speakers, especially Mr. Dallara. The cancellation of the extended arrangement, the accumulation of external arrears, and the intensification of trade restrictions since the previous Article IV consultation with Zambia were highly regrettable. On the other hand, the proposed purchase was relatively small; it would not bring Zambia's outstanding purchases under the compensatory financing facility above 50 per cent of quota. The requirement of cooperation for such a purchase was not strict; indeed, the statement from the authorities that they intended to cooperate with the Fund was sufficient. The authorities' firm determination to remove the restrictions on external transactions and to eliminate the arrears as soon as possible was certainly welcome, and Zambia should be given the benefit of the doubt.

The balance of payments data for 1981 were preliminary, even though the year had ended almost 12 months ago, Mr. Vidvei remarked, and he wondered why firmer data were still not available. During the discussion on the compensatory financing facility at EBM/82/145 (11/8/82), Executive Directors had agreed that the timeliness of statistics in support of drawings under the compensatory financing facility would have to be improved, and that whenever necessary, member countries should be reminded of their obligation to furnish the Fund with the required data. As a rule, it was useful to receive information on the ability of a member to provide timely basic data, especially in the context of discussions on requests to use the compensatory financing facility.

Mr. El-Khouri stated that the draft decision was acceptable. The proposed purchase met all the requirements of the decision on compensatory financing. Furthermore, it was based on actual data for the whole shortfall year, thereby eliminating any risk of overcompensation.

The authorities were to be commended for having cooperated with the Fund through regular Article IV consultations, Mr. El-Khouri remarked. The Executive Board had discussed developments in Zambia in November 1981 and a mission had recently visited the country to conduct the 1982 consultation. As a result, the Executive Board had been kept well informed of economic developments and policies in Zambia, something to which he attached particular importance in cases involving purchases under the compensatory financing facility for amounts up to the equivalent of 50 per cent of quota. Members making purchases in the lower tranche of the facility should not be punished for having failed to observe certain performance criteria under an arrangement with the Fund, because an attractive alternative for those countries would be not to have arrangements with the Fund. They would certainly be better off maintaining such arrangements than avoiding them.

Mr. Prowse accepted the proposed decision. Zambia obviously had a balance of payments need to use the Fund's resources, the export shortfall was temporary in nature and due to factors largely beyond the control of the authorities, and the requirement of cooperation had been met. In addition, the request was based on actual data for the shortfall year.

That it had not proved possible to negotiate a new stand-by arrangement for Zambia was disappointing, Mr. Prowse remarked. There was a clear need for ongoing and close cooperation between the Fund and the authorities, and he hoped that approval of the proposed purchase under the compensatory financing facility would encourage the authorities to maintain close contact with the Fund.

Like Mr. Schuijer, he wondered whether Zambia would be entitled to make a further purchase under the compensatory financing facility once the negotiations on a new stand-by arrangement had been successfully concluded, Mr. Prowse said. The projections for the postshortfall year seemed reasonable, although they were heavily dependent on certain assumptions about the recovery of the world economy. Still, even if the value of exports in the two postshortfall years rose by as little as 2 per cent, the amount of the drawing would still be less than the calculated shortfall. Hence, the assumptions about the two postshortfall years seemed very conservative.

The export figures for 1981 and the two previous years had been revised after the approval of Zambia's 1981 purchase under the compensatory financing facility, Mr. Prowse noted. There had been a sizable safety margin between the size of the 1981 purchase and the calculated shortfall, but he wondered whether there had been some de facto overcompensation. Had the data on the two postshortfall years for the 1981 purchase or the data for 1981, the actual shortfall year, been revised? Finally, the authorities should be encouraged to bring the present negotiations on a new stand-by arrangement to a successful conclusion.

Miss Le Lorier stated that the proposed purchase met all the relevant criteria. However, she shared the concerns that had been expressed by previous speakers and attached importance to Zambia concluding a new stand-by arrangement supported by a strong adjustment program.

The present payments difficulties demonstrated the need for a substantial adjustment effort, Miss Le Lorier remarked, although she was not as worried as previous speakers about the country's ability to make the repurchase in respect of the proposed purchase. It was difficult to forecast the prices of copper in the coming 12 months, let alone for the whole period in which the proposed purchase under the compensatory financing facility would be outstanding. It was unlikely that the world economy would continue to be depressed for another three to five years, and it would be useful to have the staff comment further on the sensitivity of the debt service ratio of Zambia to the level of copper prices. Presumably the sensitivity was strong, and Zambia should be able to make the necessary repurchase if the world economy recovered in time.

Mr. Casey commented that, even to use the so-called lower tranche of the compensatory financing facility, Zambia had to pass a forward-looking test of cooperation: the Executive Board had to have the staff's assurance that the authorities would cooperate with the Fund in the near future to find solutions to Zambia's balance of payments problems. Was the staff able to provide such assurance at a time when negotiations on a possible new stand-by arrangement were at a delicate stage? The fact that a long time had passed since the opening of the negotiations was worrying.

The payments arrears had reached the extraordinary level of SDR 614 million at end-July 1982, Mr. Casey noted. If copper prices recovered, the arrears could be brought down, but the absolute level of the arrears had been very high for a long time. The proposed purchase, if approved, would raise the Fund's holdings of kwacha to 365 per cent of quota, and there was cause for concern about Zambia's ability to make the necessary repurchase. Presumably the Fund would not have preferential status among Zambia's creditors. The Fund occasionally found itself in the odd position of lending to a country even though the risk involved was much greater than a private bank would be willing to shoulder. Hence, the case of Zambia raised certain policy issues that warranted further examination on another occasion. Given both the small amount of the proposed purchase and the tradition of giving a member the benefit of the doubt, he was willing to go along with the proposed decision.

Mr. Malhotra said that the proposed purchase met all the relevant criteria. The export shortfall was attributable to factors largely beyond the control of the authorities and seemed to be temporary, although much would depend upon conditions in the world economy in the coming several years.

In assessing the proposed decision, Mr. Malhotra continued, Executive Directors should pay close attention to the particular provisions of the decision on compensatory financing. The overall economic situation in Zambia was obviously difficult and should certainly be borne in mind, but the staff had already entered into negotiations with the authorities on a stand-by arrangement, and a more detailed assessment of the economy should be made when the proposal for such an arrangement was actually brought to the agenda of the Executive Board. Meanwhile, given the very difficult conditions in the world economy and the uncertainty about the timing of the desired recovery, the Fund should continue to apply a flexible approach toward requests to use the compensatory financing facility; in the past, there had been considerable undercompensation of export shortfalls.

Mr. Zhang stated that the proposed decision was acceptable.

The staff representative from the African Department said that, while it was true that the staff had been discussing a possible stand-by arrangement with the authorities for some time, the delay had been due in part to the feeling that it would be best to base a new arrangement on fiscal year 1983, which would begin on January 1, 1983. The authorities fully understood the need for a substantial adjustment effort to correct the present difficult financial and balance of payments situation. Considerable agreement between the staff and the authorities had been reached on the major lines of a strong and credible adjustment effort in the budgetary area. However, the next budget would not be presented to Parliament until later in January 1983, and the staff and the authorities had felt that it was too soon to assess and agree on the various specific policy actions that would be needed to support the general policy stance; considerable additional work in that area still had to be done by the authorities. The authorities also agreed that substantial action was needed in the exchange rate area, particularly in response to the low copper prices that had resulted in the accumulation of large operating losses by the mining company; however, the precise extent of the desirable exchange rate adjustment was still under discussion.

Given the poor export prospects for 1983 and the substantial external debt obligations, it would be very difficult for Zambia to meet its present schedule of debt service obligations, the staff representative said, and the authorities themselves recognized that some form of debt restructuring would be unavoidable. As for Zambia's cooperation with the Fund, the staff continued to feel that the authorities had passed the test related to a purchase of up to 50 per cent of quota. It was true that the authorities had accumulated arrears to the Fund on a temporary basis, mainly in September and October 1982, due to record low copper prices in mid-1982 and the delayed effect on foreign exchange receipts. At present, Zambia was current in its obligations to the Fund.

The next report for the Article IV consultation with Zambia would contain a fuller picture of the foreign debt situation, the staff representative commented. The authorities had made substantial progress in improving the data base on the existing stock of arrears. The 1981 balance of payments data in the report had been labeled "preliminary" mainly for precautionary reasons; certain revisions subsequently had been made in the services and capital accounts. The most recent data available were essentially final and were quite close to the figures in the report. A number of corrections had been made in the trade data, which had contained some errors. The monthly figures were provided on a quarterly basis, and there had been some difficulty in determining the correct quarter in which to record certain copper shipments, which usually took six to seven weeks.

Approximately 95 per cent of total export receipts in Zambia were attributable to copper, the staff representative said, and the debt service ratio was obviously very sensitive to copper export prices. In real terms, the present copper prices were the lowest in 50 years.

Once a new stand-by arrangement had been approved, the staff representative explained, any further request to use the compensatory financing facility by Zambia would have to be carefully examined on its merits and on the basis of the latest available trade data.

Responding to a further question, the staff representative from the African Department remarked that the staff paper contained actual trade data through end-June 1982. Hence, there was no problem with respect to the timeliness of the trade data. There had been certain difficulties in obtaining final and reliable data on various services and capital flows in the balance of payments. Export and import data were usually available within two to three months after a particular period had ended. General balance of payments data for one year were customarily available early in the next year, but the data were usually subject to some revisions.

The staff representative from the Treasurer's Department explained that Zambia would owe charges amounting to about SDR 50 million in 1983. The first payment would fall due in early January; SDR 14 million of that amount would be provided for by the proposed purchase, leaving some SDR 36 million to be covered by other sources. In addition, Zambia would have to pay about SDR 115 million in repurchases, approximately SDR 8 million in SDR Department charges, and SDR 0.3 million as interest to the Trust Fund.

The staff representative from the Research Department commented that the figure of SDR 26.7 million mentioned in footnote 2 on page 4 (EBS/82/212) was the export shortfall calculated on the basis of the revised data for the three years through the shortfall year ended June 1981, actual data for the year ended June 1982, and the current forecast of exports for the year ending June 1983. If the original forecasts were used, the shortfall would be SDR 118 million. Hence, the latest data for all five years of the trend period showed that Zambia had been overcompensated, although that issue was quite separate from overcompensation in the case of requests under the early drawing procedure, where actual exports for a shortfall year turned out to be lower than estimated exports for that year.

The weak external demand for Zambia's major export products had been the main reason for the export shortfalls in both 1981 and 1982, the staff representative explained. The recovery in the export markets that had been expected in 1982 had not occurred. As for the projected increase in cobalt exports, the stocks of cobalt accumulated in the 12 months ended June 1981 had been large and had remained so through the end of the shortfall year, in June 1982. The staff's projections of cobalt exports took into account the large cobalt stocks accumulated during the previous two years.

The Director of the Legal Department remarked that under the Articles the Fund had to ensure that a country using its resources adopted policies designed to solve the country's payments problems, and that the use of the resources would be temporary. A member had up to five years to make a repurchase in respect of a purchase under the compensatory financing facility. Zambia's request had to be judged on the basis of the decision governing compensatory financing. Under that decision, appropriate conditionality was to be applied to Zambia's purchase. Since Zambia's request would not bring the country's outstanding purchases under the compensatory financing facility above 50 per cent of quota, upper credit tranche conditionality need not be applied. Instead, the calculations should show that a shortfall in export receipts existed and that the shortfall was temporary in nature, so that the country would be in a position in the medium term to effect the necessary repurchase.

Furthermore, the Director continued, a prospective test of cooperation had to be passed. The Fund need not have proof that the member had been cooperating with the Fund; rather, the country had to assure the Fund that it would cooperate in order to find appropriate solutions to its balance of payments problems. The test involved trust and a judgment by the Fund to be exercised, in the first instance, by management and, in the final analysis, by the Executive Board. In the past, the Fund had given members the benefit of the doubt in accepting their statement that they would cooperate with the Fund to find solutions to their payments problems. In that connection, under established policy there should be discussions on the progressive reduction of any outstanding payments arrears. The Fund and the member had to reach an understanding on the eventual solution of the problem of arrears; such discussions were scheduled to take place with the Zambian authorities in connection with the effort to find solutions to the country's payments problems.

Mr. Prowse considered that the procedures for estimating overcompensation and undercompensation under the compensatory financing facility were artificial and should be re-examined during the next review of the facility. In calculating the export shortfall for Zambia's initial purchase under the compensatory financing facility, the staff had used actual data for three years and estimated data for the two subsequent years. The present paper contained revised actual data for the shortfall year and new estimates for the two postshortfall years. However, the staff had also revised the data for the first two years of the five-year period in question. In its most recent calculations the staff had chosen to use the data for the final three years of the five-year period; a quite different result would be obtained from calculations based on the data for the second, third, and fourth years of the five-year period. It was the existence of such a range of actual and revised data that made the concept of overcompensation an artificial one. Data could conceivably be revised for years after the shortfall year, so that the actual shortfall in a given period might not be known for some time after the period had ended.

Mr. Casey commented that he too felt that calculations to determine overcompensation were artificial, thereby making a repurchase obligation based on supposed overcompensation arbitrary in nature. During the previous review of overcompensation under the compensatory financing facility, he had suggested for several reasons that it might be best to eliminate the obligation to make a repurchase when overcompensation had apparently occurred. The staff routinely made the best possible estimates in support of a purchase under the compensatory financing facility, and the estimates were usually fairly accurate.

The staff representative from the Research Department remarked that the overcompensation that had been referred to at the present meeting was different from the overcompensation and the related repurchase expectation that had been discussed on previous occasions. The main issue was the formula used for determining the amount of compensation rather than the question of overcompensation or undercompensation. The geometric average formula, by which the shortfall was calculated as the difference between the value of exports in the shortfall year and the geometric average of the value of exports over the five-year period, had been used since August 1979, and the staff had routinely reported to the Executive Directors on the performance of the formula in terms of the accuracy of the export shortfall estimates.

Mr. El-Khouri observed that the staff used the term overcompensation to describe two different situations under the compensatory financing facility. The first was based on the staff's examination of actual data for the two postshortfall years. The second resulted from the use of estimated data in the shortfall year. It would be helpful to use different terminology to describe the two different situations.

The Chairman commented that the terminology that was usually employed might not be the most felicitous. The staff had found that, while some overcompensation and undercompensation had occurred, the net outcome was that export shortfall calculations had generally been fairly accurate. Mr. Casey's proposal for eliminating the repurchase requirement in the event of overcompensation was far-reaching and would have to be carefully considered.

Mr. Sangare considered that the difficulty that the authorities had had in implementing the extended arrangement should not be seen as a sign of a lack of cooperation with the Fund. The factors that had kept Zambia from implementing the extended arrangement--particularly the world prices for copper and cobalt--had not been fully within the control of the authorities, who were determined to continue to cooperate closely with the Fund to find solutions to the balance of payments problems facing Zambia. They had already expressed their willingness to enter into a new Fund-supported arrangement with more realistic targets than had been set in the past. They were prepared to act in the exchange rate area, and the only remaining difficulty in that connection was to determine the appropriate level of the rate. The authorities and the staff were working together to determine the appropriate level. The timing of an exchange rate adjustment was another complication; at present, the authorities were occupied with preparations for the coming general elections.

His authorities had always made every effort to remain current on their payment obligations, Mr. Sangare remarked. They had faced some delays in making payments because of the serious problems--particularly the low prices for copper and cobalt, the main export commodities--during the previous two years. They had seriously examined the problem of accumulated arrears and were prepared to adopt appropriate solutions, including debt renegotiations in a multilateral framework. The Government was also prepared to eliminate the restrictions as soon as external conditions improved. The special tax on travel that the staff had questioned was collected by the banking system, rather than by the Government, merely for the sake of convenience.

The Director of the Legal Department, responding to a further comment, said that the decision that Mr. Dallara had cited--Decision No. 102-(52/11), adopted Feburary 13, 1952--had been superseded by the Second Amendment of the Articles of Agreement but was still essentially valid in substance. The Fund was required to adopt policies on the use of its resources that would ensure that such use was for a temporary period. The period referred to in Decision No. 102 had been superseded by the Second Amendment, which provided that a repurchase should be made no later than five years after the purchase date, unless the Fund established a different repurchase period for such purchases by an 85 per cent majority. The decision governing compensatory financing was based on the basic principle that members' use of Fund resources should be for a temporary period; accordingly, a country wishing to use the facility had to have an export shortfall that was considered to be temporary in nature. A country was also required to cooperate with the Fund to find solutions to its balance of payments problems, so that it would be in a position to make the necessary repurchase in respect of its purchase under the compensatory financing facility.

The Chairman remarked that Executive Directors seemed to be deeply concerned about the serious economic situation in Zambia. The payments imbalance and the fundamental adjustment problems clearly required a strong program. The large and growing external arrears also had to be addressed; a multilateral approach was called for. Speakers had correctly stressed the importance of member countries' remaining current on their payments to the Fund, which could not hope to deal with the various problems facing member countries if there was even the slightest question of the willingness of members to make normal repurchases. Zambia was now current in its payments to the Fund, but significant payments would have to be made in 1983. It was his understanding that the Fund would have Zambia's full cooperation in settling the country's payments obligations to the Fund without delay. That settlement would be an important aspect of the future cooperation between the Fund and Zambia.

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

The decision was:

1. The Fund has received a request by the Government of Zambia for a purchase equivalent to SDR 34 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

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

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

Decision No. 7268-(82/159), adopted
December 13, 1982

4. NEPAL - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with Nepal (SM/82/210, 11/2/82) together with a proposed decision concluding the 1982 Article XIV consultation. They also had before them a report on recent economic developments in Nepal (SM/82/215, 11/17/82).

Mr. Panday made the following statement:

On behalf of my Nepalese authorities, I highly commend the staff for its excellent and comprehensive document on the performance of the Nepalese economy in 1981/82. My Nepalese authorities are in general agreement with the views and findings of the staff. They have asked me to inform the Board of their intention to take appropriate measures to eliminate the broken cross rates.

The scenario that the staff report (SM/82/210) and the report on recent economic developments (SM/82/215) unfold is one of a small and poor economy dominated by agriculture and related activities. Given the poor natural resource endowment, Nepal's prospects of diversified economic activities are severely limited. Per capita income of $160 is, disturbingly, one of the lowest in the world. The country's efforts to move quickly on the path to prosperity are being impeded by various constraints emanating from the rugged topography, the landlocked nature of the country, overdependence of the economy on the monsoon, and a social structure steeped in traditions. The weak administrative apparatus, with the consequent absence of a cohesive approach to attacking emerging problems, has been another major impediment to growth. The fast growing population and the deteriorating ecological system have further complicated Nepal's crusade against poverty and backwardness.

Consequently, overall growth of the Nepalese economy has been slow and uneven. The growth rate of the economy averaged about 1 per cent in the late 1970s, considerably below the average population growth of 2.6 per cent in the last decade. The overdependence of the agricultural sector--the backbone of the Nepalese economy--on weather has been largely responsible for the periodic instability of the economy. The intermittent, adverse weather reduced agricultural output, thus lowering the average growth rate. The staff rightly advised the Nepalese authorities that expanding investment in major irrigational projects and strengthening the operations of the agencies responsible for providing fertilizers and extension and marketing services to farmers are essential measures to ensure sustained growth in the future.

As for the performance of the Nepalese economy in 1982, the achievements have been quite encouraging. The economy recorded a growth rate of 4.3 per cent, which was close to the target under the Sixth Five-Year Plan. The rate of inflation abated to 10.4 per cent from the previous year's level of 13.4 per cent. The cautious monetary policy of the authorities kept monetary expansion at a lower rate. The balance of payments situation strengthened further, and there was a larger surplus of SDR 35 million. However, according to latest available information, exports fell by 15 per cent in U.S. dollar terms while imports continued increasing, although only marginally. The weaker export performance was due both to the authorities' decision to restrict exports of timber to conserve forests, and to the very unfavorable external environment. The long-run answer to the improvement of the export picture, as the staff has mentioned, lies in higher production through the development of the core sectors of the economy.

The budgetary performance shows disequieting developments, with the overall budgetary deficit widening to 5.5 per cent of the gross domestic product in fiscal year 1981/82, compared with 2.5 per cent last year. In 1982/83, the budgetary deficit is expected to widen further. The larger fiscal outlays for development in 1982/83 have been necessitated by the Government's new economic policy, which aims at stepping up investment in quick-yielding productive sectors such as agriculture and small and cottage industries, and at strengthening the financial base of the public enterprises dealing in critical inputs like fertilizers, credit, and trading in development goods. The Government is strongly committed to these measures, which are expected to improve the production base of the economy in the years ahead. The Nepalese authorities are, however, aware of the danger of overextending the budgetary deficits to an unmanageable level. They have already initiated action toward gradually phasing out subsidies, keeping the public enterprises in a sound financial position, and reducing wasteful expenditure by strengthening the fiscal administration.

Unfortunately, the economic outlook for 1983 is gloomy. The failing monsoon of last summer has adversely affected agricultural production. As a result, food production is estimated to slump by 16-20 per cent. The Nepalese authorities have already taken a series of steps to improve the performance of the economy and minimize the impact, particularly of prices of agricultural production. They have taken timely action to improve the supply of foodgrains by borrowing 10,000 metric tons of rice from India. This measure has kept prices from accelerating. More food aid coming from other friendly countries would further ease the situation. The authorities have also concentrated on improving irrigational facilities by installing 1,000 shallow tubewells in the Terai. Community irrigation and river diversion programs are being launched in the Terai and the hills to augment the winter harvest. Additional treasury offices have been established in the districts to quicken the disbursement of development funds, and high-powered teams, headed by ministers, are being sent to different zones to monitor development activities. Legal measures have been taken to strengthen the operations of the financial institutions. These steps, apart from other measures that have been adequately described by the staff in their documents, are expected to strengthen the foundations of development and brighten the prospects for achieving sustained growth.

Mr. Salehkhou remarked that, despite the problems--some of which seemed nearly insurmountable--due to the country's geographic location and inadequate infrastructure, Nepal had made important progress in increasing life expectancy and the literacy rate; and the infrastructure had been expanded. However, the remaining problems, and particularly those traceable to the geography of the country, were formidable.

External developments in 1981/82 had hurt Nepal's exports, Mr. Salehkhou commented. The persistent decline in commodity prices, particularly the prices for jute and jute products, together with certain domestic measures, had kept total exports in 1981/82 from exceeding the level of the previous year. Continued adverse developments might well cause a substantial balance of payments deficit in 1982/83. A revival of exports, which now equaled only one third of imports, was crucial to achieving sustained economic growth, and since June 1982 the authorities had introduced a series of trade policy measures. The recent emphasis on the development of export-oriented cottage industries and import-substituting industries was particularly encouraging. Further staff comment on its assessment of the trade measures introduced in June 1982 would be useful. Nearly half of Nepal's total trade was with India, and the decisions of Nepalese producers and exporters were naturally affected by India's market situation and cost structure. In the present circumstances of Nepal, the influence of exchange rate changes on exports was probably relatively limited.

The fiscal position had weakened considerably as a result of the increase in development expenditures in 1981/82, Mr. Salehkhou observed. The budget deficit was projected to rise to 9 per cent of GDP in 1982/83 and domestic bank financing to some 3 per cent of GDP. Although the availability of commodities, and the size of the domestic food supply in particular, should lessen inflationary pressures, the staff had wisely cautioned the authorities to pay close attention to those pressures. The authorities had decided to phase out certain budget subsidies, and the staff had recommended that the authorities shift most of the specific taxes to an ad valorem basis and extend the coverage of the sales tax.

In addition, Mr. Salehkhou went on, there seemed to be some room for raising taxes on profits, income, and property, particularly as the growth of that category of taxes had fallen behind the rising trend of taxes on domestic goods and services and on traded goods. However, any such action should be approached cautiously, especially in the light of the declining volume of private investment as a proportion of GDP and of the weak demand by the private sector for credit, probably because of the inefficiency and low profitability of private sector investment. Recommendations on taxation had to be tentative because of the lack of information on the structure and composition of private sector credit and investment, and particularly the elasticity of private sector taxation. Nevertheless, he hoped that the authorities would take additional steps to encourage private investment in labor-intensive projects. The increase in lending to the private sector in the period 1978-81 had taken the form of loans for working capital and to finance imports, rather than long-term project lending.

Further monetization of the economy and an extension and intensification of the banking network would increase the volume of private savings, Mr. Salehkhou commented. The authorities understood the situation, and the priority sector lending scheme they had introduced in October 1981 was a step in the right direction. The coordination of bank credits with the basic requirements of the priority sectors should be increased. It would be useful to have an assessment of the 1981 priority sector lending scheme, which was based on the specialized area development approach. Presumably, the scheme would be able to alleviate some of the problems of credit distribution; there had been persistent difficulties in ensuring timely debt collection by banks and a sufficient supply of trained personnel to appraise projects. However, intensive area specialization by commercial banks could create operational rigidities or duplicate the functions of specialized financial institutions such as the Asian Development Bank. Finally, the proposed decision was acceptable.

Mr. Hirao said that he generally agreed with the staff appraisal and accepted the proposed decision welcoming the authorities' intention to take appropriate steps to eliminate the broken cross rates. The performance of the economy in 1981/82 had basically been good. Real GDP had risen by about 4 per cent--mainly because of the accelerated growth of agricultural output and the continued increase in nonagricultural production--and the rate of inflation had fallen, largely as a result of the continued improvement in the domestic food supply. Externally, the current account deficit had remained at the same level--1 per cent of GDP--as the previous year, and the overall external surplus had nearly doubled.

Some of the developments in 1981/82 were worrying, Mr. Hirao went on. Private investment had continued to be weak, and the major stimulus to domestic demand had come from a substantial expansion of the government sector, mainly through a rapid increase in development expenditures. As a result, the government deficit had increased substantially and, for the first time, the Government had undertaken large-scale bank borrowing to finance part of the deficit. In addition, exports had virtually stagnated after growing rapidly in 1980/81, as the world demand for Nepal's major exports--particularly jute and timber--had declined. At the same time, the exportable surplus of foodgrains had declined.

Commenting on the prospects for 1982/83, Mr. Hirao said that the delay in the monsoon was likely to have an adverse effect on almost every aspect of the economy. The projected decline in agricultural output would probably more than offset the expected accelerated growth in nonagricultural production and, as a result, overall growth was likely to slow. Inflation had already begun to accelerate, and the external balance was likely to record a substantial overall deficit as a result of the large decline in agricultural exports and the rapid rise in imports. The unfavorable outlook suggested that a cautious review of government policies was warranted.

The overall budget deficit for 1982/83 was expected to be substantially larger than the deficit in 1981/82, Mr. Hirao noted, mainly as a result of the considerable increase in development expenditure. The major part of the deficit was to be financed by external borrowing, but domestic bank financing was projected to rise sharply. The large size of the deficit and the increase in bank financing were causes for concern because of their impact on inflation and the balance of payments, and he agreed with the staff that the authorities needed to take prompt action in those areas. The authorities had already decided to phase out some of the budget subsidies and had implemented measures to strengthen the operations of the public enterprises. Those steps were certainly in the right direction, but their favorable effects on the budget would be felt only in the long run. If the price and external conditions continued to deteriorate, the authorities might have to consider slowing the growth of development expenditure. The staff's projection for development expenditure was substantially different from the figure in the budget. In the past, expenditure and revenue had fallen considerably short of the budgeted amounts, and the authorities' efforts to improve the presentation of the budget were welcome.

Commenting on monetary policy, Mr. Hirao said that in June 1982 the authorities had raised the commercial banks' lending and deposit rates, which had been unchanged since 1978. That move was very welcome, and presumably the importance of maintaining a flexible interest rate policy would gradually increase because the authorities were no longer using credit ceilings as a major instrument of credit control. However, the authorities had indicated that they had strong reservations about further raising interest rates, and staff comment on the matter would be welcome.

The supply of broad money was expected to increase by 29 per cent in 1982/83 and total domestic credit by 32 per cent, Mr. Hirao observed. Those increases seemed to be excessive, particularly in the light of the expected nominal GDP growth of 15.8 per cent, even after taking into account the long-term declining trend in the velocity of money. There was a clear need to restrain domestic credit, especially to the government sector.

The authorities' projections for 1982/83 had included an increase in the current account deficit and a smaller overall surplus than had originally been anticipated, Mr. Hirao commented. However, because of the delay in the monsoon, agricultural exports would be substantially smaller than had been foreseen, and there would probably be a sizable overall balance of payments deficit. The authorities had reacted by adopting both short-term and medium-term measures, the former including an intensification of quantitative restrictions, mainly on luxury and semiluxury imports. The medium-term measures included fiscal incentives, a rationalization of the tariff structure, and an increase in foreign investment to promote exports and import substitution. In that connection, a more flexible exchange rate policy would play an important role. He hoped that the medium-term measures would enable Nepal to strengthen its external balance without further increasing import restrictions.

Mr. Dallara stated that he broadly agreed with the staff appraisal and accepted the proposed decision. The intention of the authorities to take appropriate steps to eliminate the broken cross rates was welcome, and further comment on the likely timing of the move would be useful. The authorities should take advantage of the opportunity they would have at that time to reconsider the appropriate level of the exchange rate.

Although fiscal policy in Nepal had tended to be conservative, fiscal management had recently become a cause for concern, Mr. Dallara remarked, and he agreed with the staff and Mr. Hirao that, as current expenditure was exceeding available resources, more rigorous expenditure controls and an increase in resource mobilization were needed. The significant rise in domestic bank financing of the budget deficit was also worrying. The authorities clearly shared the concerns that he had expressed, and they should be encouraged to act promptly to deal with the problems. Further information on the authorities' plans to reduce the subsidies would be useful.

Mr. Malhotra supported the draft decision. He hoped that the authorities' efforts to tackle the difficult problems facing the economy would be successful. The delay in the monsoon would probably reduce national income and adversely affect the budget. The situation in Nepal was similar to that of many other low-income developing countries where agriculture made the main contribution to GDP. Nepal seemed to experience two-year or three-year cycles of poor rainfall, low budgetary receipts, and rising budgetary expenditures to support farmers. The authorities were fully aware of the fiscal and other problems facing the economy, and wished to make significant progress in implementing the staff's suggestion for increasing import substitution. Such tasks were, however, long term and required considerable capital resources.

The Deputy Director of the Exchange and Trade Relations Department remarked that the new trade policy had been formulated quite recently, and it was too soon to evaluate it. The staff had little information on the 1981 priority sector development scheme beyond that which was reported on page 34 of SM/82/215. The new scheme had eliminated a number of cumbersome rules and regulations and had increased the ability of individual farmers to obtain loans.

Interest rates in Nepal were not low, the Deputy Director remarked. The lending rates ranged from 11 per cent to 13 per cent and deposit rates from 8.5 per cent to 13.5 per cent; therefore, the rates were on average clearly positive in real terms. In discussing the structure of interest rates with the authorities, the staff had stressed that the authorities should continue to maintain a flexible policy, the real rates should be kept at appropriate levels, and more attention should be paid to the rates on short-term deposits in order to stimulate savings. The authorities felt that a further extension of the banking network would make a greater contribution to stimulating savings than a further increase in interest rates.

The authorities were examining the possibility of introducing a currency basket, the Deputy Director of the Exchange and Trade Relations Department explained. They wished to give a large weight to the Indian rupee and to use margins so that they could maintain relative exchange rate stability vis-à-vis the U.S. dollar and the Indian rupee. The Fund's resident representative in Nepal was helping the authorities to examine the possibilities for introducing a currency basket.

Mr. Panday remarked that there were social, political, and even economic factors that made it difficult for the authorities to decide on a specific timetable for the complete elimination of the subsidies. The authorities had decided to phase out gradually certain budget subsidies. Their recent decisions raising the administered prices of essential commodities, such as rice, fuel wood, and petroleum products, clearly reflected their intention to reduce the burden of the subsidies on the budget.

Their comments at the present meeting showed that Executive Directors clearly understood the difficult problems facing the Nepalese economy, Mr. Panday said. The progress that the Government had made in developing the economy would not have been possible without general financial assistance from friendly countries and international institutions. Such assistance would be increasingly important in the coming years as the authorities maintained their efforts to accelerate the pace of economic growth.

The Chairman made the following summing up:

Executive Directors noted that Nepal's economic recovery, which started in 1980/81, continued in 1981/82. However, they observed that the economy remained critically dependent on the monsoon rainfalls, which were delayed this summer, thereby adversely affecting the prospects for growth in 1982/83.

Commenting on financial policies, Directors said that Nepal was beginning to face serious resource constraints which could exacerbate the existing inflationary pressures and have unsettling effects on the balance of payments. In this context, they supported the intention of the authorities to phase out certain budget subsidies and rationalize the financial operations of the public enterprises. They considered that the authorities should take additional measures, such as broadening the tax base and streamlining expenditures, for instance, by reducing remaining subsidies, in order to reduce the budget deficit. Several Directors also considerd that a tightening of credit and a more flexible interest rate policy would be appropriate. The importance of further monetization of the economy, including the expansion of branches of commercial banks, was noted in relation to the need to mobilize domestic savings.

Directors supported the authorities' objective of strengthening the weak underlying structure of the balance of payments by stimulating the production of traded goods through fiscal incentives, rationalization of the tariff structure, and use of modern technology. Steps should also be taken to develop further the tourist sector, which has a considerable potential for growth.

Directors welcomed the simplification of the exchange system and expressed the intention of the authorities to eliminate the broken cross rates. They hoped that the authorities would review their exchange rate policy with a view to achieving an appropriate level of the exchange rate.

The recent and projected rapid growth of foreign debt was noted with some concern.

The Executive Board then took the following decision:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision relating to Nepal's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1982 Article XIV consultation with Nepal, in the light of the 1982 Article IV consultation with Nepal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund welcomes the termination of the remaining bilateral payments arrangement with a Fund member. Nepal's exchange system continues to give rise to broken cross rates. The Fund encourages the authorities to take early steps to eliminate these rates.

Decision No. 7269-(82/159), adopted
December 13, 1982

APPROVED: May 17, 1983

LEO VAN HOUTVEN
Secretary

Lamberto Dini
Chairman of the Deputies
of the Group of Ten

Paris, December 11, 1982

Dear Mr. de Larosière:

Attached is my understanding of the principal conclusions reached by the G-10 Deputies at their meeting of December 10, 1982, which you may wish to use in connection with the Executive Board discussion on the GAB.

Sincerely yours,

/s/

L. Dini

Attachment

Mr. J. de Larosière
Managing Director
International Monetary Fund
Washington, D.C.

ATTACHMENT

G-10 Deputies Meeting of December 10, 1982

Conclusions

At their meeting of December 10, 1982 in Paris, the Deputies of the G-10 reached certain conclusions in principle regarding the main elements of a revised and expanded GAB. It was their view that the expanded GAB would continue to perform its present functions for participants, but provision would be made for the use of the GAB resources to finance purchases from the IMF by nonparticipants in certain circumstances.

The main conclusions were as follows:

1. Quotas would remain the principal source of IMF resources to meet the ordinary balance of payments financing requirements of its members. The broad purpose of the GAB would remain to supplement the IMF resources, if needed to forestall or cope with an impairment of the international monetary system.

2. The size of the GAB would be raised from the equivalent of about SDR 6.4 billion to SDR 15-20 billion. The participants' credit commitments will be denominated in SDRs. Any agreement with other countries on the provision of financing to the IMF in parallel with the GAB would augment the amounts available.

3. The credit commitments of individual participants should be broadly reflective of their size and roles in the international economy and of their ability to provide financing to the IMF. It was agreed that participants' shares in the arrangement should be appropriately adjusted in light of these principles.

4. Conditions and procedures for activation for purchases from the IMF by participants would remain unchanged. The revised GAB could be activated to finance purchases by other members if the following criteria were met:

(i) that the IMF was faced with an inadequacy of resources to meet appropriate requests for conditional financing;

(ii) that this inadequacy of resources arose from an exceptional situation associated with requests from countries with balance of payments problems of a character or of aggregate size that could pose a threat to the stability of the international monetary system.

In considering proposals for activation of the GAB for nonparticipants, the participants would consult among themselves for the purpose of ascertaining whether the above criteria were met. Such consultation would not extend to the examination of specific programs for use of Fund resources, which remains the responsibility of the Executive Board.

Activation of the GAB for the benefit of nonparticipants would need to pay due regard to potential calls on the arrangements for the purpose of financing purchases by participants.

5. Credit extended to the IMF under the GAB would earn interest at a rate equal to 100 per cent of the combined market rate used to determine the SDR interest rate. The 1/2 per cent transfer charge now levied would be abolished.

6. There was some discussion regarding the relationship with other potential lenders willing to provide resources in parallel with the GAB. It was assumed that lending under such parallel arrangements would be available to finance purchases by GAB participants as well as nonparticipants, and that parallel lenders would have the same access to GAB resources as participants.

7. The revised and expanded GAB will be reviewed at the time of the Ninth General Review of Quotas.

8. It was recognized that implementation of the above conclusions would require amendments of the GAB decision; it was considered desirable that, in the interest of speed, the amendments should be kept to a minimum. Regarding the criteria for activation for the benefit of nonparticipants, it was left open whether they should be included in the decision or whether they should be expressed in some form of understanding among participants.

9. It was understood that the revision of the GAB along the lines indicated above was contingent upon reaching satisfactory agreement on the other issues relating to the Eighth Quota Review.