NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 81/136

10:00 a.m., November 4, 1981

W. B. Dale, Acting Chairman

Executive Directors	Alternate Exeuctive Directors
	O. Kabbaj
	C. Taylor
A. Buira	M. A. Senior
	H. G. Schneider
	J. E. Leimone, Temporary
M. Finaish	
T. Hirao	A. Nagashima
	F. A. Tourreilles, Temporary
R. K. Joyce	
	J. R. Gabriel-Peña
B. Kharmawan	V. Supinit
S. Kiingi	
G. Laske	
	C. P. Caranicas
	A. Le Lorier
S. Nana-Sinkam	
M. Narasimham	D. L. Kannangara
	S. El-Khouri
	T. de Vries
A. R. G. Prowse	
	L. Vidvei
	Wang E., Temporary

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

Also Present

Asian Department: H. Neiss, Deputy Director; A. Abadjis, J. T. Boorman, C. M. Browne, L. H. De Wulf, M. J. Fetherston, T. T. Gibson, R. J. Hides, M. R. P. Salgado, D. A. Scott, G. Szapary. European Department: L. A. Whittome, Counsellor and Director; J.-P. C. Gollé. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; D. K. Palmer, Deputy Director; H. W. Gerhard, M. Guitian, N. L. Happe, S. Kanesa-Thasan, J. M. T. Paljarvi, E. J. Zervoudakis. External Relations Department: A. F. Mohammed, Director; G. P. Newman. Fiscal Affairs Department. A. A. Premchand, O. Tsukahara. IMF Institute: G. J. Mage, T. Savundrariayagam, Participants. Legal Department: J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, A. O. Liuksila. Research Department: K.-Y. Chu, L. U. Ecevit, N. M. Kaibni, T. K. Morrison, P. C. Ugolini. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: A. M. Al-Samarrie. Advisors to Executive Directors: S. R. Abiad, C. J. Batliwalla, C. Bouchard, M. A. Janjua, G. Jauregui, P. D. Peroz. Assistants to Executive Directors: E. M. Ainley, M. J. Callaghan, R. J. J. Costa, A. Halevi, J. M. Jones, J. S. Mair, V. K. S. Nair, J. R. Novaes de Almeida, Y. Okubo, J. G. Pedersen, C. N. Pinfield, J. Reddy, H. Suzuki, O. Üçer, J. F. Williams, A. Yasseri.

1. <u>SRI LANKA - EXTENDED ARRANGEMENT - MID-TERM REVIEW</u>

Executive Directors considered a staff report on the mid-term review of the program for the third year of the extended arrangement for Sri Lanka (EBS/81/210, 10/20/81; and Sup. 1, 10/29/81).

The staff representative from the Asian Department commented that one of the understandings under the third-year program of the extended arrangement was that, by the time of the Executive Board's mid-term review, the exchange rate would have been fixed at a level likely to restore Sri Lanka's competitive position to that of December 1980. To accomplish that objective the Sri Lanka rupee had had to be depreciated against the U.S. dollar by about 11.5 per cent to offset the appreciation of the U.S. dollar against the currencies of Sri Lanka's major trading partners since December 1980. In addition, to adjust for the relatively poor price performance in Sri Lanka compared with its trading partners, an additional depreciation of about 4.5 per cent had been required. On November 3, 1981, the exchange rate had been US$1.00 = SL Rs 21.20, a level that was consistent with that understanding.

Mr. Kannangara made the following statement:

> The staff paper gives a clear and concise picture of developments in the Sri Lankan economy in the third year of the extended arrangement and reviews the implementation of the program since our discussions in June of this year. My authorities and I appreciate the understanding that the staff has shown of the problems facing my authorities and the measures that had been taken to solve them. My authorities broadly agree with the staff appraisal.
>
> A word of explanation might be in order as to why the review, which was originally scheduled to be discussed in the Executive Board in September 1981, was somewhat delayed. The reason was that, because of certain unforeseen circumstances, some policy decisions had to be phased over a slightly longer period. For instance, one of the key elements of the program is to manage the exchange rate to ensure the maintenance of Sri Lanka's competitive position. As a result of the continued sharp appreciation of the U.S. dollar, the attainment of this objective was made difficult, although the authorities remained committed to maintaining Sri Lanka's competitive position at the level that prevailed in December 1980. Since August of this year, they have moved to reverse this appreciation, and by November 3 the Sri Lanka rupee had depreciated to SL Rs 21.20 per U.S. dollar, thereby erasing much of the rise in the real effective exchange value of the Sri Lanka rupee since the end of 1980. Fortunately, the improvement in the domestic price level also helped the external value of the Sri Lanka rupee. My authorities remain committed to managing the exchange rate in a flexible manner with a view to strengthening the balance of payments.

In the area of adjustment of domestic prices to world market levels, I should point out that, despite the development of a difficult internal situation about three or four months ago, the Government pressed ahead with domestic price adjustments. Some of the decisions had to be briefly delayed and phased over a slightly longer period, but in September of this year the retail price of flour was increased by 21 per cent, and the price of fertilizer was raised by 30 per cent. In order to stabilize growth of credit to the private sector, the Central Bank increased the bank rate from 12 per cent to 14 per cent in August and reduced the level above which central bank credit would be available to banks at penalty rates, while increasing the penalty rates themselves. The implementation of these measures at a time of national emergency testifies to the determination of the authorities not to delay the adjustment effort. Some of the measures, if not all of them, reflect the sacrifices that are being made to achieve both a viable external payments position and sustained growth in the medium and longer term.

There is one other aspect of the adjustment effort on which some clarification is called for. Owing to difficulties encountered by the housing and urban development authorities in selling some of their assets to finance their projects, supplementary authorizations amounting to 2 per cent of total budgetary expenditure have become necessary. Of course, the statutory authorities concerned could have pruned their programs to adhere to their budget ceilings, but it is not always easy to halt or delay the building of houses and public buildings in an ongoing process of construction activities. However, as the staff has pointed out, the supplementary authorizations have been permitted because the statutory corporations have taken positive measures to reduce and rephase their housing and urban development schemes for the remainder of this year and in coming years. In the context of the overall budget, the supplementary appropriations will not increase budgeted capital expenditure because they have been offset by savings on capital account in other areas.

I wish to conclude by noting that developments thus far in 1981 indicate that there has been a significant readjustment of the economy to the problems that emerged in 1980. The favorable turn that the economy has taken enables my authorities to look forward to the future with a measure of confidence.

Mr. Hirao said that the performance of the economy in 1981 had been better than expected: all of the performance criteria had been met, and there had been improvements in output, prices, and the balance of payments. Real output was estimated to grow at about 6 per cent in 1981, thereby maintaining the high rate recorded in recent years; the rate of inflation, as measured by the GDP deflator, had fallen from 22 per cent in 1980 to 18 per cent in 1981; and the external current account deficit and the overall balance of payments deficit were expected to decline even more than had been originally forecast. The favorable developments in 1981 contrasted markedly with the discouraging performance of the economy in 1980.

The improvements were attributable largely to the authorities' adjustment policies, Mr. Hirao commented. The greater use of pricing policy, and particularly the increase in the price incentives for paddy and subsidiary crop producers, had contributed to the continued expansion in agricultural production--despite unfavorable weather conditions--which had boosted the output in related processing industries and had lessened the inflationary pressure on the prices of agricultural products. Moreover, the larger supplies of foodcrops had enabled Sri Lanka to reduce its wheat imports, thereby helping the balance of payments position. Pricing policy had also played an important role in the energy sector; the rise in domestic oil prices had restrained total oil consumption and had reduced imports of crude oil and petroleum products.

Effective fiscal and monetary measures had been introduced as a part of the authorities' effort to restrain aggregate demand and to counter inflation, Mr. Hirao noted. The Treasury had strengthened expenditure controls, as the Executive Board had recommended, and capital expenditure, whose rapid expansion had generated strong inflationary pressures in 1980, had been substantially reduced in 1981; and the ceiling on credit to the public sector was likely to be observed. In the monetary field, the authorities had successfully restrained the expansion of domestic credit by increasing both the reserve ratios on bank deposits and bank lending rates. The fact that the higher interest rates had caused a rapid increase in domestic savings was encouraging.

Despite the commendable performance in 1981, Mr. Hirao remarked, there were a few areas in which the authorities should be encouraged to make further adjustments. The projected size of the budget deficit in the coming fiscal year was worrying, and the authorities should continue their efforts to reduce it. It would be useful to introduce more effective expenditure controls in some of the spending agencies, especially the Urban Development Authority and the National Housing Development Authority, which had failed to adhere to their budget ceilings for 1981. In the monetary field, as a result of the restraint exercised thus far in 1981, there was substantial scope for expansion of domestic credit within the present ceiling. However, he agreed with the staff that full utilization of the remaining room for credit expansion would contribute considerably to the inflationary pressures. Maintaining the present cautious control over the growth of total liquidity was also highly desirable.

Appropriate pricing policy alone could not be expected to cause a significant increase in tree crop output, Mr. Hirao went on; improvement in the management of the public estates was also needed. That improvement was essential to achieving a sustainable balance of payments position, as more than half of the total export earnings were accounted for by tree crops. In the exchange rate area, the recent depreciation of the

Sri Lanka rupee had offset most of the rise in the real effective exchange rate in the period end-1980 through July 1981. He hoped that the authorities would adhere to the policy of maintaining Sri Lanka's competitive position at the level that had prevailed in December 1980. Finally, it would be useful to know why consumer prices had reaccelerated in September 1981.

Mr. El-Khouri said that he generally agreed with the staff appraisal and that he approved the proposed decision. The authorities were to be commended for maintaining policies that had enabled them to observe all the performance criteria in the program for the third year of the extended arrangement. On the budget side, the restraint on expenditure thus far in 1981 was a welcome contrast to the budgetary situation in 1980, but the present size of the overall budget deficit was still a cause for concern. The fact that the ratio of the budget deficit to GDP in 1981 was larger than it had been in 1979--the first year of the extended arrangement--underscored the need to continue to exercise budgetary restraint even after the period of the extended arrangement.

He wondered, Mr. El-Khouri continued, whether the staff could not have included in its report the budget figures for the first half of 1981, so that Executive Directors could compare them with the estimates for 1981 as a whole and with the actual figures for the first half of 1980. It would also have been useful to receive more information about the magnitude of foreign financing in 1981. The table on page 7 on the budget contained a revised estimate for foreign financing that was lower than the original figure in the adjustment program, but the balance of payments table on page 12 contained revised estimates for official transfers to the Government and net capital inflows to the Government which were larger than the original figures in the 1981 program. He wondered whether the exchange rates used accounted for the difference in the figures.

The credit ceilings under the program were of considerable practical importance, Mr. El-Khouri said. The staff had mentioned that the rate of increase in net bank credit to the public sector was less than the program target, and had compared the actual behavior of private sector credit with the relevant estimate in the program. However, neither the present report nor the previous one (EBS/81/119, 5/20/81) explicitly stated the program targets on credit to the private sector, the Government proper, or the public entities. In the monetary survey (Table 3) in the present paper the staff could have usefully broken down the data on net domestic assets to show how actual developments had compared with the program targets. It would also be useful to know why the change in the category "other assets (net)" had been steadily increasing in 1980 and 1981.

He wondered how in practice the authorities were acting to achieve their goal of exchange rate equilibrium, Mr. El-Khouri commented. Did the staff routinely send the authorities its estimates of relative prices and trade weights?

Mr. Laske said that he was pleased that the authorities had made important progress in the exchange rate area, and that they intended to maintain the present flexible policy. The serious deterioration in the overall economic situation in Sri Lanka in 1980 had been reflected most visibly in the large fiscal imbalance and the acceleration of inflation. The stabilization measures that the authorities had subsequently adopted had brought the extended arrangement back on track, and they had been able to meet all the performance criteria for 1981. The rate of inflation had been considerably reduced, although the 18 per cent rate recorded in the previous 12 months was still unsatisfactory, and the authorities should continue their efforts to reduce the inflationary pressures through an appropriate combination of fiscal, monetary, and flexible exchange rate policies.

A tight fiscal policy would have to continue to be the centerpiece of the adjustment effort in Sri Lanka, Mr. Laske went on, and it was important to note that the projected overall budget deficit for 1981 probably could be financed without either intensifying the pressure on available resources or fueling inflation. It was regrettable that the necessary scaling down of public expenditure had been achieved through a severe curtailment of public investment, mainly in housing and urban development, but it had been evident for some time that the investment plans of the authorities in those two areas had been straining the implementation capacity of the economy. The sizable reduction in capital outlays in real terms was a realistic move away from the earlier excessively ambitious target and, in the long run, it should help to ensure more balanced growth and development.

The revised budget estimates for 1981 were a major improvement over the actual figures for 1980, Mr. Laske commented. The authorities' decisive action in the area of pricing policy, which had reduced the fiscal burden from both consumer subsidies and assistance to public sector enterprises, was particularly welcome.

Inadequate expenditure control had obviously been one of the causes of the unfavorable fiscal performance in 1980, Mr. Laske went on, and the staff appraisal suggested that the new cash management procedures were designed to improve the situation. The authorities should be urged to keep a close watch on expenditure to prevent any slippages. There seemed to be some expenditure overhang from the excessively large housing and urban development programs. Although construction activities had been drastically cut back, the need for supplementary expenditures had not been fully eliminated.

Credit developments, however, appeared to be on track, Mr. Laske remarked. The authorities had moved swiftly to curb excessive credit expansion earlier in 1981. The replacement of quantitative credit restrictions--the initial response to the excessive monetary expansion--by traditional central bank instruments was particularly welcome. He was pleased that economic developments in Sri Lanka in 1981 were on course, and that no new measures were needed at the present stage. He warmly supported the proposed decision.

Mr. Taylor said that he agreed with the thrust of the comments by previous speakers. The authorities were to be commended on the impressive performance of the economy in 1981, which was in marked contrast to the disappointing developments of 1980. The extended arrangement had been brought back on track; all the performance criteria had been met and appropriate corrective measures had been introduced despite the difficult international environment and the periodic domestic unrest in Sri Lanka. The authorities had amply demonstrated the strength of their commitment to the adjustment effort. Their shift to more cautious budgetary and credit policies, the significant liberalization of domestic prices, and the more flexible exchange rate policy were particularly welcome. The results of those policies were evident in the sustained growth of the economy, the increase in employment, the reduction in the rate of inflation, and the improvement in the balance of payments--signs that the economy was clearly moving in the right direction.

Still, Mr. Taylor continued, much remained to be done, particularly in the fiscal field, and he agreed that continued adherence to the present policy stance was important. The authorities' stated commitment to observing the performance criteria for the rest of the period of the third-year program was welcome, and the positive response of agricultural production to the shift in relative prices was most encouraging. However, he agreed with the staff that the authorities should begin to focus their attention on some of the longer-term problems in agriculture; in particular, improving the organization and management of the tree crop sector--which was a major source of employment--and increasing export earnings and tax revenue would underpin the incipient recovery of the economy.

The problems in the electric power sector had adversely affected industrial performance, Mr. Taylor observed. The electricity shortages that Sri Lanka had experienced had perhaps lessened its attractiveness as a free trade zone, and the full cost of electric power generation should be passed on to consumers. Greater efficiency in the energy sector seemed to be called for, particularly as energy consumption had continued to outstrip supply. New measures should be designed to alter the behavior of inefficient energy users without inhibiting the relatively productive sectors.

He shared the staff's view, Mr. Taylor said, that the authorities should firmly adhere to the goal of developing an internationally competitive manufacturing sector despite the problems that were inevitably associated with the initial stage, including import liberalization efforts. The review of the tariff structure should be approached with that need in mind, and it would be useful to know whether the staff had any recent information on likely changes in tariffs.

Previous speakers had correctly noted the improvement in the budgetary position, Mr. Taylor said, and he agreed with them that continued effective control of capital expenditure was essential if the overall budget deficit was to fall to the target level of 15 per cent of GDP.

In that connection, there should be a beneficial effect from the trimming of the urban housing projects and the improvement in cash management techniques. However, underspending continued to introduce an element of uncertainty into fiscal planning, and he was somewhat worried that there might be scope under the financial program for an acceleration in bank financing to the public sector later in 1981; the authorities' commitment to monitoring developments closely was certainly welcome.

In the monetary field, Mr. Taylor remarked, the timely and effective response by the authorities to the rapid expansion of credit to the private sector early in 1981 was commendable, and the recent increase in the Central Bank's discount rate seemed to have appropriately raised the general level of interest rates. Given the need for sustained growth in private savings, interest rates would have to remain at an attractively high level.

Recent developments in Sri Lanka were a good illustration of the power of the price mechanism to correct trade imbalances, Mr. Taylor commented. The Executive Board had recently discussed a number of similar cases that offered encouraging evidence of the positive role that could be played by a flexible exchange rate policy. As the staff had concluded, continued use of such a policy in Sri Lanka should help to strengthen further the balance of payments. The staff had usefully noted that an appropriate exchange rate level had been reached, and Mr. Kannangara had stated that the authorities intended to maintain a flexible exchange rate policy.

It would also be useful, Mr. Taylor went on, to have Mr. Kannangara or the staff assess the success of the extended arrangement for Sri Lanka. Given the country's continued need for adjustment, there might well be a case for further collaboration between the Fund and Sri Lanka after the period of the present extended arrangement.

Mr. Finaish said that he agreed with the thrust of the staff appraisal. In implementing the program for 1981 the authorities had introduced a wide range of policy measures to reduce both domestic and external imbalances and, as a result, financial discipline had been restored to a large extent, the competitiveness of the country's export sector had been improved, the economy had grown at the projected rate, the budget deficit had been reduced, and the balance of payments and price developments had been favorable. Still, he agreed with previous speakers that the budget deficit continued to be quite large and that further efforts should be made to trim it in the period after the extended arrangement.

Despite difficult domestic conditions and an unfavorable international economic environment, Mr. Finaish continued, all of the performance criteria for the 1981 program had been observed. The prudent demand management policies had significantly contributed to correcting the weaknesses in the economy. The fiscal measures that had been adopted in response to the developments in 1980 had made a particularly important contribution to the improvement in the budgetary position in 1981. Significant monetary and price measures had also been introduced.

Financial stability had been restored partly at the expense of maintaining the desired level of development expenditures, Mr. Finaish noted, but it should help to achieve sustained growth in coming years. On the supply side, the economy's response to increased prices and other incentives had been quite encouraging, particularly in agriculture, where the boost in production had helped to improve the balance of payments position. The rise in the price of fertilizers had not caused a decline in their use, and Sri Lanka could become a net exporter of rice and certain other foodcrops in the near future. At the present stage, the authorities should concentrate on the longer-term problems in the agricultural sector.

Although there had been some slippage in the 1980 economic program, Mr. Finaish said, Sri Lanka was now a good example of how a country could use appropriate demand and supply policies to make needed adjustments while recording an adequate rate of economic growth. He had no difficulty in accepting the proposed decision.

Mr. Vidvei stated that he broadly agreed with the staff appraisal and approved the proposed decision. Measures introduced in March 1981, including new cash management techniques, had enabled the Treasury to restore the expenditure restraint that had nearly disappeared in the previous period. How had the authorities been able to achieve such a large change in public administration so quickly? He wondered whether the authorities had not resorted to fairly blunt policy instruments that, in the long run, could harm productivity.

In a press report dated October 30, 1981, Mr. Vidvei noted, the Minister of Finance and Planning of Sri Lanka was quoted as saying that the country's budget deficit was expected to increase by 46 per cent in 1982. He wondered whether the report was correct, and whether the deterioration, if it actually occurred, would be consistent with the Government's objectives for the period after the extended arrangement. The aim of the arrangement had been to help the authorities to deal with the previously strained economic situation and to enable them to establish the basis for maintaining sound monetary and budgetary policies in coming years. Was the staff worried that the program had not succeeded in that respect?

Mr. Leimone considered that the authorities were to be commended both for their efforts to bring the program back on track, and for adhering to the targets after the interruption in the program caused by the excessively expansionary expenditures in 1980. Sri Lanka's program showed that effectively implemented supply-side policies could have very positive effects. The continued effort at structural adjustment in Sri Lanka, particularly through the flexible pricing and interest rate policies and the reduction in subsidies, had benefited the external current account, the fiscal performance, and domestic savings.

In consolidating the progress that had been made thus far the authorities would have to maintain continued vigilance, particularly in the budgetary and monetary areas, and they would have to keep the present flexible exchange rate policy, Mr. Leimone said. The reduction in the budget deficit from 21 per cent of GDP to 15 per cent was certainly a substantial accomplishment, but the deficit was still large. The authorities were in the process of introducing new tax measures, but they should be urged to take a more careful look than hitherto at expenditures, and to continue maintaining flexible pricing policies for state-owned enterprises. As previous speakers and the staff had stressed, the authorities should proceed cautiously in utilizing the present margin for expanding public sector credit; they should avoid an excessively strong injection of liquidity into the domestic economy.

Mr. Joyce remarked that he too thought that the authorities were to be commended on the steps that they had taken to bring the economic and financial program back on track. The task had certainly not been an easy one; difficult decisions implementing stricter policies than hitherto had obviously been required. That the exchange rate was now at what the staff deemed to be an appropriate level was certainly welcome, and the authorities were to be congratulated in particular for the adjustments they had made in pricing policy, especially the increases in the prices of wheat and fertilizer.

The information that Mr. Kannangara had provided on public expenditure was quite useful, Mr. Joyce continued. He had clearly shown that the supplementary appropriations required by the housing and urban development authorities had been offset by cuts elsewhere in the budget. Still, the need for the supplementary appropriations suggested that somewhat better expenditure controls might be required.

The fact that bank financing of the government deficit and of public enterprises so far was less than had been expected was welcome, Mr. Joyce continued, but there had been some difficulty in identifying the precise causes of that development and in reconciling it with the budget estimates, and some improvement in the system for monitoring government expenditure seemed warranted. Did the authorities have any contingency plans in the event that there was a sudden increase in the budget deficit in the final months of 1981 and the unexpectedly low level of bank financing was found to be the result of an unknown seasonal factor or a reversible development?

The size of the budget deficit was still a cause for concern, Mr. Joyce said, and the authorities' intention of introducing new revenue measures in 1982 was welcome. The increase in government revenues in 1981 had fallen short of the increase in nominal GDP, and he hoped that the new revenue measures would increase the elasticity of the tax system.

On the monetary side, Mr. Joyce continued, the authorities had moved swiftly to contain the undue expansion of credit earlier in the year. In the energy field, however, he agreed with Mr. Taylor that the adverse effects on the investment climate of the shortage of electricity were worrying. What steps did the authorities plan to take to improve the supply of electricity or to limit the demand for it?

There had been pressure in Sri Lanka, Mr. Joyce noted, to increase the level of protection for the manufacturing sector. That kind of pressure was common to many countries and was often difficult to resist, but the Sri Lanka authorities should be encouraged to maintain their commitment to develop an internationally competitive manufacturing sector. That task was certainly not an easy one but, in the long run, it would provide significant benefits in terms of sustainable employment and incomes.

He, like previous speakers, Mr. Joyce said, was concerned about the outlook for Sri Lanka's economy. The results thus far in 1981 had been satisfactory, but substantial adjustment was still required in many areas; after all, the actual developments in the first half of 1981 had fallen far short of the original projections under the extended arrangement. The rate of inflation continued to be high, a better balance between investment and savings was still needed, and both the size of the deficit and the level of public sector borrowing from the banking sector were worrying. Moreover, the external current account deficit in 1981 was the equivalent of about 12 per cent of GDP and was not expected to decline in the coming period. The period of the extended arrangement was almost over, and it would be useful to have Mr. Kannangara or the staff comment on likely future developments in Sri Lanka. Finally, the prospects for continued cooperation with the Fund had been mentioned during the Executive Board's discussion on Sri Lanka at EBM/81/89 and EBM/81/90 (6/12/81), and he wondered whether any progress had been made.

Mr. de Vries commented that Mr. Kannangara had usefully underscored the important policy commitments that the Sri Lanka authorities had made, and he fully supported the proposed decision, although the Fund's support for Sri Lanka in the decision could have been stated more clearly. The case of Sri Lanka was an important example both of effective cooperation between a member country and the Fund, and of successful use of the extended Fund facility. The new Government in Sri Lanka had wished to change the country's policy direction and to make sizable needed adjustments, and it had required considerable financial support; the arrangement with the authorities had probably been as successful as was possible given the conditions in Sri Lanka and in the world economy. The authorities had made impressive progress in 1981 after experiencing serious setbacks in 1980. The measures that the authorities had taken and their determination to persevere in the implementation of important and difficult decisions were most impressive.

He fully agreed with Mr. Hirao's analysis of recent developments in Sri Lanka, Mr. de Vries continued. He had been particularly struck by the positive response of savings to the recent increases in interest rates. The balance of payments had also reacted in an important way to adjustments in prices and exchange rate policy. Nevertheless, the outlook for the economy was not necessarily promising. The budget deficit had been considerably reduced but was still sizable; and although monetary policy had been tightened, dangers in that area still remained. He hoped that the authorities would continue to persevere in the implementation of the needed policies.

The staff expected a 25 per cent rate of increase in liquidity in 1981, Mr. de Vries noted. The rate of inflation in the previous 12 months had been about 18 per cent, and he wondered what effect the expected liquidity expansion was likely to have on inflation in the coming period.

Given the great success of the extended arrangement for Sri Lanka despite the difficult domestic and international situation, Mr. de Vries commented, it should be reviewed in depth to ensure that the Fund learned everything possible from it for the benefit of future arrangements. He looked forward to hearing Mr. Kannangara's and the staff's initial assessment of the extended arrangement for Sri Lanka, but a detailed analysis by the staff would also be useful.

Mr. Kharmawan recalled that, although in its initial stage the extended arrangement for Sri Lanka had been favorable, it had gone seriously off course in 1980. The authorities were to be highly commended for the courage and determination they had shown in bringing the adjustment effort back on track, and they could look forward to the coming period with greater confidence than had been possible in 1980. All of the domestic adjustment measures had contributed to the good growth performance, and the fact that Sri Lanka might well become a net exporter of rice and other foodcrops in the near future was a welcome development both for Sri Lanka itself and for the region as a whole, which had only a handful of food exporting countries.

He agreed with previous speakers, Mr. Kharmawan continued, that the authorities would have to continue to be vigilant in monitoring budgetary and exchange rate developments. It would be useful to know the staff's estimate of the likely impact of the continuing stagflation in the world economy on Sri Lanka's balance of payments in 1981.

Previous speakers had correctly stressed the need to reduce further the level of subsidies, Mr. Kharmawan noted, but such courageous domestic efforts should be matched by the relaxation of protectionist measures in other countries. He hoped that the deterioration in the international economic situation--and particularly the onset of recession in the United States--would not cause protectionism to intensify.

Mr. Wang stated that he agreed with the staff appraisal and supported the proposed decision. He hoped that the authorities would continue their major adjustment efforts under the 1981 economic and financial program.

The Acting Chairman remarked that Mr. de Vries' suggestion for studying in detail the Fund's experience with Sri Lanka under the extended arrangement was interesting. Essential ingredients of successful implementation of adjustment programs were a strong belief by the authorities concerned in the need for, and potential effectiveness of, the program, and the courage to implement it even under adverse conditions. Those factors were particularly important when there was a need to bring a program back on track.

The staff representative from the Asian Department commented that there were a number of problems with the press report that Mr. Vidvei had mentioned. The comments on the balance of payments position by the Central Bank's Director of Research had apparently been misquoted, and the article incorrectly portrayed the balance of payments position as worsening. The figures for 1981 in the article were simply incorrect. There were similar problems with the statement attributed to the Minister of Finance and Planning. The preliminary indications given to the staff by the authorities differed from the figures in the article attributed to the Minister; it was conceivable that the figures in the article did not take into account the new tax measures in the 1982 budget that were expected to raise as much as SL Rs 2 billion in revenues.

Nevertheless, the staff representative went on, the preliminary data provided by the authorities suggested that, both in absolute terms and in relation to GDP, the budget deficit would increase somewhat in 1982. At the time of the discussions with the authorities, there were substantial uncertainties about the budget, which had been in an early stage of preparation. One of the problems was that during the next 12-18 months there would be a bulge in the budget resulting from a number of sizable investments designed, in part, to deal with the shortage of electricity. The authorities had accelerated the Mahaweli Hydroelectric Power Project and had given priority to ensuring that the increase in hydroelectric power from the Victoria Dam that had been planned for mid-1984 occurred on schedule. The outlook for the budget was still somewhat uncertain, and that would undoubtedly have a bearing on the collaboration between the Fund and Sri Lanka in the period after the extended arrangement.

The bulge in the budget was to be financed largely by concessional aid flows, the staff representative explained. Recently signed contracts for some of the major elements of the investment program provided additional information about their phasing and cost. On the basis of the new information, it seemed advisable for the authorities to make an additional effort to rephase and adjust the investment program to bring it into line with their overall macroeconomic objectives for the coming year. The budget situation was still under discussion in Sri Lanka.

Commenting on the behavior of consumer prices, the staff representative said that prices had actually fallen in July and August 1981. They had picked up again in September, the interharvest period, when increases in the prices of some food items traditionally occurred. In addition, certain administered prices, such as the prices of fertilizer and flour, had been increased in September as a part of the effort to ensure that the level of subsidies was held to the target in the economic and financial program.

A question had been raised, the staff representative recalled, about the apparent conflict between the reduction in the estimate for foreign financing in the budget in 1981 and the corresponding balance of payments figure. There was a reduction in foreign inflows to the budget because of the readjustment of expenditure expectations for certain large projects, particularly a rural electrification project financed by the Asian Development Bank, which would not be implemented according to the schedule that had originally been established. However, as had been anticipated under the economic and financial program for 1981, there was to be a slight increase--about $15 million--in commercial borrowing, which would be taken down by the Government. That possibility had been discussed in the process of formulating the program, and it was fully in line with the foreign borrowing ceilings that had been established.

In response to a query as to why actual budget data had not been presented for some part of 1981 and perhaps compared with developments in a similar period of 1980, the staff representative explained that the budget figures for the first six months of 1981 were unavailable. The staff had only cash flow data for that period. On the basis of that information, a substantial revision of the budget estimates had been made, and that was reflected in the present staff papers; indeed, many items in the revised budget had been adjusted according to actual developments in the first half of 1981.

In the monetary survey on page 10, the staff representative noted, the figures for net credit to Government for budgetary operations reflected the taking down of credits by the budget proper. There was a problem in comparing the figures for December 1980 with those for June 1981; there had been a carryover of credit expansion into the January 1981 data from budgetary operations late in 1980. Hence, there was not an exact correspondence between the monetary survey and budget figures on bank financing for expansion of credit in a given period, say, December to June 1981.

The large increase in the item "other assets (net)" in the monetary survey, the staff representative explained, was due mainly to the large payments to the Central Bank by the budget, primarily for interest due on treasury bills, which had resulted in large part from the expansion of credit to the Government in 1980. In 1980 government debt held by the Central Bank had increased from approximately SL Rs 3 billion to SL Rs 10 billion, thereby causing a large increase in interest payments to the Central Bank. Under the financial program for 1981, the Central Bank was sterilizing the receipt of those payments; that act was reflected in the large increase in the item for "other assets (net)."

Each month, the staff representative commented, the staff sent to the authorities in Sri Lanka its own calculations of trade-weighted effective exchange rates and relative prices for the country's major trading partners. On the basis of those data and their own computations, the authorities decided what adjustments were needed to continue meeting their commitment to maintain the exchange rate at the competitive position that had prevailed at the end of 1980.

During the previous nine months, the staff representative explained, a Tariff Commission had been operating in Sri Lanka with a view to designing a tariff system based on the principle of effective protection. The Commission had recently drafted a report but had not yet officially submitted it.

The extended arrangement, the staff representative commented, was aimed at increasing growth and employment and at continuing the process of the liberalization of the economy which had been begun in 1977. A major element of the liberalization was an adjustment of domestic prices to international levels in order to subject the external sector of the economy to competitive conditions in world markets and to bring prices in Sri Lanka up to levels that would provide incentives to domestic producers. In the light of those objectives, the extended arrangement had been quite successful. Growth had averaged approximately 6 per cent in the period of the arrangement, employment had increased substantially, and, as a result of the incentive price system, food production had risen dramatically. Rice production, for instance, had grown from 60 million bushels a year to 105 million bushels in the period 1976-81. The increase was attributable primarily to the rise in the guaranteed prices that producers were provided and to the growing activity of the private sector in the rice trading network. It was important to note that the conditions in the world economy in the period of the extended arrangement had been much less favorable than had been originally expected. The terms of trade had deteriorated by 50 per cent in the period in which the authorities had attempted to introduce incentives and to accelerate the investment program.

The bluntness of the monetary measures that had been introduced in April 1981 probably should not be taken to be a sign of weakness in the financial program, the staff representative considered. Rather, the measures had been a natural response to the excessively rapid expansion of credit. The April measures had been quickly rescinded; in June 1981 the reserve requirement had been increased, and more fundamental measures had been adopted to guide the long-term expansion of credit in the banking system.

Further improvement in expenditure control was clearly needed in the coming period, the staff representative said. The mechanisms that had been used in 1981 to reverse the adverse trend of 1980--when expenditures had exceeded all budgeted estimates by substantial margins--were designed primarily to control cash disbursements and were not the kind of budgeting and cash system mechanisms that the staff and the authorities would ideally wish to see the country introduce. Substantial additional work had to be done to guide the development of the appropriate mechanisms and, to that end, there was a Fiscal Affairs Department expert assigned to the Treasury in Sri Lanka.

The imbalance between savings and investment in Sri Lanka had resulted partly from the changes in the world economic situation and partly from problems with the tax system in Sri Lanka, the staff representative commented. Revenue had not increased as rapidly in relation to the growth of nominal income as the staff and the authorities had wished, leading to a disappointing performance in public sector savings, but the interest rate adjustments had led to a significant increase in private sector savings. Hence, the difficulties in achieving the appropriate balance between savings and investment seemed to be sectoral in nature and was related to some extent to budgetary developments.

The exchange rate was now at what the staff felt was an appropriate level, the staff representative said. Most of the adjustment in that level had taken place in the previous few months; ideally, perhaps, the adjustment could have been made somewhat earlier in the year.

The staff's discussion on underspending in its report had been based on data through June 1981, the staff representative explained. Data through September were now available, and they showed that the underspending trend had continued. Hence, for the moment, there were no indications of potential difficulties in the form of an unexpectedly large increase in the budget deficit.

Thus far in 1981, the staff representative continued, M-1 had been basically stagnant. Indeed, in the period January-June 1981 it had declined by 2 per cent. The 25 per cent rate of expansion of total liquidity mentioned by the staff in its report reflected the 40 per cent increase in quasi-money resulting from the rise in the level of financial savings in the private sector following the interest rate adjustments.

The low level of activity in the world economy had had a serious adverse effect on Sri Lanka's external sector, the staff representative from the Asian Department commented. For instance, the decline in the price of rubber had obviously affected the balance of payments in 1981. In addition, the stagflation abroad, as well as the quotas on exports of such goods as garments, had limited Sri Lanka's ability to develop new exports. There was some uncertainty about the speed at which investors would be able to exploit the facilities that had been made available through Sri Lanka's free trade zone.

Mr. Kannangara remarked that the authorities fully understood the need for effective budgetary control; although some success had already been achieved in that area, much remained to be done. A new unit had been established in the Ministry of Finance and Planning specifically to control expenditure, and an expert assigned by the Fiscal Affairs Department was advising the unit. There was no reason to expect a larger fiscal deficit at the end of 1981 than had been anticipated at the beginning of the year, although the authorities would of course keep a close watch on developments. The newspaper report that Mr. Vidvei had mentioned seemed to have misquoted the authorities. New revenue measures were to be introduced in 1982, and the budget deficit probably would not increase by as much as the article seemed to imply.

The authorities were aware of the need to increase the managerial efficiency of the tree crop sector, Mr. Kannangara commented. They had already decentralized the control of the sector by reorganizing the two government corporations involved into four regional boards. The plantations had recently been brought into closer contact with the private sector, which had been given permission to export rubber, and the authorities certainly would not hesitate to take further necessary practical steps.

Commenting on the effectiveness of the extended arrangement, Mr. Kannangara said that impressive reforms had been made in a relatively short time and, as a result, there had been a structural transformation of the economy after a long period of stagnation. Of course, further adjustment measures were needed. Sri Lanka had been cooperating with the Fund over a long period, and any further use of Fund resources after the extended arrangement would depend upon domestic and international developments.

The Acting Chairman, responding to a question by Mr. Vidvei, remarked that, as Mr. Kannangara had mentioned, the future financial relationship between the Fund and Sri Lanka would depend in large part on economic developments in coming months. It was of course up to a member country to initiate discussions on the possible use of Fund resources and technical assistance. Management and staff would naturally continue to be responsive to the authorities' request for technical assistance. Finally, it was useful to note that the data on page 17, particularly on the Fund's holdings of Sri Lanka rupees, showed that there was ample room within the existing cumulative guidelines for possible future use of Fund resources by Sri Lanka.

The staff representative from the Asian Department added that the staff clearly had an ongoing interest in continuing the assessment of Sri Lanka's interesting economic and financial program, which had been implemented with great success. The staff planned to send a mission to Sri Lanka in the final week of November 1981 in order to examine the latest budget presentation and to update its information on the continuing pace of adjustment in 1981, thereby placing the staff in a position to consider a program beyond the one for 1981, should that be requested by the authorities.

The Acting Chairman commented that there had clearly been a number of positive developments in the economy in the previous three years as a result of the Government's wide-ranging reforms. However, as many Executive Directors had stressed, there were still at least three main problem areas: additional steps were needed to control expenditures and to improve the effectiveness of taxation; there were imbalances between savings and investment, and between the mix of public and private savings; and the external current account deficit was still too large. As the staff representative from the Asian Department had emphasized, Sri Lanka had experienced an extraordinarily large, and only partially foreseen, adverse shift in its terms of trade in the period of the extended arrangement.

The Executive Directors then turned to the proposed decision.

Mr. Caranicas considered that the language of the proposed decision was rather awkward, particularly the suggestion that the review had been conducted by the Fund and Sri Lanka.

The Deputy General Counsel commented that the language of the proposed decision was based on the language of the extended arrangement, which provided, in part, that the Government would conduct with the Fund a review of the program and, if necessary, reach new understandings with the Fund. A reference to "the Fund," such as the one in the draft text under consideration, meant the competent organ of the institution which, in the present case, was the Executive Board.

The Acting Chairman suggested that it might be useful to break the text in question into two sentences, the second of which could read: "It is concluded that no new understandings are necessary with respect to the period of the program after September 30, 1981."

The Executive Board approved the proposed decision, as amended by the Acting Chairman.

The decision was:

> The Fund and Sri Lanka have conducted the review of the program pursuant to paragraph 2(c) of the letter dated May 7, 1981, and annexed to the extended arrangement for Sri Lanka, EBS/79/16, Supplement 2 (1/29/79) and EBS/81/119 (5/20/81). It is concluded that no new understandings are necessary with respect to the period of the program after September 30, 1981.

Decision No. 6977-(81/136), adopted
November 4, 1981

2. PAPUA NEW GUINEA - PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered a request from Papua New Guinea for a purchase equivalent to SDR 45 million under the Decision on Compensatory Financing of Export Fluctuations (EBS/81/209, 10/20/81; and Sup. 1, 10/27/81).

Mr. Prowse made the following statement:

> My authorities and I feel that the staff analysis is very satisfactory, and we have no disagreements with it. In July the Executive Board discussed Papua New Guinea's economy and economic policy in its consideration of the staff report for the 1981 Article IV consultation. At that time, the staff had mentioned that possible access by Papua New Guinea to the compensatory financing facility was under review and, in the light of current trends and prospects for exports, it appeared that Papua New Guinea would be able to seek access to the facility later in 1981. That prediction has proved to be accurate. Against the background of that discussion, during which a good deal of interest in Papua New Guinea's

economy was shown, and in the light of the very good new staff paper, I wish to comment briefly on developments in the economy since that Board discussion and to reinforce a few points that seem to be especially relevant to the Board's consideration of the Government's request to use the compensatory financing facility. I particularly wish to comment on the technical side of the proposal, namely, the export shortfall, and to speak briefly, with very mixed feelings and, even, some nervousness, about the aspect of the compensatory financing facility that we have been looking at a good deal lately, namely, cooperation with the Fund.

During the discussion in July, Executive Directors noted that, while Papua New Guinea's longer-term prospects remained good, there had been a deterioration in the performance of the economy and, in particular, that a substantial external current account deficit was projected for 1981. That situation reflected to a significant extent the weakening in the markets for Papua New Guinea's exports and, as some Executive Directors pointed out, some underlying structural problems in the economy. At the same time, of course, Executive Directors endorsed the Government's general economic policy thrust. Since July 1981, there have been some significant economic policy developments and a further deterioration in the short-term export situation, although, largely because of the policy measures adopted, there has been an offsetting reduction in the projected level of imports. As a result, there has been no growth on the export side but there has been a moderation in the level of imports, and in the third quarter of 1981 reserves apparently rose slightly, compared with the decline of about K 15 million that was originally anticipated. Thus, the authorities have made some progress in the external economy, despite continuing adverse conditions. When an adjustment is made for mining and development-related imports, the worsening of the current account during 1981 is less than the deterioration in the terms of trade. In other words, imports from mining and development aside, the volume of imports thus far in 1981 has declined; and the authorities expect the decline to continue through the final quarter of 1981. Of course, the practice of leaving aside development and mining imports is somewhat debatable, but no one would wish to see those kinds of imports constrained, especially given the long-term restructuring and development needs of the economy. Thus, the authorities have already used much of the room for restraint that has been available in the area of the external current account.

Monetary conditions are certainly tight, and that trend is related to the decline in imports. A considerable effort is also being made on the fiscal side, and Executive Directors who showed particular interest in developments at the previous discussion on Papua New Guinea might wish to know more about the 1982 budget and the 1982-85 expenditure plan, which were presented in Parliament on November 3, 1981. Real expenditures will be reduced by 3 per cent in 1982 and 1983; the program previously provided for a real increase of 3 per cent. Hence, there has been a clear and strong adjustment in fiscal policy. While capital works expenditures have been maintained and new expenditure programs have been introduced to promote production in the medium term, current expenditures have been cut sharply. The level of public service expenditures, which has been reduced by 4 per cent in 1981, is scheduled to be cut a further 6 per cent in 1982. Major savings are also to be made in nonessential areas, such as vehicle purchases and overseas travel.

The new revenue measures in the 1982 budget total K 19.7 million, the equivalent of 5 per cent of 1981 revenue. The major measures and the estimated revenue gains include: a rise in petroleum product duties (K 5.7 million); an increase in vehicle import duties, raising the fee for passenger cars from 50 per cent to 70 per cent (K 1.5 million); increases in the taxes on beer (K 1.7 million) and cigarettes (K 3.7 million); a boost in the general import levy from 2.5 per cent to 3.5 per cent (K 4.5 million); an increase in the import duty on luxury goods from 50 per cent to 70 per cent (K 1.2 million); and a doubling of the departure tax from K 10 to K 20 (K 1.0 million). The overall budget deficit is estimated to be about K 72 million, or 3.7 per cent of 1982 GDP; the lack of major improvement reflects the sharp drop expected in domestic revenues due to unfavorable economic conditions. Hence, in the short run, the policy adjustments in Papua New Guinea have been along the lines that the Executive Board endorsed in its July 1981 discussion.

Executive Directors have also been very interested in the role of economic policy in the structure of Papua New Guinea's economy, and progress has been made in that area as well. In the past, one of the problem areas has been the commercial plantations, and it is felt that productivity and investment in that sector was adversely affected by the plantation redistribution scheme. At the time of the discussion of the staff report for the 1981 Article IV consultation, the scheme was suspended, and the authorities now feel that real progress has been made in this area; the Government has agreed to renew leases for expatriates on the basis of a commitment by the leaseholders to redevelop the plantations. My understanding is that the expatriate leaseholders are satisfied that there has been a real change in policy and are now seeking funds for redevelopment.

The authorities in Papua New Guinea have requested a drawing under the compensatory financing facility in respect of an export shortfall experienced in the year to June 1981. Final data for total export receipts are available only up to December 1980. However, it is important to note that the estimate for the first six months of 1981 is based on actual data for the commodities that provide virtually all of Papua New Guinea's export receipts, as mentioned in footnote 3 on page 5 of EBS/81/209. We can therefore have a good deal of confidence in the numbers that have been used in the calculations.

Papua New Guinea is heavily dependent on exports of primary commodities. Copper, gold, coffee, cocoa, and copra accounted for 80 per cent of Papua New Guinea's export receipts in the year to June 1980. In the 12 months to June 1981 earnings from all of these commodities declined. In terms of unit values, there has been a 10 per cent decline for copper, coffee, and cocoa, and a fall of more than 30 per cent for copra. The export volumes of cocoa and coffee have fallen by more than 15 per cent, because of delayed harvest and bad weather. The contribution of gold exports to the computed shortfall is negative, as a moderate increase in the price of gold is forecast.

The staff projections for export volumes and unit values in 1981 and 1982 seem prudent and realistic. They result in a computed shortfall of SDR 65.1 million, which is considerably more than the requested drawing of SDR 45 million, although that figure is the equivalent of 100 per cent of Papua New Guinea's quota.

In considering requests for drawings under the compensatory financing facility the Executive Directors have recently been paying increasing attention to the question of cooperation with the Fund. This is entirely appropriate. As the drawing requested by Papua New Guinea amounts to 100 per cent of the country's quota, the Executive Board must satisfy itself that Papua New Guinea has been cooperating with the Fund in efforts to find appropriate solutions to its balance of payments difficulties. In this case, the record is clear. At the time of the Article IV consultation, the Executive Board, while recommending various policy improvements, welcomed the decisions that had been taken up to that time. In addition, since the visit of the mission to Port Moresby at the end of April 1981, there have been a number of important developments. Control of government expenditure has been substantially improved, and expenditure in 1981 is expected to be held to the same level, in real terms, as that in 1980. Expenditure in the 1982 budget has been cut back from the programed level equivalent to a 3 per cent increase in the rate of real growth to a level equivalent to a 3 per cent decline. That change, together with additional measures designed to provide new revenue equivalent to 5 per cent of 1981, is expected to reduce the overall government deficit from 5 per cent of GDP in 1981 to 3.7 per cent in 1982. Furthermore, credit conditions are tight, and interest rates have been raised. Papua New Guinea is using the technical assistance services of the Fund very effectively; there are three Fund experts in the Bank of Papua New Guinea, and arrangements are being made for placement of a tax expert.

Mr. Kharmawan considered that the staff and Mr. Prowse had made a convincing case for the approval of Papua New Guinea's request. A balance of payments need had been clearly established, and the export shortfall had been caused by factors largely beyond the control of the Government. Indeed, those two requirements had been amply met, and he therefore warmly supported Papua New Guinea's request.

The Papua New Guinea authorities had also fully met the requirement of stricter cooperation, Mr. Kharmawan continued. The Executive Board was scheduled to discuss that criterion in particular in the near future, something that he strongly welcomed, as he had not agreed with some of the previous interpretations of it. Indeed, in the present case of Papua New Guinea, the authorities had easily met the cooperation criterion; they had already adopted measures designed to improve the balance of payments position.

The main difficulty with the application of the cooperation requirement in the past, Mr. Kharmawan continued, was that the Fund had seemed to require members to make a comprehensive effort to adjust the external sector in order to improve the overall balance of payments position. It seemed more appropriate to ask members to qualify to use the compensatory financing facility by adopting measures aimed specifically at dealing with export shortfalls. Papua New Guinea had experienced considerable pressures on its balance of payments largely because of cyclical low world prices for its exports, the increase in the cost of oil imports, and domestic supply constraints. In the circumstances of Papua New Guinea, it would be unreasonable for the Fund to say that the Government could use the compensatory financing facility only after it had adopted comprehensive adjustment measures designed to improve the general balance of payments situation.

Mr. Nana-Sinkam stated that he accepted the proposed decision. The existence of an export shortfall and a balance of payments need had been clearly established, although Papua New Guinea continued to have a high level of reserves and could perhaps have drawn on them to a greater extent than it actually had.

The present case of Papua New Guinea, Mr. Nana-Sinkam continued, brought to mind again the difficult issue of the criterion of cooperation, which was to be discussed in the Executive Board on another occasion. The Executive Board had recently decided not to permit a particular member country to bring its outstanding drawings under the compensatory financing facility above 50 per cent of quota because the country had failed to meet one of the performance criteria in its upper credit tranche stand-by arrangement. It was true that Papua New Guinea had adopted a number of different measures, but those actions did not amount to the implementation of a comprehensive adjustment program. A drawing in the upper credit tranches usually involved conditions on such important factors as the level of arrears and the volume of official foreign borrowing. The measures that the Government of Papua New Guinea had adopted did not seem to involve all the necessary elements of adjustment. Moreover, the export shortfall of Papua New Guinea was perhaps not fully consistent with the requirements of the relevant Fund decision. It had been caused by, among other things, the uncertainties over land tenure, the inadequate infrastructure, and the deterioration in the quality of ores used in mineral exports. There was no indication that the authorities had made any significant attempt to diversify exports. Nor was there any evidence that measures appropriate to a higher credit tranche drawing had been adopted in agriculture.

scheme giving nationals plantation land that had been owned by expatriates. The authorities had recognized that the scheme had discouraged agricultural investment and they had recently rescinded it. The decision to permit expatriates to lease or re-lease plantation land was expected to have a markedly favorable effect on production. In addition, the authorities had asked the World Bank to help them improve agricultural policy, establish appropriate agencies for the sector, and improve extension services. The effort to diversify agricultural production had been started only quite recently. The authorities were attempting to develop food product import substitutes and were exploring possible areas of export diversification involving some minor products. Papua New Guinea was well established in the production of cocoa, coffee, and copra, and agricultural resources were naturally being concentrated on those products. The new copper mine at Ok Tedi was a substantial investment but would not begin to create significant net benefits for the balance of payments until 1986, although Papua New Guinea expected to begin exporting copper from the mine in 1984. The copper mine could be seen as a part of the diversification effort because, although Papua New Guinea had been mining copper for some time, the latest investments had been devoted to a new mine in a part of the country where copper mining had not previously taken place.

Commenting on cooperation with the Fund, the staff representative from the Asian Department said that the corrective steps that the authorities had recently taken were the maximum that they could have taken in the short run. Monetary and fiscal policies had been considerably tightened in 1981 and the effort had begun to show results, particularly in the moderation of import demand, excluding mining sector imports which had been financed by direct foreign investment. Moreover, the proposed 1982 budget represented a major departure from the policy that had been maintained during the previous five years; hitherto, the authorities had attempted to maintain an increase in real expenditure of approximately 3 per cent a year, while the new budget called for a 3 per cent decline in real terms. Furthermore, interest rates had been adjusted upward. The authorities had even adopted measures designed to tackle some of the longer-term problems facing the economy. A number of the measures that they had taken were consistent with suggestions that had been made in the past in the Executive Board, and the staff was satisfied that the Government had been cooperating with the Fund. On a number of previous occasions the staff had raised with the authorities the possibility of their adopting a Fund-supported stabilization program. General elections were scheduled to be held in mid-1982, and the Government was naturally reluctant to undertake commitments for a period substantially beyond the date of the elections. The discussion with the authorities on the possibility of a stabilization program was very much alive. The next consultation with Papua New Guinea was scheduled to take place in March or April 1982.

The staff representative from the Research Department, responding to a question by the Acting Chairman, said that there had been 16 cases similar to that of Papua New Guinea, in which a member had made a purchase under the compensatory financing facility which had brought its outstanding purchases under the facility above 50 per cent of quota even though the country had not had a Fund-supported program in effect at the time of the purchase. There had been 47 other cases in which a member country had had a program in effect or approved at the time that it had made a purchase under the compensatory financing facility which had brought its outstanding purchases under the facility above 50 per cent of quota. There had been 12 cases--one of which had been referred to by Mr. Nana-Sinkam--in which the drawings under the facility had been limited so that the amount outstanding under the facility did not exceed 50 per cent of quota; in all of those cases, the members either did not have an arrangement with the Fund or had an arrangement under which drawings had been interrupted at the time the request for a drawing under the compensatory financing facility had been made. There had been another 4 cases in which the members had drawn above 50 per cent of quota although they had an arrangement with the Fund under which drawings had been interrupted at the time of the compensatory financing request. Requests for compensatory financing made at a time when the member's rights to draw under an arrangement had been interrupted were obviously the most difficult to justify. The Executive Board was scheduled to hold a separate discussion in the near future on the issue of cooperation in connection with the compensatory financing facility, but it was useful to note that the established policy was that a Fund-supported program was not a prerequisite for meeting the requirement of cooperation. That policy had been confirmed during reviews of the compensatory financing facility by the Executive Board.

Mr. Nana-Sinkam remarked that he wondered why the recently adopted corrective measures--which had been described as constituting the maximum effort that the authorities could have made in the short run--had not had a significant favorable impact on the economy. Despite the new measures, the present rate of inflation was higher than the rate in 1979, the budget deficit had been gradually increasing, and the financial situation continued to be unsatisfactory. Did the staff feel that the new measures would constitute an acceptable basis for a Fund-supported stabilization program in the higher credit tranches?

The staff, Mr. Nana-Sinkam noted, apparently considered that the case that he had mentioned earlier, involving a country that had wished to use the compensatory financing facility, had been particularly difficult. In fact, however, at the time of its request to use the compensatory financing facility the country in question had met all but one of the performance criteria under its stand-by arrangement; the country had been denied access to the facility because of its failure to observe the one performance criterion. If the same kind of approach was used for Papua New Guinea, it seemed likely that the actual performance of the economy after the introduction of corrective measures would be felt by the Fund to be inadequate. The previous case that he had in mind had been no more difficult than the present one of Papua New Guinea, especially as Papua New Guinea did not have a stand-by arrangement in operation.

Mr. Prowse commented that the case of Papua New Guinea should be judged on the basis of established policy and not on some possible future policies, and not by making comparisons with previous cases. The level of a member country's reserves was not even mentioned as a factor in the decision on compensatory financing as affecting the determination of eligibility to use the compensatory financing facility. Under the decision on compensatory financing, a member country was required to cooperate with the Fund to find solutions to its balance of payments problems, and it had to have an export shortfall that was temporary in nature and that had been caused by factors largely beyond the control of the country; there was no reference to reserves. In any event, the reserves of Papua New Guinea had declined by approximately 60 per cent in the previous three years and were projected to fall to the equivalent of three months of imports in 1982, a low level for a country that was heavily dependent on exports of primary products that were traded in very volatile market conditions. Moreover, the export shortfall of Papua New Guinea had been caused largely by price factors that had been beyond the control of the authorities, as well as by the limits imposed by the International Coffee Agreement and by poor weather in the country. Indeed, Papua New Guinea's request to use the compensatory financing facility was probably a textbook example of a clear-cut case.

Commenting on the temporary nature of the export shortfall in Papua New Guinea, Mr. Prowse noted that the projections in the staff report were consistent with the figures in the World Economic Outlook, which were themselves somewhat conservative. On the production side, the staff representative from the Asian Department had correctly stressed the positive effect of the change in policy on plantation ownership; expatriate leaseholders seemed to be convinced that a useful change in policy had been made, and they had been seeking redevelopment funds.

The set of measures that the authorities had adopted, Mr. Prowse continued, constituted the maximum effort that could reasonably be expected in the short run even if the authorities had been acting under a stand-by arrangement. During the previous Board discussion on Papua New Guinea, it had been suggested that there was a basis for a potential arrangement with the Fund and that such an arrangement was under consideration. The possibility was still being actively considered and would be a topic for discussion during the next Article IV consultation. If a decision was made to proceed with such an arrangement, a proposal could conceivably be placed before Executive Directors sometime after the elections in mid-1982.

It was true, Mr. Prowse said, that the overall deficit of the Central Government was expected to reach the equivalent of 5 per cent of GDP in 1981, but the deficit was expected to fall to the equivalent of 3.6 per cent of GDP in 1982, a very low figure for an economy like that of Papua New Guinea. Finally, Executive Directors' comments on Papua New Guinea at the present meeting could more properly be seen as part of the coming discussion on the issue of cooperation under the compensatory financing facility.

Mr. de Vries considered that the discussion on Papua New Guinea's request to use the compensatory financing facility showed the need for the policy discussion that was to be held in the near future. Two of the main issues that had been brought to mind by the case of Papua New Guinea were the level of cooperation that was required, and the attribution of a country's export shortfall to circumstances beyond its control. Apparently the quality of copper mined in Papua New Guinea had been declining, and the authorities had responded by making certain structural adjustments. Those adjustments were of course welcome, but the copper export shortfall did not seem to be the kind of shortfall that the compensatory financing facility was meant to cover. In agriculture, the authorities were convinced that they had taken steps to improve production, but that fact in itself strongly suggested that the trends of agricultural production and exports had been within the control of the authorities themselves.

Commenting on the issue of cooperation, Mr. de Vries said that it was true that a member country need not have a stand-by arrangement in the upper credit tranches in order to qualify to use the compensatory financing facility. However, the Papua New Guinea authorities had obviously concluded that there were serious deficiencies in their economic and financial policies, and in introducing their new budget they had made a major policy reversal. There seemed to be some uncertainty about the application of the stricter cooperation criterion to Papua New Guinea and, as Mr. Prowse had suggested, it would be unfair to deny Papua New Guinea's request because of the questionable application of a policy that was to be debated separately in the Executive Board in the near future. To avoid prejudicing the outcome of that discussion, he would not oppose Papua New Guinea's request to use the compensatory financing facility.

Mr. Nana-Sinkam remarked that a requirement of need had to be established for the use of any of the Fund's resources by a member country. It was in that context that he had mentioned the reserves of Papua New Guinea.

Mr. Laske said that the comments by Mr. Prowse and the staff representatives had satisfied him to a certain extent, and he was willing to go along with the proposed decision. His concerns about Papua New Guinea's purchase request and the larger questions having to do with the operation of the compensatory financing facility had not been fully met, and he looked forward to the coming policy discussion.

After a further brief discussion, the Acting Chairman commented that the existence of a balance of payments need was a precondition for the use by a member country of any of the Fund's resources. Under the Articles, a balance of payments need existed when there was a balance of payments deficit, or an exceptionally low level of reserves, or a sizable change in the level of reserves. Any of those factors, either individually or in combination, could satisfy the balance of payments need requirement. As for the requirement of stricter cooperation with the Fund, he was fully convinced that Papua New Guinea had met it. The issue of cooperation would be fully discussed in the Executive Board in the near future.

Mr. Prowse remarked that the level of a country's reserves was usually the outcome of the implementation of a whole set of policies affecting the external accounts; the level of reserves should not be examined separately from the overall structure of the external accounts. In the case of Papua New Guinea, it was useful to note that the external deficit was projected at SDR 337 million in 1981 and SDR 525 million in 1982, a substantial portion of which was traceable to the official capital account. Conceivably there was some feeling that the level of official borrowing might be excessively high. However, the level of reserves was the balancing item in the external accounts, and any decline in reserves would not necessarily involve a decline in official borrowing; the question of the appropriate level of foreign borrowing was a complex one.

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

The decision was:

1. The Fund has received a request from the Government of Papua New Guinea for a purchase of the equivalent of SDR 45.0 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 Papua New Guinea and approves the purchase in accordance with the request.

Decision No. 6978-(81/136), adopted November 4, 1981

3. HUNGARY - MEMBERSHIP - EXPRESSION OF INTEREST

The Acting Chairman said that he had that morning received representatives from Hungary, led by Mr. Janos Fekete, a senior official in the central bank, who had handed him Hungary's formal application for membership in the Fund. The representatives had explained that they were planning to meet forthwith with the President of the World Bank to give him Hungary's application for membership in that institution. The Hungarian representatives had also said that they wished to inform the press about their application in Budapest later in the day. He intended to issue a short press communiqué on the matter, and a staff team would visit Hungary soon to collect the usual background data. Thereafter, a membership committee for Hungary would be established.

The Executive Directors took note of the Acting Chairman's statement.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/81/135 (10/30/81) and EBM/81/136 (11/4/81).

4. SAUDI ARABIA - TECHNICAL ASSISTANCE

In response to a request from the Saudi Arabian authorities for technical assistance, the Executive Board approves the proposal set forth in EBD/81/280 (10/28/81); and Cor. 1 (10/29/81).

Adopted November 3, 1981

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/81/344 (10/29/81) and by an Advisor to Executive Director as set forth in EBAP/81/348 (10/29/81) is approved.

APPROVED: March 17, 1982

LEO VAN HOUTVEN
Secretary