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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 81/130

10:00 a.m., October 9, 1981

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

Executive Directors	Alternate Executive Directors
	O. Kabbaj
	C. Taylor
A. Buira	
	L. E. J. Coene, Temporary
R. D. Erb	
	M. A. Janjua, Temporary
T. Hirao	A. Nagashima
J. C. Iarezza	
	M. Casey
	G. Jauregui, Temporary
B. Kharmawan	V. Supinit
S. Kiingi	F. Sangare
G. Laske	G. Winkelmann
G. Lovato	C. P. Caranicas
P. Mentré de Loye	P. D. Peroz, Temporary
S. Nana-Sinkam	A. Alfidja
	D. L. Kannangara
	S. El-Khouri, Temporary
J. J. Polak	T. de Vries
A. R. G. Prowse	B. Legarda
J. Sigurdsson	
	Tai Q.

J. W. Lang, Jr., Acting Secretary
J. A. Kay, Assistant

Also Present

African Department: J. B. Zulu, Director; E. L. Bornemann, E. A. Calamitsis, R. O. Carstens, I. A. H. Diogo, M. E. Edo, S. P. O. Itam, O. E. G. Johnson, B. Karlstroem, J. W. Kratz, J. K. Laker, W. J. Shields, D. E. Syvrud, U. Wilson. European Department: E. Croce, D. N. Lachman, T. M. Ter-Minassian. Exchange and Trade Relations Department: C. D. Finch, Director; S. J. Anjaria, E. H. Brau, K. B. Dillon, H. M. Flickenschild, P. J. Quirk. External Relations Department: G. P. Newman. Fiscal Affairs Department: C. A. Sisson. IMF Institute: S. Rossi, Participant. Legal Department: J. G. Evans, Jr., Deputy General Counsel; A. O. Liuksila, S. A. Silard. Research Department: G. I. Brown, K.-Y. Chu, N. M. Kaibni, G. Khatchadourian. Treasurer's Department: A. M. Al-Samarrie. Western Hemisphere Department: O. Albertelli. Bureau of Statistics: A. G. Muirragui. Finance and Development: S. I. Katz, Editor. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Director: E. A. Ajayi, C. Bouchard, A. B. Diao, J. U. Holst, K. V. Jännäri, A. K. Mullei, F. Yeo T. Y. Assistants to Executive Directors: E. M. Ainley, A. F. P. Bakker, L. Barbone, M. J. Callaghan, J. L. Feito, F. Guena, J. M. Jones, P. Kohnert, S.-W. Kwon, J. S. Mair, V. K. S. Nair, Y. Okubo, C. N. Pinfield, J. Schuijer, D. I. S. Shaw, O. Üçer, J. F. Williams.

1. ZAMBIA - PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered a request from Zambia for a purchase equivalent to SDR 59.3 million under the compensatory financing facility, together with a draft decision (EBS/81/194, 9/25/81; and Sup. 1, 10/5/81).

Mr. Kiingi explained that the request was based on an expected shortfall in export earnings for the 12-month period ended June 1981. The major cause of the shortfall had been the decline in the volume and price of copper and output of cobalt, commodities that constituted the major proportion of Zambia's exports. The volume and price of copper had fallen by 11 per cent and 8 per cent, respectively, from the average levels of the two preshortfall years. The staff had stated that the drop in export earnings had been due to factors largely beyond the control of the authorities, and it had agreed with the assessment of the Zambian authorities that the shortfall was of a temporary nature. Export earnings from both copper and cobalt were expected to improve substantially in the postshortfall years. The improvement in the performance of copper was expected to result from an increase in both volume and price, while the improvement in cobalt was expected to result from an increase in production.

The balance of pa ments position of Zambia, Mr. Kiingi went on, justified the proposed purchase, as could be seen in Table 1 of EBS/81/194. Gross international reserves had dropped to SDR 39.4 million in July 1981 from SDR 61.3 million in 1980, and a balance of payments deficit of some SDR 173 million was projected for 1981. The Zambian authorities had been cooperating fully with the Fund. Zambia had an extended arrangement with the Fund approved by the Executive Board on May 8, 1981, and the authorities were continuing to work closely with the Fund in their efforts to find appropriate solutions to the balance of payments problems of the country.

The request by Zambia met all the criteria laid down for a drawing under the compensatory financing facility, Mr. Kiingi concluded. He therefore hoped that the Executive Board would approve the request.

Mr. Erb stated that while he would support the request by Zambia, he wished to raise two questions regarding the mechanism of the compensatory financing facility. The first had to do with the fact that, as the staff had stated on page 11, the shortfall in cobalt could not be considered to be due to factors largely beyond the control of the member. He agreed with the staff assessment. It was clear that Zambia and other major cobalt producers had attempted to take advantage of a short-term development to fix the price of cobalt, which had been some $25 a pound in December 1980, or about four times the price level in 1978 and earlier years. Although the members of the cartel were unable to hold to their agreement, the producers, particularly those in Zambia, had continued to charge prices in the range of $12-17 a pound, which were high not only compared to pre-1979 prices but, more important, also high compared with those of the substitutes for cobalt. Naturally, there had been some shifting by users of cobalt to substitutes. He agreed with the staff's comment that Zambia would have to lower the price of cobalt still further if it wished to increase the volume of exports substantially in the next year or two. His information was that the price would probably have to fall to a range of $8-10 a pound to re-establish cobalt's competitive relationship with substitutes. It was true that, as the staff had noted, even if some adjustment were made to take into account Zambia's pricing policy for cobalt, it would not have a significant impact on the overall shortfall in 1980/81, the shortfall being due primarily to the decline in the price of copper. That was indeed the only reason for which the United States was prepared to support the request. In future, when the components of an export shortfall could be clearly attributed to circumstances not largely outside the authorities' control, those components ought to be excluded from the calculation of the shortfall.

The second point he wished to raise, Mr. Erb went on, was that the Zambian authorities had included in their request a statement to the effect that Zambia would cooperate with the Fund in efforts to find an appropriate solution to its balance of payments difficulties. In the light of Zambia's failure to meet its June performance criteria, it might well have been more appropriate to have waited until the evidence on whether Zambia had met the September 1981 performance criteria would be perfectly clear. Aside from that qualification, he did support the Zambian request.

Mr. El-Khouri remarked that the staff had estimated the size of the export shortfall to be SDR 257 million compared with the requested purchase of some SDR 60 million. A good case had been made for compensation for a shortfall in copper exports, estimated at SDR 192 million. The reasons for the copper shortfall were clearly beyond the control of the authorities, and the projections for the two postshortfall years were well justified. The case for the shortfall in cobalt was not very convincing, but the amount was no more than SDR 52 million. Zambia certainly had a balance of payments need and its foreign exchange position remained very weak. It was true that the authorities could have postponed the request for two or three weeks until it was known whether they had met the ceilings under the extended arrangement for end-September 1981. But the authorities had expressed their confidence that the ceilings would be met, and since the drawing would only bring Zambia's outstanding purchases under the compensatory financing facility to 50 per cent of quota, he could support the request in its present form.

Mr. Casey stated that he favored meeting the request by the Zambian authorities although he had a number of questions. First, much of the export shortfall appeared to be due to factors that were perhaps not entirely outside the control of the authorities. Among them were domestic strikes, transport difficulties, production bottlenecks, and especially the overpricing and withholding of cobalt exports. In general, he agreed with Mr. Erb that the withholding of an export commodity should not be counted as part of the shortfall, although in the present instance the exclusion would make little difference to the calculation.

Second, Mr. Casey went on, he noted that the requested drawing was much lower than the estimated shortfall. He wondered whether the intention was to limit the purchase to that portion of the shortfall that the staff regarded as being clearly beyond the control of the authorities; or whether the stricter test of cooperation (required if the drawings under the compensatory financing facility exceeded 50 per cent of quota) might not be met in view of the recent performance of the Zambian economy under the extended Fund facility. Third, the export recovery in copper in the two postshortfall years looked fairly reasonable. The forecasts of copper prices by certain agencies were indeed higher than those made by the staff, although others were perhaps slightly lower. But it would be useful to know how the staff had reached the forecasts for 1982 and 1983. It would also be useful to know why the staff predicted a zero increase in volume growth in copper exports for Zambia from one year to the next. Did the staff foresee supply constraints within Zambia or sluggish demand for copper among the industrial countries in 1983? Fourth, part of the recent deterioration in Zambia's balance of payments had been caused by imports of maize. He was not clear whether the deterioration had been due to an increase in price or an increase in volume, but he did wonder whether the authorities had given consideration to a request for a purchase under the integrated cereal facility. On the whole, however, the request by Zambia might be said to err on the side of caution, and he could certainly support it.

Mr. Polak said that he would approve the request by Zambia. However, the staff ought not to have placed the comments regarding the stocks of cobalt in a footnote at the bottom of page 9 but in the text itself. Admittedly, the figures were uncertain, but the uncertainty did not affect the conclusions in the end. He would not agree with Mr. Erb that cobalt should have been eliminated in making the calculations; rather its value should have been reduced as explained in the footnote. It would also be interesting to know whether, once the Zambian authorities were in compliance with the criteria for drawings under the existing extended Fund arrangement, they intended to apply for an additional 50 per cent of quota under the compensatory financing facility.

Mr. Taylor stated that he could support the proposed decision, although he shared some of the concerns expressed by Mr. Erb and others. Some of his concerns, particularly those relating to the interpretation of the test of cooperation and the need to clarify the meaning of the term "factors beyond a member's control," suggested that it might be appropriate to examine certain aspects of the operation of the compensatory financing facility. He understood that a paper on the test of cooperation was being prepared, and he wondered when it would become available. The case put forward by the Zambian authorities did seem to stress the need to define the concept of the term "factors beyond a member's control more fully." It seemed odd to him that the staff should include the shortfall in cobalt exports in their overall shortfall calculations, while recognizing that the shortfall could not be considered to be due to factors beyond the control of the member. He could certainly agree with the staff that the shortfall in copper earnings could be attributed to basic world price movements rather than to the effects of domestic bottlenecks. Nevertheless, while the bottlenecks persisted Zambia would be unable to realize its full export potential for copper, and he would therefore be interested to learn whether efforts were being made to overcome the bottlenecks, particularly in the transport sector. Executive Directors had noted that some of the end-June performance criteria under Zambia's extended arrangement with the Fund had not been met; he would therefore be grateful to learn whether the criteria for the end of September 1981 had been met.

There had been reports in the press, Mr. Taylor noted, to the effect that there had been a continued expansion of commercial credit in Zambia, and he wondered whether the staff was acquainted with them. If the expansion related in the main to import credit, the situation would be rather disturbing, especially as sharp reductions in external payments arrears had been provided for in the extended Fund arrangement. In passing, it would be interesting to know how the purchase under the compensatory financing facility, if approved, would affect the performance criteria relating to external arrears in the extended Fund arrangement. Directors might recall that the programmed reduction in arrears under the extended arrangement had been made partly dependent on export receipts. He therefore wondered whether a drawing under the compensatory financing facility would count as an export receipt for the purpose of the extended arrangement.

His questions, Mr. Taylor explained, were not to be taken as implying any criticism of the adjustment by the Zambian authorities or any lack of support for the request by his chair. They reflected his concern that there should be effective and successful cooperation between the Fund and the Zambian authorities.

Mr. Prowse stated that he would warmly support the request by the Zambian authorities. As he understood it, all the requirements for a drawing under the compensatory financing facility had been met. Consequently, the questions that he intended to raise were for purposes of clarification only; one of his objects was to obtain information with which to guide certain members of his constituency who were considering making applications for drawings under the compensatory financing facility in the near future. The two questions that he wished to put to the staff were: how was the amount of the shortfall determined, and how was the amount of the purchase calculated? It would have been helpful if the staff had given more precision regarding the calculation of the shortfall, since it had simply noted that even if the maximum possible adjustment were made to take account of the accumulated stocks of cobalt, the remaining amount of the shortfall would be three times the amount of the proposed purchase. It would be interesting to know whether the staff could estimate the amount of the shortfall that could be attributed to cobalt. His own feeling was that cobalt should not be included in the estimation of the shortfall at all.

There appeared to be some discrepancy between the views held by the staff on page 4 of the paper, where it stated that the copper shortfall of SDR 192 million was more related to price factors than to volume factors, and on page 11, where the staff had stated that the copper shortfall was related to declines of 11 per cent in volume and 8 per cent in price from the average levels of the two preshortfall years. There was also the question of how far the decline in export earnings was beyond the control of the authorities. Apart from the transport bottlenecks there had also been strikes. On page 7, the staff had noted that the authorities could not prevent the strikes but that they had taken prompt action to bring them to a close. In other words, the staff suggested that strikes were largely outside the control of the authorities. Nevertheless, some further clarification would be useful.

The purchase proposed was clearly far smaller than the shortfall, Mr. Prowse noted. He could envisage a number of possibilities as to why it should be so; the first was that the amount was chosen by the Zambian authorities to fit into their financial strategy; the second was that it was related to an adjusted measure of the shortfall to take account of various factors that other Directors had mentioned; the third was that 50 per cent was as far as the authorities cared to go with the request for the compensatory financing facility at a time when they might not be in complete compliance with the criteria under an extended Fund arrangement. It would be of considerable interest to know which of those explanations was the correct one.

The question of early repayment also seemed to arise in connection with Zambia's previous drawing under the compensatory financing facility, Mr. Prowse commented; the shortfall for the year ended March 1978 had turned out to be SDR 154.2 million while the purchase of SDR 48.75 million had been to offset that year's shortfall. Under the compensatory financing facility if the amount drawn on the basis of estimated data exceeded the amount that could have been drawn on the basis of actual data, a member had to make prompt repurchase. He wondered whether there was symmetry in that proposition, meaning that if the actual shortfall was larger than the estimated shortfall, would a country be entitled to make a second request for the same shortfall period?

Mr. Laske said that he too favored approval of Zambia's request for a drawing under the compensatory financing facility. The export shortfall had clearly been established, and the balance of payments need was indisputable. Like some other Executive Directors he had been interested in the question whether disruptions in production and delivery because of labor unrest and transportation difficulties could be clearly considered as events outside the control of the authorities for the purpose of calculating the export shortfall. He also wondered whether the expectation that there would be a substantial increase in the price of copper was not rather courageous. Experience showed that copper prices moved erratically at times, and in some instances in the past forecasts of copper prices had not been realized. Without casting any implied criticism on the efforts of the staff, it did seem to him that the price projections might turn out to be rather optimistic.

Finally, Mr. Laske continued, it was clear that Zambia's balance of payments difficulties went well beyond the question of an export shortfall, whether within or without the control of the authorities. The country suffered from much more fundamental distortions and imbalances, and he hoped that the negotiations between the authorities and the staff would bring the extended arrangement back on track. In that connection, he welcomed the statement by the Zambian authorities about adhering to the criteria at the end of September 1981.

Mr. Nana-Sinkam stated that he would reluctantly support the request by the Zambian authorities, not because of their failure to meet any criteria, but because he felt that the country ought to have been in a position to draw the maximum possible under the compensatory financing facility. He did however understand that the test of cooperation prevented the authorities from drawing more than 50 per cent of quota under the compensatory financing facility. Like others, he would have liked to see the authorities wait a few weeks longer to satisfy the Fund regarding adherence to the criteria under the extended Fund arrangement, and then draw the whole amount that would have been available to them. He certainly hoped that once the test of cooperation had been met, the country would be permitted to return for an additional 50 per cent of quota under the compensatory financing facility; the drawing would be justified on the basis of the copper shortfall alone.

Regarding Mr. Erb's point whether the cobalt shortfall was within the control of the authorities, Mr. Nana-Sinkam considered that most of the developing countries were in a dilemma. Developing countries for the most part had to struggle to obtain an appropriate return on production; very often the world price was far below the production cost in their own country, and if they tried to obtain anything like the real price of their labor and commodity, they tended to be criticized.

While he understood the working of the market system, Mr. Nana-Sinkam went on, he did not believe that it made very much sense when a developing country was struggling to obtain appropriate rewards for its output. In Cameroon, for instance, the producer received approximately $1 a kilogram of cocoa, while the market price to the retail consumer was some $2 a kilogram. The export price was however some $1.80 a kilogram and the Government had to make good the difference between the export price and the domestic price. The situation seemed to be somewhat similar with Zambia's copper.

Some Executive Directors had inquired whether the strike in Zambia had not been within the control of the authorities, Mr. Nana-Sinkam recalled. However, according to the staff, the strike had not really been concerned with wages. In any event, even if the authorities felt that by paying more for labor they would be receiving a smaller return from exports, the strike itself could hardly be considered as being within the control of the authorities. The difficulty for the authorities arose from the fact that they had to find more money from the budget with which to pay the higher wages and that in so doing they might fail to meet one of the criteria in a Fund program.

The Executive Directors representing industrial countries should sometimes be present when a Fund mission was establishing a program in a developing country in order to ensure that the mission understood the real facts of life on the spot, Mr. Nana-Sinkam considered, and he hoped that the staff would look into the possibility of ensuring that such arrangements were made for the future. It was very difficult for Executive Directors who had not visited developing countries themselves to understand the circumstances in which they were negotiating with the Fund.

An Executive Director had raised the question of whether there would really be no increase in the volume of copper production in Zambia between 1982 and 1983, Mr. Nana-Sinkam noted. What would be equally worth knowing was whether the production level foreseen by the staff would maximize revenue for the country concerned. Had the figure been chosen because any additional output would depress the world price, or because the price suited the Zambian authorities?

Mr. Sigurdsson commented that he would approve the proposed decision, although like others he had some questions concerning the way in which the case had been presented. Speakers had doubted whether certain of the shortfall components were indeed beyond the control of the authorities, and whether therefore they should be included in the calculation. The staff should perhaps consider preparing a short paper on that aspect of the compensatory financing facility, in order to see whether the teachings of the past could help to draw the line between events that were within the control of the authorities and those that were not from the standpoint of the facility. He would also welcome assurances that the authorities would be complying with the criteria laid down for end-September 1981 in the extended arrangement. He would also like to hear the staff's reply to Mr. Prowse's question whether, in the case of an underestimation of the shortfall, the country should not be entitled to apply for a further drawing once the actual shortfall had been calculated. Like Mr. Casey and others, he would be interested to hear the staff's explanation regarding the large increase in copper prices expected over the coming two years.

Mr. Kharmawan remarked that he could wholeheartedly support the request by the Zambian authorities; a balance of payments need had clearly been demonstrated. He welcomed the observations that had been made regarding the calculation of the shortfall; discussion of such points would improve the application of the facility which had already been in existence for some years. In general, he could support the line taken by the staff, although he would make a few additional comments.

The question of whether something was or was not beyond the control of the authorities was never easy to resolve, Mr. Kharmawan considered. His own view was that a strike was beyond the control of the authorities. While no government wished to tolerate a general strike, it was difficult to see what it could do if it had made every effort to avoid one and the strike still occurred. Naturally, there would be repercussions on both production and exports, but he would give the benefit of the doubt to the authorities in saying that those effects were outside their control.

Transportation bottlenecks might of course be in a different category, as it could be argued that the Government should have made greater efforts to overcome them. But there were many cases where even there a government was powerless to obtain the results that it might desire. It would really be unwise to examine in too much detail what fell within the control of the authorities and what fell outside.

On the question of stockpiling, the staff seemed to him to have taken the right line, Mr. Kharmawan went on. The staff had made the point that even if the stocks were included, the shortfall would still be substantial, and that the presence of the stocks would have no impact on the actual calculation of the shortfall or the entitlement of the country. Nevertheless, the question raised by Mr. Erb was an important one. Naturally, if at a given moment the price of a specific commodity like cobalt was increased substantially and it was found in later years that the price could not be maintained, there was bound to be stockpiling. Seen from the other side, if a country did not take advantage of the favorable market situation to raise the price at a given moment, its authorities might be considered to be acting unwisely. It was only natural that the market price of cobalt should rise if there were difficulties in Zaïre, one of the main sources; and the country ought not to be penalized if later the world economy underwent a downturn so that the price fell. How could it be argued that a country should be excluded from access to the compensatory financing facility because it did not adjust its price downward quickly enough? It really ought not to make very much difference whether the marketing of the commodity were in the hands of a government corporation or of the private sector. The staff seemed to have taken the right line by accepting that if a country tried to sell a commodity at a price higher than that prevailing in the world market it would have to accumulate stocks, and that in due course the stocks would have to be dissipated by reducing the price. Meanwhile--as he understood the staff position--there would be a shortfall even taking the stock into consideration, and the country ought therefore to be allowed to draw under the shortfall provisions of the compensatory financing facility.

Taking up the question of cooperation, Mr. Kharmawan said that he doubted whether it would be proper to insist on a country meeting the performance criteria under an extended arrangement as a test of cooperation with the Fund for drawing under the compensatory financing facility. An extended arrangement covered a much larger scope than was implied by a request for a drawing under the compensatory financing facility. Naturally, some sort of cooperation should be insisted upon, and it would be reasonable to urge a country to remove bottlenecks, such as those in transportation, that were hindering its exports. But it would be going too far to insist that a country should observe all the performance criteria and policy recommendations previously agreed upon with the Fund to have access to a drawing equivalent to 50 per cent of quota under the compensatory financing facility.

One final point that was certainly of interest, Mr. Kharmawan noted, was that in the calculations for the compensatory financing facility purchase by Zambia in 1978 the projections for the two shortfall years made by the staff had been lower than the actual outcome. Normally, the staff's projections had been rather more optimistic than the actual results.

Mr. Erb inquired to what extent the failure by the Zambian authorities to meet the performance criteria at the end of June 1981 had been related to any unexpected developments in imports or exports. Put differently, when the authorities were preparing for the extended Fund arrangement, had Zambia's actual exports during 1980/81 been fairly closely in line with the forecasts, or had actual export performance been worse than the forecast performance? He asked because he was interested in the replies to the question raised by Mr. Taylor, namely, whether a purchase under the compensatory financing facility could be considered as revenue in meeting the performance criteria under the extended arrangement. At first sight, if a country had deviated from the performance criteria because export developments had not turned out to be as expected, and exports fell off sufficiently to justify drawing under the compensatory financing facility, there might well be a justification for a larger drawing under the compensatory financing facility that would assist the country in meeting the performance criteria under the extended Fund arrangement. Such a position would of course only be defensible if, when the extended arrangement was being worked out, the forecast had not taken into account the pattern of exports during, say, 1981.

The staff representative from the African Department recalled that in August 1981 Article IV consultation discussions were held with Zambia and the staff had used the opportunity to conduct a review of the program under the extended arrangement. The report of that mission was in preparation and would be circulated to the Executive Directors within a few weeks. The mission had found that at the end of June 1981 most of the performance criteria had not been observed, although by relatively small amounts. In reply to a specific question, it had been the judgment of the mission that the nonobservance of the ceilings on credit to the Government and on overall credit had not been affected by the shortfall in export receipts. Export performance had in fact been worse during 1981 than had been thought likely at the time that the extended arrangement had been discussed, and the shortfall in export receipts had clearly had an impact on external payments arrears, which had turned out to be much higher than originally envisaged. As the Zambian authorities had stated that they believed they would be able to comply with the credit ceilings at the end of September 1981, the mission had concluded that it could not support a waiver of the credit ceilings for end-June 1981; it would be preferable to await the results for the end of September. However, the end-September results would not be known before some time late in October.

As the performance criteria had not been met at the end of June 1981, the staff representative went on, the purchase of SDR 90 million scheduled for mid-August 1981 could not be made, and the foreign exchange situation had deteriorated further. The staff had therefore thought that an immediate discussion of a request for a drawing under the compensatory financing facility would be helpful to the Zambian authorities, rather than asking them to wait for another month or so until data under the extended arrangement became available. Once the situation at the end of September 1981 was known, the staff would probably return to the Executive Board to propose a technical modification of the base figure for external arrears.

As to why the present purchase had been limited to 50 per cent of quota, the staff representative explained that it was his understanding that in the present circumstances, as some performance criteria had not been observed, it would be preferable to limit the purchase to that amount. Naturally, it would be proper to inquire what the position would be if the performance criteria were met at the end of September 1981. As already mentioned, the authorities had stated that they would be able to meet the ceilings at that time, and the staff took the view that technically they could do so, although there was no certainty. Once the figures were known, the staff, in discussing the program for the second year of the extended arrangement, would again examine whether there was justification for a further purchase under the compensatory financing facility. On the question of the recent trend in arrears, they had declined sharply following the first purchase under the extended arrangement in May, but they had begun to increase again in recent months, although relatively slowly.

In drawing up the extended arrangement, the staff representative from the African Department added, the staff had assumed that Zambia's copper production would be roughly 600,000 tons a year for each of the three years in the period. Such a forecast seemed reasonable, because during the past few years copper production had actually been declining from a previous level of about 700,000 tons a year. As Zambia's copper had been mined for many years, the room for expansion appeared to be limited. In addition to the technical factors associated with the mining operations, there continued to be problems with the supply of adequate spare parts and skilled manpower. The lack of adequate transportation had also caused some decline in export volume, for reasons that were largely beyond the control of the Zambian authorities. They could not be held responsible either for congestion in the port of Dar es Salaam in Tanzania, or for the transportation difficulties that had arisen between Zambia's borders and the sea ports.

The staff representative from the Research Department commented that the question of stock adjustment very rarely had to be faced in connection with drawings under the compensatory financing facility. The procedures for dealing with the matter had been first discussed and adopted by the Executive Board in 1976 and reviewed in 1979. When stocks were accumulated as a result of commitments under international agreements, the stocking was deemed to be outside the control of the member, and no action was taken to adjust any compensation that might be due. There had been some 12 cases since 1976 in which the staff had had to take account of stocking a commodity instead of selling it in connection with a drawing under the compensatory financing facility, but in only 2 of those cases had the amount of the compensation been affected.

Under existing procedures, the staff representative explained, it was necessary to try to estimate the value of the stocks accumulated during the shortfall year and to add that amount to the value of the commodities exported during the shortfall year. To the extent that the stocks were included in the projection for the next two years their value should be subtracted from the exports in those years. It was not always easy to decide on the price that ought to be attached to the stocked commodity. In the case of Zambia's cobalt, if in fact the country had been able to sell the stocks at the price it realized on its cobalt exports during the shortfall year, it would have obviously sold the stocks. The estimated value of the stocks, mentioned in a footnote by the staff, had been based on that assumption. The staff's purpose had however been to show that even if the cobalt were valued at that unrealistically high price, Zambia's total exports would still have shown a shortfall that was significantly larger than the drawing. Also, the estimated value of stocks had been inflated because the total volume of stocks, rather than the change in stocks, was used. On page 9 of EBS/81/194 the staff had shown that Zambia had held 2,350 tons of cobalt at the end of June 1981, of which 1,678 tons--it was now known--had been accumulated during the shortfall year. Applying the procedure described in the footnote, the value of cobalt exports should be raised by SDR 56 million in the shortfall year and reduced by SDR 50 million in the post-shortfall years. There would in fact have been a small shortfall of SDR 2 million on account of cobalt exports, and the shortfall in total exports would have been reduced to SDR 205 million. Had that information been available, the staff would have been able to show more explicitly the calculation of the compensable amount.

The exclusion of cobalt from export data, suggested by Mr. Erb, was not in fact the procedure used by the staff, the staff representative explained. To make such an exclusion would not give a true reflection of changes in stocks on the calculation of the shortfall. In the present case, the adjustment by exclusion suggested by Mr. Erb would result in roughly the same reduction in the shortfall as the reduction based on the method applied by the staff; but if cobalt were a major commodity, it could influence the figures very substantially. The staff only made very few adjustments in compensation for stockpiling because of lack of reliable data on stocks, and then only when the available data suggested they were significant to the calculation of the shortfall.

The projected growth in exports was another area where it was difficult to make estimates for individual years, the staff representative explained. The apparent stability of the volume of copper exports projected for the two postshortfall years should be viewed as an average over a two-year period, and not necessarily a precise projection for each year. The staff also paid considerable attention to the way in which it made price projections using quantitative methods as well as quantitative judgments. One point worth noting was that price projections that might appear excessive when looked at in terms of SDRs were more reasonable in terms of U.S. dollars. In that sense, the staff had estimated a price increase of some 10 per cent for copper in the first year and 21 per cent in the second year. What had counted heavily in making the estimate was the fact that stock levels were extremely low, not only in the industrial countries but also in producing countries. The reason might be that the high rates of interest had made holding stocks more costly than usual.

As to the question of whether the shortfall was due to a decline in the price or the volume of copper, the staff representative continued, it could be seen from Table 4 that in 1981, the shortfall year, both the volume and the unit value had fallen substantially from their average levels in the two preshortfall years. In the last column of the same table, which showed the value shortfall separated into its volume and price shortfalls, it could be seen that the volume shortfall was 9.0 per cent and the unit value was 14.7 per cent, leading to the conclusion that the value shortfall was related more closely to price than to volume factors. The difference in the formulation, referred to by Mr. Prowse, arose from the fact that in the one case the staff had been comparing the figures in the two preshortfall years, whereas in the other the staff had been making a comparison with the trend, which included not only the two preshortfall years, but also the two postshortfall years.

There was also the question of whether the member was entitled to additional compensation to offset the undercompensation received by the authorities in connection with a drawing under the compensatory financing facility in 1978, the staff representative from the Research Department observed. The drawing, which had been made in May 1978, related to a shortfall for the year ended March 1978. At that time, under the procedures laid down for the compensatory financing facility, the maximum amount of a drawing under the facility could not exceed 75 per cent of quota. Zambia's drawing, which had been equivalent to some 35 per cent of quota, had raised the Fund's holdings of Zambia's currency to the then maximum of 75 per cent of quota. Consequently, Zambia could not have purchased more at that moment, regardless of the size of the shortfall. The second part of the question was of course whether, when the shortfall based on actual rather than projected exports suggested that the member had been undercompensated, it was possible to offer the country post hoc compensation. The main difficulty was that the actual data only became known some two years after the date of purchase. For instance, the drawings concerned had been made in May 1978 and the data for the two postshortfall years had perhaps become known by June 1980. In the interval the rules for drawings on the compensatory financing facility had been changed. But, more significantly, under the terms of the decision on compensatory financing, Zambia would have had to present a new request; and since each request had to be based on its own merit, the shortfall supporting the request would have had to be based on the latest available data, rather than the 1978 data.

The staff representative from the Legal Department, discussing the question of cooperation between Zambia and the Fund, remarked that in order to be able to make a drawing under the compensatory financing facility up to 50 per cent of the member's quota, the member would have to express its willingness to cooperate with the Fund in finding appropriate solutions to its balance of payments difficulties; and the Zambian authorities had indeed done so. Even when a stand-by arrangement or extended arrangement was not being observed, it was important to maintain the principle of the uniform treatment of members. Any arrangement for a member was bound to carry with it the inherent risk of nonobservance of some criteria at one time or another. If the criteria were not observed at a given moment, it was possible that they would be observed later, that a waiver may be granted, or that the arrangement might have to be modified or even canceled in favor of a new arrangement. But, a member should be able to enter into an arrangement with confidence, without having to feel that it would forgo access to the Fund's other facilities if certain of the performance criteria were not observed. At the present time, the satisfaction of criteria under an arrangement in effect at the time when a member made a request for a purchase up to 50 per cent of its quota under the compensatory financing facility did not enter into consideration in connection with the request, and the staff view was that it ought not to do so. One way of looking at the matter was to say that whether or not a member had a prior stand-by or extended arrangement it should be able to come to the Fund and seek compensation for a shortfall that was largely beyond its control, knowing that the Fund would grant its request up to 50 per cent of the member's quota if it was satisfied that the member would cooperate with the Fund in finding appropriate solutions for its balance of payments difficulties.

The question of a possible adjustment for the case when the calculated shortfall had turned out to be smaller than the actual shortfall had been raised by a number of Executive Directors, the staff representative from the Legal Department recalled. It would be quite difficult to provide for a future purchase increasing the amount of the compensation in a case such as that presented by Zambia. The country had submitted a request that would bring its drawing up to 50 per cent of quota. If the later request for an increase took the total beyond the 50 per cent figure, in order to grant the request the Executive Board would have to take a different view of the extent of cooperation between the member and the Fund, which in the present case was that the cooperation justified a drawing up to 50 per cent of quota and no more.

Mr. Erb commented that he had some difficulty with the staff's method of calculating the adjustment for stocks. After all, a government might decide to hold production down rather than to accumulate stocks, and there would be no way of taking that action into account in the present type of calculation. More generally, he was rather disturbed by the vagueness of the concept of what was inside and what was outside the control of the authorities.

The Chairman indicated that the staff would certainly have to study the complex topics raised by Mr. Erb and Mr. Kharmawan, although it might not be possible to obtain any clear-cut answers.

Mr. Erb admitted that there was such a variety of circumstances that it might be difficult to find any clear-cut solution. In the present case, however, it was clear that the Government had sought to enter a commodity agreement that would fix the price of cobalt. He had no difficulty with the group raising the price during a period when world market prices had been rising sharply; what disturbed him was that it had been unwilling to reduce prices sufficiently rapidly when world demand changed.

The Chairman said that he understood Mr. Erb's point. However, had the same type of action been taken by a multinational corporation, it would have been very difficult to say whether the action was within or without the control of the authorities.

Mr. Prowse commented that the question of stocks had been clearly set out in IMF Pamphlet No. 34, on the compensatory financing facility. His only thought was that slightly more precision regarding the matter of calculation of the shortfall might have been given in the present paper.

Mr. Kiingi observed that all Executive Directors who had spoken had supported the request, some more enthusiastically than others. While there might be some advantage in reviewing the decision on compensatory financing to see whether it was possible to improve upon the test of cooperation, in the present instance the amount requested by the authorities was so small that the only reproach that could be made to the staff was that it had perhaps erred excessively on the side of caution. The transportation bottlenecks were largely beyond the control of the member, while the internal transportation difficulties were of a structural nature. There was little that the government of a developing country could do about them in the short term. The question of the inclusion or exclusion of cobalt in the shortfall calculations was of course a technical matter; his own approach to the problem would have been to calculate the shortfall, to determine the extent to which it had been affected by factors beyond the control of the member, and then to decide the extent to which the shortfall should have been avoided. In other words, there would be two separate exercises to determine what should be included or what should be excluded. There could be no doubt that, even if in June 1981 his Zambian authorities had not met all the criteria under the extended arrangement, they had been cooperating with the Fund, and he was glad to hear that the staff believed that the next review under the extended arrangement would be more positive. When the team from Zambia had been in Washington, its members had tried to meet not only the staff members but the Managing Director himself to explain the difficulties against which they were working, and to show how much they desired to work with the Fund in overcoming them. He would certainly communicate to his authorities the observations made by Executive Directors, and he thanked the Executive Board for its support.

The Executive Board then took the following decision:

1. The Fund has received a request from the Government of Zambia for a purchase equivalent to SDR 59.3 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

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

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

Decision No. 6964-(81/130), adopted
October 9, 1981

2. ITALY - EXCHANGE SYSTEM, AND CONSULTATION WITH CONTRACTING PARTIES TO GATT - FUND GUIDANCE

The Executive Directors considered a paper on the extension of the Italian import deposit requirement introduced on May 28, 1981, until February 28, 1982 (EBS/81/199, 10/6/81; and Cor. 1, 10/8/81). They also considered a proposed Fund statement to the CONTRACTING PARTIES to the GATT in connection with the GATT consultation with Italy on the advance deposit requirement scheduled for October 13, 1981 in Geneva (EBD/81/253, 10/6/81; and Cor. 1, 10/8/81).

Mr. Lovato made the following statement:

As the economic developments of Italy have been thoroughly reviewed during the recent Article IV consultation, I will confine myself to the more recent evolutions which have prompted the decision of my authorities to phase out the compulsory deposit scheme adopted on May 27 this year over the period October 1, 1981 to February 28, 1982, ending definitively on the latter date. In my authorities' view, although some of the reasons for the setting-up of the scheme appear less pressing at this time, prudential considerations recommend the phasing out in order to avoid sharp movements in foreign currency and liquidity flows. Let me remind the Board that the scheme was introduced at a time when the balance of payments appeared to be rapidly deteriorating. In fact, during the first five months of 1981 the current account balance on a cash basis recorded a deficit of some Lit 7.4 trillion, with a sizable worsening in May. During the same period net medium- and long-term capital inflows, partly of a compensatory nature, totaled Lit 2.7 trillion so that the overall balance came to Lit -4.9 trillion; since capital outflows through the banks amounted to Lit 700 billion, the net foreign position of the Bank of Italy, after exchange rate and gold price adjustments, deteriorated by some Lit 5.6 trillion.

Foreign exchange reserves fell from $10.9 billion at end-1980 to $5.5 billion at end-May. Interventions in the foreign exchange market by the Bank of Italy amounted to some $120 million a day during the second half of May.

At the same time the appreciation of the dollar, in a context of unsettled international financial markets, the liquidity creation resulting from a growing treasury financing requirement, and the continuing relative strength of the domestic economy combined to create a very difficult situation. Beyond these developments, the political crisis which led to the sudden resignation of the Italian Government on May 26 brought about a sharp deterioration of the economic climate, and specifically of the balance of payments. In the absence of prompt and effective measures, adverse speculative movements against the lira might have gathered momentum, leading to a full-fledged foreign exchange crisis. This was regarded by the Italian authorities as an unacceptable risk. Therefore, the authorities, being well aware that the deposit scheme could provide only a temporary relief, took a set of vigorous economic policy decisions and measures. Specifically:

Since July the Bank of Italy has abandoned its policy of purchasing at issue treasury bills and certificates not taken up by the banks and public, thereby improving its ability to control flows of monetary base creation.

In August measures to commence a gradual unification of public sector operations were brought into force; in fact, local authorities have been required to deposit their liquid balances held with banks with the Treasury.

The budget for next year is focused on curtailing the expansion of expenditure aggregates, a goal that becomes all the more urgent as it proves increasingly difficult to cut back the state sector borrowing requirement in 1981 to the set limit and as the rising trend of current spending caused by past legislation gains strength in 1982. The deficit, as a percentage of GDP, is forecast as declining, and major changes in expenditure procedures and parameters are defusing the mechanisms of automatic increase that threaten to make public spending uncontrollable.

The tight budget policy accompanies the efforts that have been made since the new Government was formed to promote an agreement with management and labor on a course to reduce inflation. These complex negotiations revolve around the establishment of a limit on the increase in labor costs, within the general context of a programed and decreasing rate of inflation.

> Interest rates on bank loans were, on average, raised by 2 points since the beginning of the year; the gradual easing of inflation amplified the effects on real rates. Interest rates on treasury bills were gradually pushed up, from 17 per cent to over 20 per cent. On the bond market the rise came to more than 4 per cent; the present level of 20.5 per cent is well above the expected rate of inflation.

All these economic policy decisions correspond to, and are in line with, the recommendations made by this Board last July during the discussions on the Article IV consultation with Italy.

While the authorities were fully convinced of the necessity of implementing with determination the measures I have just mentioned, they recognized that it would have taken time before any favorable effects could materialize.

Since the inception of the scheme, the deposit requirement has entailed a liquidity drain of some Lit 1.8 trillion a month during its first three months of operation: at end-August the total amount of frozen deposits was Lit 5.5 trillion. In September new deposits should broadly match the release of those made in June.

In the three months from June to August the balance of payments recorded a significant improvement. The current account surplus (still on a cash basis) amounted to nearly Lit 2.7 trillion. With medium- and long-term capital inflows totaling Lit 2.8 trillion, the overall balance came to Lit 5.5 trillion. Net banking flows continued to show a deficit of about Lit 1 trillion; consequently the net gain in the external position of the Bank of Italy came to Lit 4.5 trillion. Foreign exchange reserves rose back up, to stand at some $9.2 billion at mid-September.

In evaluating the effects of the scheme, let me stress the fact that the additional cost for the importers is estimated at less than 2 per cent of the import value. For this reason and on the basis of the available data, it does not appear that real flows of imported goods have been markedly affected by the measure.

It goes without saying that the improvement in the balance of payments has also been made possible by the favorable evolution in both relative cyclical and competitive positions. In fact, the positive gap existing between the level of activity in Italy and the other major countries has been narrowing. At the beginning of the year the growth rate of industrial production was 4 per cent higher in Italy than in the other big six OECD countries. In recent months Italian industrial production appears to be at the same level as the other countries. At the same time, the competitive position has benefited from both the slowing down of the inflation rate and the depreciation of the Italian lira vis-à-vis the dollar and the currencies in the European Monetary System.

Within this new economic context, as I have said, the deposit on purchases of foreign exchange could now appear to be less necessary. There are nevertheless some reasons for which it should be abolished gradually:

First, the economic policy measures that I have mentioned and which this Board recommended to be taken, need some time in order to exert their effects in full; specifically, the decisions to curtail the current public deficit will not be able to produce their effects until the early months of 1982.

Second, a simple abolition would lead to a concentration of foreign currency payments, both current and deferred, at a seasonally unfavorable time.

Third, with a simple abolition, liquidity would return to the financial system at a time when liquidity creation by the Treasury is high. I would like to recall that about 35 per cent of the year's borrowing requirements occur in the last quarter of the year. A sudden increase of the liquidity would surely impair the program of the monetary authorities.

Given the present high level of interest rates (also in real terms), alternative measures for controlling the liquidity--and in particular an increase of the reserve requirements--have not been considered advisable by my authorities insofar as they could accelerate the disintermediation process of the banks.

A gradual elimination of the import deposit scheme on the one hand would avoid strong movements in foreign currency and liquidity flows, and, on the other, it would not seriously affect the export of Italy's trade partners. The import deposit scheme has primarily affected the structure of payments, thereby confirming its function, stressed from the outset, as an instrument specifically designed to provide temporary relief from external payments difficulties and to permit a direct and efficient drainage of the economy's liquidity.

In this context, it is useful to remember that during 1981 credit aggregates will probably grow by 18.2 per cent, with some uncertainty coming particularly from the still unclear size of the public sector's borrowing requirements. Of the expected Lit 73 trillion growth in total domestic credit, Lit 29 trillion should go to the private sector. On the assets side, there has been a considerable reduction in the rate of expansion of currency and deposits (to about 10 per cent), with a shift from the banks' system to the Treasury because of a better return, as already mentioned. On the whole, the rate of growth of the economy's financial assets is forecast to be about 17 per cent.

The need for a gradual phasing out of the scheme is also emphasized by the outlook for 1982. This is in fact strongly conditioned by the economic program that the Italian Government is determined to pursue. As previously mentioned, it provides for a reduction of the public sector deficit of about 2 percentage points of GDP. In nominal terms, this would imply a public sector deficit of about Lit 50 trillion, equivalent to the likely 1981 figures, i.e., in real terms, there would be a substantial reduction. This is an ambitious target and it might be a rather difficult goal to achieve; in conjunction with moderation in the wage demands on the part of the unions, it might allow for a certain improvement in the real aggregates. Real GDP should in fact increase by 1 per cent. According to some official estimates it could rise to 2 per cent, with a reduction in the inflation rate from 20 per cent to about 16 per cent. The current account of the balance of payments should show an improvement, with a decrease of the deficit from Lit 11 trillion in 1981 to Lit 9 trillion (i.e., from 2.8 per cent to 1.9 per cent of GDP).

Given however the uncertainties connected to the size of the public sector deficit, a strict monetary policy will have to be maintained; but that could be imperiled instead by an immediate and complete abolition of the deposit scheme, and a consequent sudden return of liquidity to the financial system.

These are the reasons why my authorities decided to phase out the deposit scheme, and these are the reasons why the EEC authorities approved the measure.

Mr. Taylor stated that he would support the proposed decision set out in EBS/81/199 for an extension of the approval of the exchange restrictions adopted by the Italian authorities, as well as the statement for the CONTRACTING PARTIES to the GATT. He agreed with the analysis and the views of the staff. He was glad to see that both circumstances and policy adjustment allowed the deposit requirement scheme to be removed, and he appreciated that the removal would take place over a number of months for the reasons that had been given.

Mr. Prowse said that he would approve the proposed decision, on the assumption that the Italian authorities had decided to phase out the deposit requirement scheme and undertake the policy adjustments described by Mr. Lovato. The assessment of the effects of the scheme had perhaps not been as comprehensive as might have been hoped for, and he wondered whether, once the scheme was terminated at the end of February 1982, it would be possible to have a review of the costs and benefits for the Italian economy. During the recent discussion of the Article IV consultation with Italy (EBM/81/101) the Executive Board had put forward the view that such schemes were generally undesirable, particularly because they did not address the fundamental problems of the economy. Mr. Lovato had made as good a case as possible that in some circumstances such schemes might be justifiable; but he would like to have more information on the end result. The staff stated that the scheme had had a significant impact on the balance of payments but it had had to admit that the effect had been more on the timing of imports than on the volume. He had received the impression that the result had been a rise in trade credit flows, which might well be reversed when the import payments were made in due course, resulting in a large bunching of import payments. The gradual phasing out of the scheme did seem to be justified, since it should have the effect of overcoming the sudden unwinding of the leads and lags that otherwise seemed unavoidable. But he would like to be assured that importers would not be delaying payments until after the end of February 1982. In any event, it seemed likely that there would be a sudden increase in liquidity when the scheme was withdrawn, and he wondered whether the Italian authorities would not find it necessary to take some offsetting action in the early part of the year.

At the time of the Article IV consultation, Mr. Prowse recalled, several speakers had said that it seemed unlikely that the advance deposit scheme would help the underlying economic conditions in the Italian economy. While the Executive Board might have been slightly pessimistic, and capital outflows during the period had been slowed down, there must have been costs in terms of economic management that would still need to be reviewed.

Import payments were being delayed and the effect on the budget was quite unresolved, Mr. Prowse considered. It was therefore worth drawing attention to the staff's language on page 9 of EBS/81/199, where it said that it was regrettable that restrictive action relating to international payments had been resorted to in lieu of appropriate adjustment of macroeconomic policies. The staff had gone on to say that it was essential that corrective action of a fundamental nature be adopted if the need for future recourse to payments restrictions was to be avoided. While he would endorse that comment, he understood from Mr. Lovato that the Italian authorities did have some such policy adjustments in mind. Meanwhile, he would like to see the language of the decision redrafted somewhat to indicate less enthusiasm for the advance deposit requirement itself. The language could be:

> The Fund noted the decision of the Italian authorities to phase out the exchange restriction arising from the retention by Italy of the deposit requirement on most foreign exchange purchases, as described in EBS/81/199 and Correction 1, and accordingly grants approval of the restriction until February 28, 1982.

His own approval of the extension was based on the decision that it would be phased out in February 1982 rather than on the existence of the scheme as such.

Mr. Sigurdsson recalled that during the discussion of the Article IV consultation with Italy at EBM/81/101 he, like many others, had expressed his authorities' regret that Italy had found it necessary to introduce payments restrictions. It had seemed doubtful then, and it still seemed doubtful, that the measure would help to solve Italy's economic problems. It was therefore easy to agree with the staff appraisal of the scheme, and with the passage quoted by Mr. Prowse. His authorities welcomed the decision by the Italian authorities to eliminate the deposit requirement by February 28, 1982. He could support the proposed decision to grant approval for a phasing out by that date. He stressed the importance for the Italian authorities of adhering strictly to that decision, which he liked to consider as the technical implementation of the original decision to eliminate the deposit requirement by September 30, 1981.

As to the consultation with the GATT, Mr. Sigurdsson went on, he could in general accept the proposed statement set out in EBD/81/253; but he would prefer to see rather more qualified support for the supposed effects of the deposit scheme on the balance of payments. He was particularly unhappy with such remarks as "the deposit scheme itself and a further tightening of monetary policy were also important factors," and "it would appear that the scheme has had a significant impact on the balance of payments and to a lesser extent on domestic liquidity." Such language might be taken to imply that the Fund had been giving the scheme more credit than it deserved.

Mr. Laske stated that he could support the proposed decision to extend the approval of the exchange restrictions introduced by the Italian authorities in May 1981 and approved by the Executive Board in early July. At that time, doubts had been expressed about the wisdom of such a scheme, and they had not yet been completely eliminated. His authorities were glad that the Italian authorities had decided to terminate the scheme, although they would have preferred it if the decision had been to terminate it at the end of September as previously envisaged. He could however understand the reasons why the Italian authorities had opted for a gradual phasing out of the scheme; nevertheless, like other speakers, he placed considerable importance on the adoption of appropriate overall economic measures by the authorities to deal with their balance of payments situation. Naturally, he hoped that they would find it possible to phase out the scheme more rapidly than they currently envisaged.

Mr. Polak remarked that he was glad that the Italian authorities intended to terminate the import deposit scheme; his only regret was that they intended to take five months to do so. It was important to stress that the scheme was not desirable either as a means of controlling domestic liquidity or as a way of affecting the balance of payments. He had heard Mr. Lovato's argument in favor of phasing out the scheme rather than an immediate elimination. Indeed, it might perhaps have been predicted that the Executive Board would be faced with such a position at the end of September 1981. He would like the staff to look into past history and to see whether all such schemes had not in fact been phased out rather than eliminated, even though elimination at a particular date had originally been proposed to the Fund.

So far as the guidance for the CONTRACTING PARTIES to the GATT was concerned, he had views similar to those of Mr. Sigurdsson, Mr. Polak said. Moreover, he wondered whether the Fund could not find a better way of describing what had taken place during the realignment in the European Monetary System. It might be preferable to say that the lira and the French franc had been devalued by 8.5 per cent compared with the deutsche mark and the Dutch guilder and by 3 per cent compared with the Belgian franc, the Irish pound, etc., rather than to adopt the language of the European Monetary System.

Mr. Kharmawan said that he too could support the proposal for extending approval of the deposit scheme introduced by the Italian authorities, even though, like others, he would have preferred it if the scheme could have been terminated on September 30, 1981. Some of the arguments put forward by Mr. Lovato for phasing out the scheme were not entirely convincing. For instance, there was bound to be an increase in liquidity regardless of whether the scheme was eliminated on September 30, 1981 or on February 28, 1982. Nevertheless, the Italian authorities should be given the benefit of the doubt so far as knowing how to run their own economy was concerned, and he could agree with the request that the scheme be phased out.

At the same time, Mr. Kharmawan went on, he had some difficulty with the justification that the staff had put forward on behalf of the import deposit scheme. For instance, the staff had written that the deposit requirement was introduced as a temporary measure to limit speculative inventory accumulation, and to promote balance of payments adjustment. He wondered whether that was correct, and whether the Fund did consider import deposit schemes as a device for promoting balance of payments adjustment. On the contrary, it seemed to him that import deposit requirements retarded the balance of payments adjustment by putting off the day when appropriate measures addressed to the underlying situation would have to be introduced. A better formulation was to be found in EBS/81/125, page 4, where the staff had written: "The introduction of the import deposit requirement is likely to provide a temporary reinforcement to monetary restraint efforts by draining liquidity (or reducing the room available for other credit expansion under the ceilings). Nevertheless, the staff is of the view that the objectives of the temporary measure will be better served by a sustained strengthening of more general policy actions rather than by a measure that is directed specifically against imports."

Moreover, Mr. Kharmawan continued, in EBS/81/199, page 5, the staff had written: "Preliminary data provided by the Bank of Italy suggest that while a more favorable evolution in both relative cyclical and competitive positions contributed to the improvement in the balance of payments, the main factors behind such improvement must be related to the deposit scheme itself and a further tightening of monetary policy." He doubted whether that was a true statement. Surely it would be more important to lay emphasis on appropriate monetary policy than to impute merits to the deposit scheme as one of the main factors behind any improvement. Similarly, in the guidance for the CONTRACTING PARTIES to the GATT the Fund had reluctantly given approval to the introduction of the advance deposit scheme, saying that the authorities should also take fundamental measures. Now it appeared to be endorsing the scheme as contributing substantially to the improvement of the balance of payments. It would be most unwise for the Fund to deviate from its formal stance with respect to import deposit schemes.

When the United Kingdom had introduced a scheme of the same sort, Mr. Kharmawan continued, he recalled that the whole Executive Board had been extremely critical. And, when his own country had adopted another similar scheme--in which he had played some part--the Executive Board had commented that it was unlikely to be successful, and it had not been. All that such deposit schemes did was to postpone the moment when other measures had to be introduced, and they definitely contributed to bunching, a point to which the Italian authorities would have to pay great attention at the end of February 1982.

The most important thing, however, was to avoid giving the appearance of staff support for the scheme, especially when there was no statistical evidence that it had contributed substantially to any improvement that there might have been in the Italian economy, Mr. Kharmawan stated. He therefore doubted the correctness of the language in EBS/81/199 or the wisdom of offering guidance to the CONTRACTING PARTIES to the GATT in the form in which it was set out in EBD/81/253.

Mr. Hirao stated that, like other Executive Directors, he could support the proposed decision extending Fund approval for the imposition of import deposits by the Italian authorities until the end of February 1982. It was regrettable that the authorities had been unable to discontinue the deposit requirement at the end of September 1981. However, in view of the continued uncertainties in the foreign exchange market, the seasonal nature of the Italian balance of payments, and the Italian authorities' efforts to take appropriate measures to correct the fundamental weaknesses in the economy, he warmly supported the proposed decision.

Mr. Erb recalled that in July 1981 his U.S. colleague had expressed reluctant support for the decision, and that he had expressed the hope that the Italian authorities would remove the import deposit scheme as rapidly as possible. He understood the problems that the Italian authorities had been facing, and he agreed with the decision to permit a gradual phasing out of the import deposit scheme by February 1982. He would, however support Mr. Prowse's proposed amendment to the decision to make it more explicit. He would also agree with Mr. Prowse's suggestion that the matter should be looked at <u>ex post</u> if at all possible. Only in that way would it be possible to obtain the underlying data with which to conduct a satisfactory review of the impact of the scheme. Like Mr. Sigurdsson, Mr. Polak, and Mr. Kharmawan, he felt that the language in the guidance for the CONTRACTING PARTIES to the GATT put the deposit scheme in too favorable a light.

From his standpoint, Mr. Erb went on, the introduction of the deposit scheme significantly had exacerbated Italy's balance of payments position and the exchange rate deterioration of recent months by enabling the authorities to postpone more fundamental decisions. Some change in the guidance for the CONTRACTING PARTIES to the GATT was therefore desirable.

Mr. Peroz stated that the proposed decision should be considered as a gradual elimination of the present scheme rather than as a straightforward approval of an extension of the scheme itself. It was clear to him, as it had been to Mr. Sigurdsson, that the present proposal was essentially a technical adaptation of the original measure. In particular, the possible consequences for exchange rates and for undesirable domestic movements if the deposit were eliminated forthwith, considerations put forward by the Italian authorities, were quite acceptable. In those circumstances he had no difficulty in supporting the proposed decision.

Mr. Coene said that he agreed with the views expressed in the staff appraisal. He would however like to see the language put forward by Mr. Prowse adopted and the guidance for the CONTRACTING PARTIES to the GATT adjusted accordingly. He was glad that the Italian authorities had decided gradually to eliminate the deposit scheme, but he would have been happier still if they had eliminated it in a shorter period.

Mr. Jauregui stated that it was clear that the Italian authorities had made considerable efforts to implement the necessary economic policies, and that what they had done was likely to improve the macroeconomic situation. In particular, their intention to limit the public sector deficit to 2 per cent of GNP and to grant new autonomy to the monetary authorities represented major advances. He agreed with Mr. Lovato that an abrupt phasing out of the import deposit scheme would unnecessarily increase liquidity and consequently be counterproductive to the monetary policy stance taken by the authorities. He therefore warmly supported the decision that the scheme should be phased out within the next five months.

Mr. Casey commented that it was disappointing that the import deposit scheme was not to be dismantled immediately, as provided for in the existing decision. Like Mr. Laske and others, he hoped that the envisaged phasing out could be accomplished before the end of February 1982. But the reasons for the phased approach were understandable. The sudden unwinding of leads and lags would clearly put pressure on the balance of payments, and he noted that the balance of payments deficit tended to increase toward the end of the year for seasonal reasons. Nevertheless, like Mr. Polak, he did not fully understand why such problems were not foreseen both by the Italian authorities and by the staff when the previous decision had been proposed to the Executive Board, especially since a rather similar scheme introduced by the Italian authorities in 1976/77 had had to be phased out gradually. He also noted that the Fund had not been informed about the intention to adopt the phased approach until September 30, 1981, the deadline for compliance with the previous decision. He therefore wondered whether the staff had been informed at least unofficially beforehand.

An argument put forward by the Italian authorities in favor of the phased approach, Mr. Casey went on, was the desire to avoid a sudden release of liquidity. He wondered how serious the increase in liquidity might prove to be in practice. It was at least conceivable that short-run capital outflows would have a major offsetting effect on liquidity creation; in any event, macroeconomic policies could be tightened to offset any sharp increase in liquidity.

On the macroeconomic level, Mr. Casey observed, it was encouraging to note that inflation had leveled off, so that interest rates were now more appropriate than they had been. The two realignments of the Italian lira should help the adjustment process, although there was still some doubt whether Italy's competitiveness had been sufficiently restored. The recently approved cuts in government expenditure, particularly on health, were commendable, although still more needed to be done on the fiscal side to help to bring about a sustainable balance of payments position. The overall budget deficit was currently expected to amount to some 12 per cent of GDP in 1981. He wondered how realistic that figure might be, considering that for the early months of the year the deficit had been running at twice the level for the same period in 1980.

Finally, Mr. Casey stated, he agreed with the last paragraph of the staff appraisal, which strongly urged corrective action of a more fundamental nature. It was only on that basis that he could go along with the proposed decision. The difficulties involved in eliminating the import deposit scheme should be a warning to all about the undesirability of adopting such schemes in the first instance. As to the guidance for the CONTRACTING PARTIES to the GATT, he agreed with Mr. Sigurdsson and others that too much credit had been attributed to the import deposit scheme, and especially to its supposed role in balance of payments adjustment. Like Mr. Prowse, he would encourage the staff to undertake a postmortem on the scheme once it was eliminated.

The Director of the Exchange and Trade Relations Department reminded the Executive Directors that the description of the deposit requirement as "a temporary measure to limit speculative inventory accumulation and to promote balance of payments adjustment" represented the views of the Italian authorities and gave the reasons for which they had adopted the scheme in the first place. It was certainly not the view of the staff that import deposit schemes promoted adjustment. What the staff had accepted was that there had been an impact on short-term capital movements. The scheme had attracted capital from abroad to help finance the immediate balance of payments needs, although there was the disadvantage stressed by Mr. Prowse and others that once the scheme was eliminated, the short-term capital movements would tend to be reversed. Naturally, the staff would examine the overall benefits or disadvantages of the scheme on the occasion of the next Article IV consultation with Italy. Meanwhile, as the staff had emphasized in EBS/81/199, it considered that the adjustment of the balance of payments should be achieved by action of a fundamental nature promoting balance of payments, namely, the adoption of appropriate fiscal, monetary, and exchange rate policies.

The staff would have no difficulty with the language of the decision proposed by Mr. Prowse, the Director stated.

The Secretary noted that the language proposed by Mr. Prowse would make the decision read:

> The Fund notes the decision of the Italian authorities to phase out the exchange restriction arising from the retention by Italy of the deposit requirement on most foreign exchange purchases, as described in EBS/81/199 and Correction 1, and accordingly grants approval of the restriction until February 28, 1982.

Mr. Erb inquired whether, if the phasing out did not take place as planned, the matter would be brought back to the Executive Board.

The Director of the Exchange and Trade Relations Department explained that the decision would mean that the proposal was being accepted as described by the Italian authorities, including the period for phasing out. If there were any deviations from the decision, naturally the matter would be returned to the Executive Board.

Taking up the changes in language proposed in the guidance for the CONTRACTING PARTIES to the GATT (EBD/81/253), the Director suggested that the second sentence in the second paragraph on page 2 should be extended to read "While a more favorable evolution in both relative cyclical and competitive positions contributed to this improvement, the deposit scheme itself and a further tightening of monetary policy were also important factors affecting short-term capital flows." In that way, the staff could only be taken to mean that the effects were of a short-term nature, and that they might be unwound later. Thus, the deposit scheme could be seen for what it was--a measure transferring pressure to a different point in time, rather than a measure of adjustment.

In the third paragraph on page 2, the Director continued, an adjustment could be made so that the first sentence would read in part "...it would appear that the scheme would have a significant influence in the short term on the balance of payments and to a lesser extent on domestic liquidity." The effect would be to convey to the CONTRACTING PARTIES to the GATT that the Fund considered that the import deposit scheme was not contributing to an elimination of the balance of payments problem but simply dealing with the immediate impact. He would have no difficulty in accepting Mr. Polak's suggestion for showing the realignment of the Italian lira of October 4, 1981 against the other currencies in the European Monetary System (EMS) in a way that was perhaps more usual in the Fund than the language used by the staff, which was that of the EMS authorities themselves.

Mr. Polak suggested that the description of the devaluation should be in terms of the central rate for the lira, etc., to indicate that the figures did not refer to the market rate.

Mr. Kharmawan suggested that the best way of dealing with the third paragraph on page 2 would be to delete the first sentence entirely.

The staff representative from the European Department assured Mr. Casey that the staff had been in touch with the Italian authorities repeatedly during the month of September 1981, and had held discussions with some of them at the time of the Annual Meeting just prior to September 30. While the need for phasing out could perhaps have been foreseen, when the import deposit scheme was introduced it had been hoped that the measures that the Italian authorities were contemplating, and had in fact announced on the fiscal side, would have reduced the volume of liquidity likely to be injected into the economy during the fourth quarter of 1981. Unfortunately the measures had not been approved by parliament and had had to be represented as part of the 1982 budget. Consequently, it was fair to say that there was a reasonable hope that the import deposit scheme could be terminated on September 30, 1981 as planned; unfortunately, events had dictated otherwise.

Mr. Lovato, replying to observations by Executive Directors, recalled that at the time when the import deposit scheme had been introduced the Italian economy had been suffering from speculative purchases caused by anticipation of a devaluation of the lira, accompanied by political circumstances that were unlikely to recur at the present time. Moreover, domestic demand was slackening off and a revival of domestic activity was not foreseen in the near future. As to the question whether the import deposit scheme could not have been terminated on September 30, 1981, at the time of its introduction the authorities had been quite determined to eliminate it on that date, on the assumption that the Government would be able to take the necessary fiscal measures. Unfortunately, the new Government had had considerable difficulty in gathering support for the necessary measures, and the Prime Minister had been attempting to obtain a consensus not only of the political parties but also of the labor unions. He had in fact achieved success, but four months later than expected.

As to the comment that it would have been better if the Italian authorities had tackled the underlying problems by more far-reaching measures, Mr. Lovato recalled that the Finance Minister, Mr. Andreatta, had said at the time of the Annual Meeting that it was worth noting that recently the Bank of Italy had been released from its obligation to purchase treasury paper. That decision had considerably increased the Bank's autonomy and had made it possible both to abandon credit ceilings as soon as circumstances permitted, and to shift to indirect control of the evolution of monetary aggregates.

The Executive Board then took the following decisions:

Exchange System

The Fund notes the decision of the Italian authorities to phase out the exchange restriction arising from the retention by Italy of the deposit requirement on most foreign exchange purchases, as described in EBS/81/125 (6/8/81) and EBS/81/199 (10/6/81), and Correction 1 (10/8/81), and, accordingly, grants approval of the restriction until February 28, 1982.

Decision No. 6965-(81/130), adopted
October 9, 1981

Consultation with CONTRACTING PARTIES to GATT - Fund Guidance

The Executive Board approves the Fund statement to the CONTRACTING PARTIES to the GATT in connection with the GATT consultation with Italy, as set out in EBD/81/253, Supplement 1 (10/9/81).

Decision No. 6966-(81/130), adopted
October 9, 1981

3. BENIN - ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1981 Article IV consultation with Benin together with a proposed decision concluding the 1981 Article XIV consultation (SM/81/174, 8/17/81). They also had before them a report on recent economic developments in Benin (SM/81/184, 9/10/81).

Mr. Nana-Sinkam made the following statement:

On behalf of my Beninese authorities, I would like to thank the staff for its clear presentation of the current economic and financial situation in Benin. My authorities and I have no major difficulties with the staff analysis and we are in broad agreement with the staff appraisal.

Despite the present difficult international economic environment, the Beninese economy continued to perform rather satisfactorily. Indeed, real GDP continues to grow by more than 4 per cent and the deceleration in the rate of growth observed in 1980 has been reversed and this upward trend is expected to continue in 1982. However, despite the overall relative strength of the Beninese economy, several structural weaknesses still persist, translated mainly into disquieting pressures on the balance of payments.

In the development policies field, the overall objective is to bring about in a reasonable time the structural transformation of the economy, which would allow Benin to attain a rapid and sustainable rate of economic growth. The emphasis is on balanced regional and sectoral growth, with particular attention on rural development. Benin is essentially an agricultural country and, accordingly, agriculture is high on the priority list. In this field, policies will continue to be aimed at improving extension services and productivity, and at attaining not only self-sufficiency in food but also a sizable surplus for export to existing and potential markets. To this end, not only will the authorities maintain producer prices at remunerative levels, but they are also determined to see to it that fertilizers, extension services, and credit are made available to the rural population. In the industrial sector, the efforts will be directed toward the promotion of small- and medium-scale enterprises and the stimulation and further development of national entrepreneurship.

With respect to prices and incomes policies, efforts are aimed at reconciling the need for adequate supplies of basic consumer goods with that of ensuring relatively stable, uniform, and low prices for these goods. The authorities follow a policy regulating markups and profit margins in a manner compatible with a policy of wage restraint and low inflation.

In the fiscal field, the authorities remain fully committed to their well-established policy of at least balancing the current budget. As can be noted, the budget shows an emphasis on investment rather than on current expenditure. The authorities recognize along with the staff that there is still room for further improvement with respect to the budgeting process, especially as it affects revenue forecasting and expenditure allocations. On the revenue side, efforts should continue to be directed toward making state enterprises more efficient and profitable. This obviously calls for an improvement not only in the management of these enterprises but also in their pricing system. The commitment to the policy of at least balancing the current budget constitutes a reassuring feature of budgetary policy in Benin, and accordingly there is little reason to worry about having problems on the expenditure side.

In the monetary field, the authorities are committed to following a cautious policy stance. Credit expansion will continue to be under close control although the authorities are fully determined to emphasize on productive activities. The rate of credit expansion to the private sector is expected to drop significantly in 1981 compared to 1980, reflecting a relative slowdown in the private sector's economic activities.

In the external sector, the deterioration in the country's current account stemmed primarily from adverse developments in the terms of trade. It is worth mentioning that although imports are still on the rise, their structure has changed significantly, especially as the country has attained self-sufficiency in food, a circumstance that has allowed a marked increase in imports of capital goods for the implementation of investment programs. The discovery of mineral resources embodies favorable prospects, and the imminent exploitation of these resources will undoubtedly contribute to the strengthening of Benin's external financial position in particular and overall economic development in general.

The authorities continue to be fully committed to the attainment of rapid and sustainable economic development, and they are determined to pursue the sound economic and financial policies of the past several years.

Mr. Sangare considered that the staff report showed that the economy of Benin had enjoyed a mixed performance. On the one hand, the 5 per cent growth rate projected for 1981 could be considered satisfactory; on the other, it was impossible not to express concern over the fact that the current account deficit in the balance of payments was expected to be much larger in 1981 than in 1980, and that the budgetary position of the Government continued to be weak. The difficulties in the external sector were certainly due in part to the deterioration in the terms of trade. However, part of the problem seemed to stem from the decline in the production of food and traditional export crops. He thus welcomed the authorities' intention to implement measures that would increase productivity in the agricultural sector with a view to consolidating self-sufficiency in food, while leaving a surplus for export and expanding traditional export crops.

So far as the budget was concerned, Mr. Sangare continued, he noted that the authorities were trying to limit the overall deficit by holding down current expenditures to the level of revenues. In the process of restraining expenditure, he hoped that the authorities would continue their efforts to make the public corporations more efficient and less reliant on government subsidies. The medium-term projections for public debt showed that the debt service ratio could rise from about 9 per cent of GDP in 1981 to 30 per cent by 1985. That was a rather substantial change, and the authorities would need to monitor public borrowing very carefully in the future. The last point he had in mind was that the staff referred on several occasions to the need to improve the statistics for national accounts and the country's finances in general. He wondered whether the Fund was considering offering technical assistance to Benin in that field.

Mr. Winkelmann commented that the staff paper had played a useful role in bringing Benin's problems into the open; unfortunately they seemed to multiply faster than they could be solved. Not only was a short-term balance of payments deficit equivalent to 16 per cent of projected GDP quite high; the debt service ratio was expected to rise from 9 per cent in 1980 to 30 per cent in 1985, counting only public guaranteed debt. There did not seem to be any information about private debt, and he wondered how far exports of petroleum products would help to improve matters after 1985.

In the circumstances, Mr. Winkelmann continued, he was bound to inquire whether the money supply was really under control. The only information given by the staff was to the effect that the demand for money had risen by 41 per cent in the previous year. It was, however, difficult to know what the figure really meant, as several currencies seemed to be circulating within the country, and it was clearly hard to control the expansion of money. The staff seemed to consider that the revenue estimates were rather overoptimistic, although Mr. Nana-Sinkam seemed to think that domestic credit expansion would decline from about 50 per cent in 1980 to 35 per cent in 1981. The budget was therefore not firmly based on solid figures. In the medium term the main emphasis ought to be placed on improving the planning process and ensuring more effective implementation. The authorities had completed a two-year program, but they seemed to need an interval of two years before starting the next three-year program in 1983, although they were still faced by structural imbalances. With the forecast increase in the debt service ratio, he doubted whether the authorities ought to allow themselves so much time between one program and the next. However, the general direction of planning seemed to be quite satisfactory, with attention paid in particular to the agricultural sector and to the achievement of more balanced growth. His feeling was that the World Bank should provide more assistance at the planning stage as well as in implementing the agreed programs. He hoped that the authorities, with the assistance of the Fund and other international agencies, would be able to overcome the difficult times that seemed to lie ahead.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/81/129 (10/7/81) and EBM/81/130 (10/9/81).

4. RELATIONS WITH GATT - CONSULTATIONS WITH CONTRACTING PARTIES - FUND REPRESENTATION

The Executive Board approves Fund representation at the GATT consultations with Italy, Peru, Tunisia, and Turkey to be held in Geneva, as set forth in EBD/81/250 (10/5/81).

Adopted October 7, 1981

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/81/311 (10/7/81), Sup. 1 (10/8/81) and EBAP/81/312 (10/7/81) and by an Advisor to Executive Director as set forth in EBAP/81/313 (10/7/81) is approved.

APPROVED: March 10, 1982

LEO VAN HOUTVEN
Secretary