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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/122

3:00 p.m., July 25, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Director
	J.-C. Obame, Temporary
C. H. Dallara	M. K. Bush
	D. C. Templeman, Temporary
	K. Celebican, Temporary
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
Huang F.	
J. E. Ismael	
	H. A. Arias
T. P. Lankester	R. Fox, Temporary
	S. King, Temporary
	H. Fugmann
M. Massé	L. Leonard
	G. D. Hodgson, Temporary
	W. K. Parmena, Temporary
F. L. Nebbia	
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	G. Ortiz
H. Ploix	S. de Forges
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
L. Collier, Assistant
K. S. Friedman, Assistant
B. J. Owen, Assistant

Also Present

African Department: A. D. Ouattara, Director. European Department: L. A. Whittome, Counsellor and Director; A. L. Bovenberg, G. S. Tavlas, H. Ungerer, H. Vittas. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; J. T. Boorman. External Relations Department: P. E. Gleason, H. O. Hartmann. Fiscal Affairs Department: G. Blöndal, A. Cheasty. Legal Department: F. Gianviti, Director; P. L. Francotte, R. H. Munzberg, J. K. Oh. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: D. Williams, Deputy Treasurer; D. H. Brown, Y. Kawakami, P. M. Tillotson, G. Wittich. Western Hemisphere Department: S. T. Beza, Associate Director; L. A. Cardemil, A. P. De La Torre, J. Fajgenbaum, J. Ferrán, M. E. Hardy, S. C. de Sosa, S. J. Stephens. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, L. K. Doe, L. P. Ebrill, S. Ganjarerndee, J. Hospedales, G. Nguyen, A. Ouanes, I. Puro, N. Toé, R. Valladares, A. Vasudevan, M. A. Weitz, K. Yao. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, A. Bertuch-Samuels, O. S.-M. Bethel, B. Bogdanovic, F. Di Mauro, J. J. Dreizzen, V. Govindarajan, T. Morita, A. H. Mustafa, J. E. Rodríguez, B. Tamami, L. Tornetta, H. van der Burg, E. L. Walker, B. D. White.

1. IRELAND - 1986 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/86/121, 7/25/86) their consideration of the staff report for the 1986 Article IV consultation with Ireland (SM/86/163, 7/3/86; and Cor. 1, 7/11/86). They also had before them a report on recent economic developments in Ireland (SM/86/166, 7/9/86; and Cor. 1, 7/21/86).

Mr. Pérez remarked that as previous speakers had underscored, the imbalance in the Irish economy had not improved in 1985. The public sector deficit and central government debt had remained high, and unemployment had worsened. However, other areas in which the authorities had applied corrective measures had produced the desired results: the rate of inflation had been low at about 4 percent, the balance of payments had shown a trade surplus for the first time in 40 years, and real investment had recovered substantially. More important, prospects in those areas were encouraging for 1986.

The staff papers indicated that the current fiscal situation resulted from failure to implement the 1984 National Plan, Mr. Pérez noted. It was difficult to determine the reason for that outcome, but he considered that social consensus was necessary for the successful implementation of government policy. That consensus seemed to be lacking in the case of Ireland, and, as a result, the prospects for change in the deteriorating trend of public finances were uncertain. Another constraint in applying a strong fiscal program stemmed from the high level of unemployment. The potential deflationary impact of a tighter fiscal stance and its negative influence on employment prevented the authorities from implementing their planned fiscal projects.

The budget for 1986 reflected in part those two factors, Mr. Pérez continued. On the revenue side, the authorities had had little choice over the past few years but to impose higher taxes to sustain the levels of public spending demanded by high unemployment, although that pressure had lessened in the 1985 budget. In the coming years, emphasis should be on the expenditure side, as envisaged in the 1986 budget. Table 2 of the staff report illustrated the sharp deceleration in interest payments expected to take place in 1986, primarily owing to favorable interest rates abroad and the devaluation of the U.S. dollar. Although some pressure would be lifted from the expenditure side, the authorities should not view that development as an opportunity to relax their efforts to reduce noninterest outlays. With respect to expenditure cuts, the question of social welfare benefits was sensitive and reductions were always vehemently opposed. Nevertheless, it would be necessary to reach agreement with the labor unions to curb such expenditures, which had perhaps gone too far.

Like others in the European Monetary System, the Irish authorities used monetary policy as the main tool to keep the exchange rate on target, Mr. Pérez observed. He missed a more detailed description by the staff of that area; it was of great importance to set the authorities' exchange rate policy in its proper perspective. The competitiveness of Irish industry had been threatened by the evolution of the exchange rate of the Irish pound vis-à-vis the U.S. dollar and pound sterling--the currencies of its two main trade partners. With the Irish pound revaluating against the pound sterling, Irish companies selling in the United Kingdom or competing with U.K. firms abroad were at a clear disadvantage, especially as Ireland was a member of the European Monetary System but did the bulk of its trade with a nonmember neighbor. He agreed with the authorities that competitiveness could and should be improved through domestic adjustment, but that view was also compatible with utilizing the exchange rate as a useful device to cope with the problem of competitive disadvantage created in part by exchange rate disarray.

Ireland, like other European countries, had the serious problem of high rates of unemployment, Mr. Pérez commented. That issue was one of the most controversial subjects of Irish economic policy. He was disappointed that the staff had referred to the issue only briefly, merely mentioning that "to mitigate the impact of unemployment, the authorities are also operating a number of special employment schemes." It would have been useful to include more information on that important subject in the staff report rather than in the report on recent economic developments. He would appreciate comments on the position of trade unions, which were still very influential in Ireland. Moreover, he wondered whether there was any possibility of reaching a social agreement that could provide an adequate framework in which to attain moderate positions and create a social environment more conducive to the reduction of the fiscal deficit and unemployment.

Because Ireland met the principles previously discussed by the Board for placing some members on a longer consultation cycle, he could support the authorities' request to extend the cycle, Mr. Pérez said. Finally, recent improvements in different areas of the Irish economy had laid the foundation for a strategy aimed at reducing the fiscal imbalance and the level of unemployment. In the case of Ireland, as in that of other small industrial countries, favorable developments in the international economy would be crucial to maintain the economic momentum.

Mrs. Ploix commented that in looking at recent developments in Ireland--an active member of the European Communities--economic performance in 1985 had not fully matched that of previous years, either in raising the growth rate or in tackling fiscal imbalances. Industrial activity had been sluggish, and agricultural output had been affected by poor weather conditions. However, inflation had declined from 8.6 percent to 5.4 percent, and the external accounts had improved significantly. Nevertheless, the staff's view was that those developments had been largely due to a more favorable international environment. She agreed with the general thrust of the staff's arguments and was pleased that the Irish authorities endorsed them, although they perhaps disagreed on the pace of adjustment.

The staff had made it clear that an improvement in the fiscal position was crucial, especially in view of the debt situation, Mrs. Ploix continued. The implicit abandonment by the authorities of the deficit target for 1987 gave cause for concern. It was evident that a compromise had to be found between a much needed fiscal consolidation and a retrenchment of fiscal stimulus because of the adverse impact on the economy, notably on unemployment. However, she wondered whether the high budget deficits of previous years had had the expected benefit in terms of job creation, and she would appreciate staff comment on that issue. The development of social welfare expenditures needed to be controlled.

One of the main features of the Irish economy was its openness, even though the geographical distribution of its exports was concentrated on the European Communities, notably the United Kingdom, Mrs. Ploix remarked. Because external trade represented 135 percent of GNP, external developments played a decisive role. The staff's medium-term external debt scenarios highlighted that aspect and stressed the importance of maintaining a strong competitive position. She also advocated the pursuit of greater balance between the external and domestic markets.

With regard to competitiveness, the marked improvement in the external accounts gave clear testimony that the policy followed to date was in the right direction, Mrs. Ploix observed. Over the period 1981-85, productivity gains had roughly compensated for increases in labor costs. However, some doubts could be raised about the sustainability of such progress over the medium term as the pressure for increases in real wages appeared to remain strong and the Government's attitude toward increases was not encouraging; the 1985 decision on real wage increases should not be repeated. The authorities' intention to follow a path consistent with current demands for pay increases and economic realities was welcome. The staff had described the strengthening of the Irish pound vis-à-vis the pound sterling; the U.K. currency's participation in the exchange mechanism of the European Monetary System would contribute to reducing its volatility.

Despite the small size of the economy and the fact that the domestic market could not fulfill the objective of full employment, the authorities should seek to encourage production that would benefit the domestic market, Mrs. Ploix stated. Heavy reliance on export-led growth did not seem fully justified or fruitful in light of past experience. The industrial policy aimed at attracting foreign investment to Ireland, which had been implemented until late 1984, had had some serious setbacks. Table 5 of the report on recent economic developments showed that the manufacturing sector had been the main contributor to the deterioration of the employment situation; that trend had to be arrested. The authorities, following the recommendations of the 1984 White Paper, were shifting their policy in a direction more in conformity with national interests. Time, however, would be needed to assess the beneficial effects of the recent change of policy in terms of employment.

Short-term prospects indicated that many problems would be eased as economic growth was expected to pick up, inflation to decelerate further, and the current account deficit to decrease, Mrs. Ploix commented. However, employment was not likely to improve significantly, leaving the authorities uncertain as to the proper course of action with respect to public finances. Conflicts arose in setting economic policy: fiscal adjustment did not contribute in the short run to political popularity, although benefits could be experienced over a longer period of time. The Irish authorities had shown courage and determination in difficult circumstances; those qualities were even more necessary at present as relaxation of their efforts would undermine the positive results achieved thus far.

With respect to the Article IV consultation cycle, she would recommend that before examining Mr. Leonard's request, the Board should have a general discussion of the issue, Mrs. Ploix concluded. In the case where the cycle was extended, provision should be made for scheduling earlier consultations if a country did not follow the recommendations of the previous consultation.

Mr. King commented that the situation facing the Irish authorities was complex. On the positive side, the short-term prospects were encouraging. Furthermore, from a slightly longer-term perspective, some progress had been made in strengthening the external position, where a current account deficit of about 1.25 percent of GNP was forecast for 1986 compared with close to 15 percent only five years previously.

Nonetheless, Mr. King continued, overshadowing those positive achievements were the substantial imbalances that continued to face the economy--imbalances that undoubtedly left the authorities with difficult policy dilemmas. Although there had been a marked improvement in the external position, there were reasons for questioning whether the underlying situation might be weaker than it appeared. First, the improvement in the trade account partly reflected the fall in oil prices, which could easily be at least partially reversed. Second, the high level of external debt left the economy vulnerable to changes in market confidence and interest rates. That debt reflected the need to finance the persistent budget deficits of recent years. The prospects for continuing large deficits in the years ahead would threaten further crowding out of private activity. The need to finance those deficits also emphasized the importance of retaining market confidence in the policy stance. Finally, the authorities faced a high level of unemployment, which was a major cause of concern.

In light of those problems, the authorities recognized the importance of taking action to put the fiscal deficit on a more sustainable basis in the years ahead, Mr. King observed. They had attempted to implement medium-term fiscal adjustment for some time, but as yet their efforts had apparently met with only limited success. Although the public sector borrowing requirement had been reduced from over 20 percent of GNP in 1981 to under 16 percent in 1985, it remained too high. Furthermore, a significant part of that improvement had stemmed from a sharp retrenchment in capital expenditures. The current budget deficit had actually widened by about 0.75 percent of GNP between 1981 and 1985. The continued weakness of the current budget was largely a result of the continued strong growth of current expenditure. Some of that rise was due to increased interest payments, but other expenditure--in particular, expenditure on social services--had risen rapidly. The share of expenditure on social services in total noninterest current expenditure had risen from 76 percent in 1981 to nearly 87 percent in 198.. To the extent that social services expenditure had been an important factor behind the rise in total expenditure, and because it represented the major item within total discretionary expenditure, that category would have to be closely examined, especially as the authorities believed that the tax burden was already too high and that future emphasis must be placed on expenditure restraint. There seemed to be an inconsistency between the general policy objectives and the further increases in social benefits allowed in 1985 and 1986, which were more generous than the commitments under the National Plan.

Despite the magnitude of the fiscal imbalance, the authorities were reluctant to accelerate the pace of fiscal reform, Mr. King commented. While he could sympathize with that reaction, he wondered whether a less gradualist approach to adjustment might not be both necessary and beneficial. The current level of the budget deficit appeared to be unsustainable and posed a considerable threat to medium-term growth prospects. Furthermore, and more fundamentally, it was unclear to what extent a reduction in the deficit would have a harmful effect on unemployment. The conjunction of a public sector borrowing requirement of nearly 16 percent of GNP and an unemployment rate of over 17 percent seemed to suggest that the problem was structural in nature rather than an example of insufficient aggregate demand. Perhaps the staff could comment; in particular, he would be interested to know if there were any estimates of the natural rate of unemployment in Ireland.

Structural and labor market policies had a crucial role to play if unemployment was to be significantly reduced, Mr. King stated. The need to reduce unemployment underlined the importance of using the available instruments to ensure that wage increases were suitably moderate. His authorities were aware of the difficulties in that area and the limitations that existed on what could be achieved by the Irish authorities. Nonetheless, the authorities might have been able to give a firmer lead by showing greater restraint in setting wages in the public sector as those wages were under their direct control. It was unfortunate that an unintended real increase in public sector wages had happened in 1986 as a result of lower than expected inflation. He supported the staff's suggestion that a pay pause might be appropriate in the 1987 budget.

The Government could also influence wage costs through its taxation and other policies, Mr. King continued. In that regard, the sizable wedge that had opened up between gross wages and the labor costs faced by employers was an obvious source of concern as it might well lead to upward pressure on wage settlements. That problem would seem to be a further factor underlining the importance of tight expenditure control, which seemed to be the only way to finance the changes in taxes and social security contributions that were needed to reduce that wedge.

His chair welcomed the reorientation of industrial policy that had taken place in 1984, Mr. King said. The greater emphasis given to increasing the integration of foreign-owned firms into the economy remained appropriate. However, he would be grateful for clarification from the staff or Mr. Leonard on how the system had been operated. The staff report seemed to indicate that the main emphasis of that policy was on industrial sector rather than services sector firms. Yet Mr. Leonard had stated that in Ireland, as in the United Kingdom and other European countries, one of the most buoyant areas within the economy was the services sector, which suggested that it should also be an important area for industrial policy.

Finally, while he could appreciate the operational difficulties that motivated Mr. Leonard's suggestion that Ireland should be moved to an 18-month consultation cycle, he was reluctant to reach a decision on the present case without first having had a chance to examine the more general issue, Mr. King stated. He therefore supported Mr. Leonard's view that the Board should return to the question after a general review of the Fund's surveillance procedures.

Mr. Zecchini made the following statement:

> Positive developments characterized the evolution of the Irish economy in 1985, in line with a favorable trend that started at the beginning of the 1980s. The current account deficit/GNP ratio fell to 3.2 percent from 14.7 percent in 1981; the trade balance recorded a surplus; and the rate of inflation measured by the consumer price index was 4.5 percent in May 1986, compared with 20.4 percent in 1981. Nevertheless, such positive results seem not to have involved an improvement in the serious imbalance of Ireland's public finances. While the debt service ratio and the ratio of external public debt to GNP were reduced for the first time in the last few years, total public debt continued to grow and as a percentage of GNP remains one of the highest among OECD countries. Moreover, in spite of a recovery in final domestic demand and a strong export performance, growth of real GNP was only 0.5 percent and the rate of unemployment continued to rise significantly.
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> In light of these developments, we share the staff's view that the limited progress in the area of public finances is a cause for serious concern, and we continue to support the recommendations put forward by the Executive Board on the occasion of last year's consultation (EBM/86/135, 9/10/85), namely, that the authorities give the highest priority to rapid fiscal adjustment mainly through a reduction in the ratio of public expenditure to GNP.

In spite of the scaling down of the medium-term fiscal objectives in the context of the National Plan, the current account deficit of the public sector in 1985 turned out to be somewhat above the target, while the Exchequer borrowing requirement was almost on target. Since the early 1980s, the attempts to correct the budget imbalances have been characterized by an excessive reliance on cuts in capital expenditure coupled with higher taxation--particularly on wages and salaries--which rose from 5.5 percent of GNP in 1981 to 36 percent in 1985. Over the same period, current expenditure, in contrast with capital expenditure, continued to grow, reaching 48.7 percent of GNP in 1985. Such a fiscal policy approach seems questionable since in the medium term it will negatively affect the prospects for fixed investment, which are already bleak after the long decline between 1982 and 1984, and eventually it will hamper the growth of the economy and the reduction of the currently high unemployment level.

We therefore support the staff's recommendation that improvements in public finances should come from the expenditure side, especially in checking the growth of social welfare benefits and public employees' wages. In this connection, the authorities' commitment for 1987 falls short of what is required. On the one hand, the National Plan correctly stresses the need to ease the tax burden on wage and salary earners. On the other hand, as indicated in the staff's report, "the Irish representatives stressed that the room for maneuver was limited as only a small part of the noninterest component of current expenditure (some 10 percent of the total) was realistically amenable to adjustment in the short run."

Moreover, we notice that the Government is planning to increase the remuneration of public sector employees to an extent in excess of its own guidelines, allowing 7 percent growth over 18 months. Although we understand the serious political implications that social expenditure cuts will have for the ruling majority in view of the upcoming elections, it should also be understood that gains in economic activity and employment obtained through relaxation of fiscal policies will be short lived.

Incomes policies and exchange rate policy have contributed to the improvement of Ireland's external position in recent years. Significant moderation in wage increases and exceptionally large increases in average productivity, associated with restructuring of the industrial sector and labor shedding, have brought about notable improvements in the competitiveness of the Irish manufacturing sector. This in turn has resulted in a steady increase of exports that has exceeded world trade growth and enlarged Ireland's market share. Nevertheless, further improvements in competitiveness are required to address effectively the problem of unemployment in a medium-term horizon.

Given the high degree of openness of the Irish economy, and the commitment of the authorities to exchange rate stability within the European Monetary System, improvements in competitiveness can only derive from further reductions of domestic costs. In this respect, the authorities' commitment to merely avoid pay increases that are in excess of the average increase in trade partners is certainly a positive step but may not be sufficient. In fact, to improve competitiveness to a firmer basis over the medium term it is necessary to aim at constraining labor cost dynamics to a trajectory much lower than that followed by trading partners because it is doubtful whether the large productivity gains that were realized in the last few years can be maintained in the future. Moreover, attention should be paid to the need to reduce the wedge between workers' earnings and labor costs.

With respect to the unemployment problem, we commend the authorities' emphasis on supply-side policies. In late 1985 a package of tax measures and other incentives were introduced to stimulate employment and private investments. One cause for concern on the supply side is the continuous decline in construction activity together with a reduction in private housing completion. As such developments can constitute a constraint to labor mobility in the medium term and hamper growth and investment prospects in the small and medium-sized industrial sector, we would be interested in knowing whether the authorities plan to address that problem.

As indicated by the Central Bank, monetary policy in 1985 was primarily aimed at mitigating the financial consequences of the continuing fiscal imbalances while stabilizing the external value of the Irish pound. In this context, it is commendable that the share of nonmonetary financing of the Exchequer borrowing requirement rose to 52.25 percent in 1985 from 29.5 percent in the previous year. It must also be recognized that in the face of both a persistently high public budget deficit and the commitment to exchange rate stability within the European Monetary System, the room for maneuver of monetary policy is very restricted. In fact, interest rate policy has to be geared to meet the external equilibrium constraint, and consequently a larger burden falls on incomes policy in creating the conditions for a livelier expansion of the economy.

Finally, we would like to support two positive elements in Ireland's external policies. First, the authorities seem committed to utilize the exchange rate as an instrument for domestic adjustment and disinflation and to avoid its use to improve competitiveness. Second, Ireland has succeeded in restructuring its external debt in the last five years. By taking advantage of more favorable conditions in international capital markets, the authorities were able to avoid bunching of maturities, to reduce the cost of debt, and to increase its average maturity.

Mr. Wijnholds said that he wished to commend the authorities for the progress they had achieved in two important instances. Inflation had come down rapidly to an acceptable rate, and on the external side the current account deficit had been reduced to a sustainable level. While those developments were welcome, Ireland's overall economic performance was marked by insufficient progress in the areas of fiscal adjustment, employment creation, and wage formation.

Progress had not been impressive in lowering the public sector borrowing requirement in recent years, which continued to exert significant undesirable pressures on the Irish economy, Mr. Wijnholds commented. In Ireland, as in some other European countries, there had perhaps been a preoccupation with the cyclical effects of fiscal retrenchment and an underestimation of the beneficial dynamic effects of a sharp curtailment of the fiscal deficit. The result had been an enormous burden of government debt, with the debt/GNP ratio reaching 131 percent in 1985--the highest figure among industrial countries. The need for further strong fiscal adjustment was therefore evident.

Unfortunately, the authorities seemed to have relaxed their intentions for budgetary action as outlined in the National Plan, Mr. Wijnholds remarked. The authorities had mentioned the high level of unemployment as a factor that would make the necessary strong fiscal adjustment hard to achieve, especially in an election year. While he understood that argument, it was only valid in the short run. As the experience in some other European countries showed, strong fiscal adjustment need not adversely affect the employment level beyond the short run. In that light, he endorsed the staff's view that the authorities should seriously consider moving toward a medium-term framework in setting its fiscal objectives.

A particularly disappointing development in the budget had been public sector wages, Mr. Wijnholds said. The Government's inability to keep its pay offer within its own guidelines was regrettable and clearly had not been helpful in promoting wage moderation in the private sector.

The need for wage restraint was given added weight by Ireland's policy of not using the exchange rate as an instrument to improve competitiveness, Mr. Wijnholds continued. That policy was correct in view of the openness of the Irish economy and the tendency for exchange rate changes to work through the entire economy quite rapidly. However, such a policy could only be successfully maintained over time as long as increases in domestic costs were sufficiently contained. Apart from wage moderation, further measures to increase the economy's efficiency were also called for, and he recognized the progress that was being made in implementing supply-side measures.

A notable development in monetary policy had been the shift away from guidelines for bank lending to reliance on market-oriented instruments, Mr. Wijnholds stated. While that step might be welcome in itself, other questions could arise as to whether monetary conditions had not eased too much. Domestic credit expansion had rebounded since the third quarter of 1985--as could be seen from Chart 9 in the staff report--owing not only to monetary financing by the Government but also to a rapid expansion of bank credit. Although he was aware that monetary policy was primarily geared to the exchange rate, he wondered whether recent developments did not point to the need for a more cautious monetary stance.

Finally, Mr. Fugmann's suggestion that the decision on the standard 12-month cycle would be subject to the outcome of the next Board review of the frequency of Article IV consultations in the framework of Fund surveillance procedures provided a good solution to the Irish authorities' request, Mr. Wijnholds concluded.

Mr. Obame commented that in 1985 Ireland had made further progress in reducing the external current account deficit and in slowing down consumer price increases. However, the pace of economic growth had not been maintained as real GDP growth had been marginal. Moreover, the fiscal imbalance remained large, and the unemployment rate had risen further.

The public sector borrowing requirement had decreased, although marginally, in 1985, Mr. Obame continued. A similar movement was forecast to take place in 1986. He shared the staff's concern about the lack of progress in reducing the fiscal imbalances that had evolved over the years, and he supported the call for a display of more resolve in tackling that problem. Without negating the need to expand the revenue base and growth, he urged the authorities to take decisive steps to contain expenditure.

Like previous speakers, he recommended that attention be focused on curbing the rise in wages and government benefit payments, Mr. Obame said. He understood that actions in those areas could be constrained by political and other considerations; however, the size and duration of the fiscal imbalances and, more important, their long-term perverse effects on the economy as a whole suggested prompt and resolute action on the part of the authorities.

He noted with concern that the rate of unemployment had continued to increase in 1985, and prospects for 1986 did not seem bright, Mr. Obame commented. The Irish authorities were aware of that situation, and he welcomed the measures taken to stimulate job creation and hiring by the private sector. He urged them to pursue their efforts, especially in the agricultural and industrial sectors, where employment had decreased steadily over the past few years.

While the Irish authorities should be encouraged to take steps to reduce the fiscal imbalances and curb the high level of unemployment prevailing in the country, it was equally important that they devote attention to enhancing the competitiveness of their exports, Mr. Obame remarked. Measures curbing wages and salaries as well as benefits could be useful in attaining those objectives.

He supported Mr. Leonard's request regarding the extension of the Article IV consultation cycle for Ireland, Mr. Obame concluded.

Mr. Romuáldez made the following statement:

> In 1985, for the first time in about 40 years, Ireland recorded a surplus in its trade account. In 1985 also, for the first time since 1981, investment grew in real terms--at 1.15 percent, a small but positive change and, it was hoped, a sign of a lasting turnaround--and prospects for 1986 seem to confirm that direction with the authorities' expecting 3 percent growth in gross fixed investment. For these significant firsts and for other relative achievements in the drive toward economic viability, we commend the Irish authorities. They continue to be successful in their efforts to contain inflationary pressures. That these developments have lowered Ireland's price change levels close to the average experienced by its main trade partners is welcome news, though mitigated somewhat by reports of the worsening in the competitive position of the Irish manufacturing sector in early 1986, viewed in terms of relative hourly earnings vis-à-vis the country's principal trade partners.
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> In the main, however, much of what we said during last year's Article IV consultation with Ireland (EBM/85/135) remains relevant. The major problems of the economy still derive from weaknesses in fiscal performance, the drain of debt service on resources, and the continuing increase in unemployment. We welcome the authorities' support of the movement toward preparations for a new round of multilateral trade negotiations. We nevertheless remain deeply concerned that they have maintained their protectionist stance for traditional labor-intensive industries, a stance that is not only disruptive of international trade and prejudicial to developing country export development efforts but also distortive of and costly for Ireland's own economy. We would have hoped, moreover, that the Irish could have injected a greater measure of rationalization into the agricultural policies of the European Communities.
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> The authorities will have to exhibit more intense determination and decisiveness than they did last year in their attempts to curb current expenditure. They recognize that adjustment must focus on expenditure and that savings need to be realized in the area of subsidies and charges for public services. More important, the tax and social welfare systems need to be reformed to strengthen work incentives. In this connection, I wonder if the existing generous social services benefits could be used more fruitfully by linking these with programs of industrial

restructuring, manpower development, and retraining. This might go hand in glove with the authorities' suggested approach to containing growth in social welfare expenditures through effective targeting of benefits.

We agree fully with the staff's appraisal of Ireland's economic situation and its prescriptions for sustainable growth and an improved employment picture in 1986 and 1987. We join the staff, moreover, in welcoming the authorities' success in improving the maturity structure of external government debt. We nevertheless share its apprehension over Ireland's high propensity to import and the vulnerability of the external current account to rising domestic demand. The staff is correct in stressing that a strong current account position is an exigency of Ireland's situation as a country saddled with high external debt and large foreign interest payments.

We urge the authorities to move from their protectionist posture to a more intensified industrial restructuring, particularly as regards some of the indigenous industries, and to greater trade liberalization.

We can go along with Mr. Leonard's request to extend the consultation cycle for Ireland.

Mr. Jayawardena made the following statement:

Since the economic difficulties that emerged in the late 1970s and early 1980s, Ireland has adjusted strongly. The magnitude of the change is seen when we compare key economic ratios between 1981, when the imbalances peaked, and 1985. During this period, the external current account deficit declined from 15 percent to 3.5 percent of GNP. Underpinning this achievement was a notable fiscal adjustment, where the Exchequer borrowing requirement was brought down from 16 percent to 13 percent of GNP and the public sector borrowing requirement from 20 percent to 16 percent. Domestic credit expansion was scaled down from 40 percent to 16 percent. Inflation was brought down from 21 percent to 6 percent. These are not small changes by any standard, and we commend the authorities for the determined manner in which they set about to put their house in order. We are heartened to observe that the authorities plan to make further progress in 1986 and that they are well on track this year to achieve their goals.

In evaluating the 1986 targets in the context of the previous year's achievements, the basic position of the staff is that the progress is inadequate, especially in public finances. We would think that part of the problem lies in the nature of the adjustment. We are inclined to believe that the problems in Ireland's adjustment arose from a strong emphasis on the demand-management side whereas inadequate attention was paid to supply-side action.

The government sector is large in Ireland, with government expenditure at 58 percent of GNP and revenue at 46 percent. Fiscal retrenchment in such a situation obviously has strong ripple effects on the economy. Along with tight credit policies, economic growth slowed from 4.5 percent in 1984 to 2.0 percent in 1985, and unemployment rose to 17 percent in 1985. Export growth weakened dramatically from 18 percent in 1984 to 7 percent in 1985 and exports are expected to decline by nearly 5 percent in 1986. To offset fiscal adjustment, there should have been supply-side policies, which do not appear to have been that effective.

While the general simplification of the tax system and the reduction of the value-added tax were welcome, I cannot describe the scaling down of the marginal income tax rate from 65 percent to 60 percent in 1985 and now to 58 percent as strong progress. Whether the new penalties for tax default and evasion and the withholding tax on financial assets will help is a moot question. Generally, the tax burden appears to be high, and a general reduction could be most helpful.

The structural rigidities in the economy, especially in the labor markets, appear to have deserved greater attention. The Government's wage policy, social welfare subsidies, and support of backward industries should have been more moderate. The wisdom of having high social transfers in an economy with a per capita income of nearly SDR 5,000 is difficult to comprehend, especially when related to work incentives. The same applies to transfers to public enterprises and marginal industries.

Given this situation of a "government overhang," I wonder whether the appropriate path for the future is merely a containment of government expenditure and the deficit alone. We are inclined to favor a strong effort to reduce the size of government itself by reducing both taxation and expenditure. If this encourages more private sector investment and activity, the authorities may not need to postpone decisions beyond the next year's election.

We are inclined to tilt toward the staff view that the exchange rate could have been used more decisively to encourage the export sector. However, Mr. Leonard states that Ireland not only held external markets but even expanded its share. It was interesting to consider how much better the export sector could have done if the exchange rate had been more competitive. Several Directors observed that the exchange rate option was not the desirable one and that domestic adjustment was preferable. But, as evident from the slowdown of the fiscal retrenchment process owing to strong inflexibilities in the system, I do not see how the relative domestic market price distortions could be rectified without adequate flexibility of the exchange rate. I would rule out exchange rate action only if the economic relativities between Ireland and its economic partners are considered optimal and correct.

The staff representative from the European Department said that many speakers had emphasized the need to speed up the pace of fiscal adjustment. In principle, neither the Irish authorities nor the staff would disagree with that assessment. However, political circumstances, higher unemployment, and budgetary commitments for 1986 and in part for 1987 would, in the view of the authorities, make it difficult to introduce substantial cuts in the various expenditure categories. The staff, however, considered that problems of fiscal imbalance, the lack of dynamic economic development of indigenous industries, and unemployment--including the difficulties of absorbing the increase in the labor force--might be interrelated. Therefore, the question could be raised as to whether, under present sociopolitical circumstances, much could be done. Furthermore, if there was a need for decisive fiscal action, it could also be asked whether that would not require an examination of the underlying political and social assumptions and philosophies in the economy. In light of the discussions with the Irish authorities, existing attitudes and philosophies seemed to indicate that major progress in public finances would be difficult.

Although some improvement had taken place over the past few years, rigidities remained in the labor market, the staff representative remarked. Unionization, although declining in the private sector, was still high, notably in the public sector. The unions' structure was such that specific unions were competing with each other. The concept of comparability of pay relativities, which was deeply entrenched in the social and labor market system in Ireland, resulted in comparability not only between various industrial sectors but between various jobs within one sector of industry, between the private sector and the public sector, and between various jobs within the public sector. Some progress had been made in the decentralization of wage negotiations, especially in the private sector, thereby diminishing the comparability problem. However, replacement ratios remained high and were a disincentive to seek jobs; in fact, the size of unemployment benefits might have contributed to the level of unemployment.

The difference between wage costs and take home pay was a problem that had been recognized and addressed by the tax reform, the staff representative commented. The reform would try to shift the tax burden away from wage earners and would thereby alleviate somewhat the cost burden on industry by lowering wages. Social security costs in Ireland, compared with those in other European countries, were relatively low.

Public pay had declined in real terms, and increases had consistently lagged behind increases in the private sector, the staff representative noted. The unions in the public sector were militant, and the Government had undoubtedly found it difficult to adhere to the established guidelines. In addition, in view of the discrepancies in pay between the private sector and the public sector, the question arose as to how strongly the public sector would have fought to apply a stringent pay policy so long as the private sector would not follow a similar policy. The difficulty of attracting highly trained people to the public sector and keeping them was an important issue, and there were indications that the sector had lost high-quality people at younger ages. The lag in public sector pay was one reason for the many requests for special pay increases in the context of comparability. If the authorities would agree that public sector pay, because of its relative size in the budget, needed to be watched carefully, they would also have to look at public sector employment. The burden should not be placed on per capita wages but on the level of employment in the public sector.

The increase in the value-added tax in 1986 from 23 percent to 25 percent applied to all energy products, the staff representative stated. Excise taxes on gasoline and automobile diesel had been raised; however, the authorities foresaw limits in that field and considered that the competitiveness of manufacturing was greatly influenced by the price of energy. The common border with Northern Ireland presented a problem as Northern Ireland's level of taxation on energy products was generally lower, imposing a limit on Ireland's room for maneuver.

The National Plan included the proposal to increase taxation on welfare benefits, the staff representative continued. The authorities considered that measure appropriate but not urgent because the long duration of unemployment had changed the nature of unemployment benefits. In addition, to implement that measure, adequate computer capability--currently being improved--would have to be put in place.

The main objective of the deposit interest retention tax was to remove certain distortions within the financial sector with regard to the taxation of different kinds of financial assets, the staff representative explained. The authorities had also wished to eliminate tax evasion, which was high for income from deposits, and to increase revenue in connection with the policy of redistributing the tax burden away from the wage earner sector. A shift of funds away from bank deposits to government securities might well have taken place, perhaps easing financing of the government deficit but also resulting in a certain degree of disintermediation and in a further step toward modernization of the financial system. Of course, any income from government securities was subject to regular income tax and therefore might be subject to a higher tax, depending on the income bracket, than the retention tax on deposits.

It was difficult to say whether past fiscal policy had provided benefits in terms of employment, the staff representative said. Most probably unemployment would have increased further if there would not have been an expansionary element in past fiscal policies. For example, as the degree of fiscal adjustment had been brought about, to a large degree, by reducing the capital account, the construction sector had suffered; consequently, unemployment in that sector had increased. There were a number of schemes that could have helped small and medium-sized industries as a result of construction activity in the commercial sector. Although unemployment had been induced to a certain extent by fiscal retrenchment, strong structural elements were also an important factor. Traditional industries that could not survive in their present configuration and size could not provide jobs to people who had been in those industries and who were in the relatively older age brackets. The high level of real wages could also be considered a structural element.

It had been emphasized that the Irish pound had appreciated as a result of the depreciation of the U.S. dollar and the pound sterling, the staff representative recalled. The rate of the pound sterling was more significant for Ireland, and it was difficult to determine how the volatility of the pound sterling could be alleviated by exchange rate adjustments among countries participating in the exchange rate mechanism of the European Monetary System, in which the United Kingdom did not participate. For example, in April 1986 there had been a slight effective depreciation of the Irish pound, which within one week had been more than compensated for by the appreciation of the pound sterling--illustrating the Irish authorities' dilemma with regard to the exchange rate. Although the authorities considered that the exchange rate was not a suitable instrument in the Irish context, the staff had suggested that its use as a potential tool within the framework of the European Monetary System should not be ruled out.

It was difficult to determine whether domestic credit expansion had been somewhat too strong in the first few months of 1986, the staff representative from the European Department remarked. That period had been dominated by exchange rate developments, and increased domestic credit expansion was closely related to speculative capital outflows that were probably reversed later, although perhaps not fully. The data were not sufficient to draw any firm conclusions at present.

Mr. Leonard said that the best solution to the problems that arose for the exchange rate of the Irish pound in relation to the pound sterling, would be participation by the pound sterling in all aspects of the European Monetary System. However, fluctuations in the rate for the pound sterling vis-à-vis the Irish pound tended to reverse themselves over time; when they did not, domestic effects in the United Kingdom asserted themselves over a longer period and costs rose, as they had risen in Ireland when the exchange rate for the Irish pound had changed. At present, the authorities believed that it was better to concentrate on maintaining stability of the rate, which gave rise to the question of competitiveness and the need to maintain costs comparable with those in other countries. To do so would require an effective incomes policy, and the authorities were trying to make progress in that area.

Through national understandings and other devices, the social partners' consensus on wages had been sought, Mr. Leonard reported. But consensus had not worked very well, and the authorities would prefer to let market forces assert themselves.

Speakers had expressed misgivings about the fiscal deficit, the modest targets set in the National Plan, and the slow progress in reaching those targets, Mr. Leonard recalled. It was not surprising that those developments were of concern; the trends were disturbing and were relieved only by the downward tendency in the ratio of external debt to GNP and the fall in the external debt service ratio. In addressing those problems, primary consideration should be given to the reduction of expenditure; raising the overall burden of taxation was not the right course. For that reason the authorities had addressed expenditure, although perhaps not with great success, as a high degree of consensus was called for. The squeeze on supply services had been severe, but expenditure on the Central Fund, which was related primarily to debt service, had to be maintained. Therefore, cuts had to be made in other areas. Perhaps targeting could help in reducing welfare expenditure, although it must be recognized that even if benefits were held at their real levels, the burden could rise, especially with regard to benefits payable to the unemployed. With an unemployment rate of 18 percent, the scope for cutbacks in welfare benefits was limited. Social cohesion could be damaged if there was too much pressure, and the goal of national consensus might be deferred even longer. In fact, social welfare benefits in absolute terms were not that high; they had risen rapidly, especially in the 1970s, but from levels that had been completely inadequate. If the Government were to revert to former levels, that action would be considered a backward step.

Directors had commented that the Government had exceeded its own pay limits in 1985, Mr. Leonard said. In part, that was the price paid to break the rules under which the pay-negotiating process took place at present. The Government had been faced with two threats: a general pay round, and special increases for various groups in the public sector. In return for a higher than desired increase under the general pay round, the Government had sought to have special pay increases for particular sectors or groups in the public service deferred over a period of years. However, one group in the public sector had not gone along with that suggestion; an arbitrator had awarded it the special pay increase, which should be honored under present rules. The Government had nevertheless opposed the arbitrator's award, had taken the issue to Parliament, and had won approval for its stance. The group affected had launched a strike, but the Government had held out and eventually settled the strike at a cost of £35 million, saving the Exchequer £75 million over three years.

The fiscal situation and the high level of unemployment--the second major structural problem in Ireland--could not be separated, Mr. Leonard commented. Rapid reduction of the deficit--especially the current budget deficit--was desirable and would introduce a rigor into fiscal management that would be highly salutary. The pace of adjustment must also have regard for the immediate effects on employment and the slightly less immediate effects on the continuing work of restructuring and extending the productive base of the economy. Since the early 1960s, great efforts had been put into transforming the Irish industrial sector from an aggregation of protected inward-looking production units serving the home market to one of internationally competitive export-oriented activities. Large segments of traditional manufacturing had disappeared--along with thousands of jobs--and they had had to be replaced largely at first by activities attracted from abroad but increasingly at present by indigenous enterprises. In effect, a new entrepreneurial sector had had to be created in the Irish economy.

The idea behind the process of adjustment--insofar as it related to the reduction of the size of the public sector, the lowering of taxation, and the diversification of the industrial sector--was that when public intervention was removed, entrepreneurs would thrive and solve the unemployment problem, Mr. Leonard remarked; people displaced from activities that had been closed down would be absorbed quickly by other activities that had taken their place. That theory, although attractive, was not universally applied, and there was no precedent for judging its application in Ireland. The vigorous industrial sector in Ireland was not a spontaneous result but largely a creation of policy and of measures of industrial promotion carefully thought out and applied over a long period. While the sector would undoubtedly continue to grow, as would services, the process would take time. In such circumstances, there was a danger that if public expenditure was cut back too quickly and the deflation process was too harsh, there would be a lag, perhaps protracted, between the resultant unemployment and the emergence of the new investment and private sector activities that would eventually offset that increase in unemployment. Moreover, the likelihood that the whole process of industrial development would be set back had to be considered by the Irish authorities.

The ratio of public debt to GNP should be stabilized in a timely manner, Mr. Leonard said. To do less would be unsustainable. As many speakers had indicated, the authorities had perhaps set a pace for the reduction of external debt that was too slow.

In sum, the limited progress in adjustment achieved so far was the result not only of overcaution but of real and present dangers, as well as factors outside the control of the authorities, Mr. Leonard remarked.

With regard to his request for lengthening the standard 12-month consultation cycle with Ireland, he thanked Mr. Fugmann for suggesting that the decision on the frequency of the Article IV consultation be subject to the outcome of the Board's next review of the Fund's surveillance procedures.

The Chairman made the following summing up:

Executive Directors noted that some further progress had been made in Ireland's economic performance since the 1985 Article IV consultation. The rate of inflation had continued to decelerate and was close to the average rate of Ireland's main trading partners. There had also been some recovery in gross fixed capital formation, while the external current account deficit had been reduced further. Continued progress in these areas was forecast for 1986. At the same time, however, Directors observed that little progress had been made in the field of public finances and that unemployment had reached a very high level.

Directors stressed that the public finances remained a cause of serious concern and noted that the already scaled-down fiscal objectives of the National Plan were unlikely to be achieved. It was regrettable that the Government's pay offer to the public service unions exceeded its own guidelines and that social welfare spending had exceeded the authorities' commitments in the National Plan.

A faster pace of fiscal adjustment was called for, Directors emphasized; the present favorable economic circumstances facilitated the pursuit of a bolder policy which would minimize the longer-term costs of adjustment and lay the foundation for sustainable growth in output and employment. While every effort should be made to achieve the fiscal objectives of the National Plan for 1986, the pace of fiscal adjustment should be stepped up further for the period beyond. In the view of several Directors, the benefits to be derived from the correction of the structural problems in public finance loomed larger than the danger of a possible deflationary impact of fiscal restraint. Directors agreed with the authorities that the emphasis of fiscal adjustment should be on the current expenditure side--particularly in such areas as wage payments, social welfare expenditure, and state support to industry, including state enterprises--as the overall tax burden was already high and adversely affected incentives.

Directors commended the importance assigned by the Irish authorities to supply-side policies, especially the tax reform measures and the reorientation of industrial policy. Such measures should, if combined with wage restraint, over time produce a positive effect on output and employment. Several Directors, however, noted that much remained to be done in removing labor market distortions and rigidities and in redistributing the tax burden to reinforce the incentives to work and invest.

The importance of improvements in competitiveness as a means of strengthening further the external account and creating employment opportunities for the rapidly growing labor force, was underscored by Directors. It was noted that although the average increases in earnings have decelerated in recent years, Ireland's competitive position in terms of relative hourly earnings had not improved. Directors expressed concern that, notwithstanding the high level of unemployment, average hourly earnings in manufacturing in 1985 had risen faster than consumer prices, while the sharp deceleration in inflation in 1986 was rendering the settlements of the last wage round in the private sector more generous than intended. Directors emphasized that settlements in the next wage round should take full account of these windfall gains, and there was support for the staff's suggestion of a pay pause in the second half of 1987.

Directors noted that the Irish authorities did not envisage using changes in the exchange rate for the purpose of promoting price competitiveness. While generally agreeing with the emphasis placed by the Irish authorities on domestic adjustment, reduction of costs, and disinflation as the appropriate strategy to improve competitiveness because of the very high degree of openness of the economy, several Directors emphasized that this approach is preconditioned on greater wage and fiscal restraint and increased efficiency of the economy. Some Directors, noting the continued vulnerability of the external current account, encouraged the Irish authorities to keep the adequacy of the exchange rate under scrutiny.

Directors welcomed the increased nonmonetary financing of the Exchequer borrowing requirement in 1985 and the slowing down of domestic credit expansion, but some Directors felt that domestic credit expansion was still on the high side. Directors also welcomed the success of the authorities in improving the maturity structure of external public debt. Several Directors stressed, however, that Ireland's external public debt was uncomfortably high and urged the authorities to scale down official borrowing abroad so as to contain the heavy drain on national resources represented by interest payments abroad.

Subject to the outcome of the next Board review of the frequency of Article IV consultations in the framework of Fund surveillance procedures, a number of Directors were favorably inclined toward Ireland's request to extend the periodicity of the Article IV consultations from the present standard 12-month cycle. The present cycle will thus be kept at 12 months, but Executive Directors will come back to the Irish request in the light of the discussion of today and in the framework of future discussions.

2. VENEZUELA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Venezuela (SM/86/152, 6/25/86). They also had before them a staff report on recent economic developments in Venezuela (SM/86/153, 7/2/86).

The staff representative from the Western Hemisphere Department made the following statement:

> On July 17, 1986, the President of the Republic announced various economic measures affecting the exchange system, the public finances, and the scope of government regulation of the economy. This announcement followed the enactment of a law on July 7, 1986 that set out new regulations for the servicing of Venezuela's private sector external debt registered by the Exchange Control Agency (RECADI). The main provisions of the new law and the principal elements of the President's announcements are described below.
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> Private external debt service
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> As explained in SM/86/152, external debts of the Venezuelan private sector had to be registered by RECADI. Following registration, private debtors were to have access to foreign exchange at preferential exchange rates for debt servicing upon signing a five-year contract with the Central Bank of Venezuela. The requirement of a contract period did not apply to debts guaranteed by foreign official agencies and to outstanding debts of less than $500,000, which were to be paid as originally scheduled. Once these contracts were signed, amortization payments of registered private external debt had access to the Bs 4.30 per U.S. dollar exchange rate. The latter rate was also applied to payments on the original contractual period in the case of debts guaranteed by foreign official agencies and debts amounting to less than $500,000. The process of registration was only completed toward the end of 1985, and by March 1986 contracts had been signed covering some $3 billion out of approximately $5 billion of debts still eligible for such treatment.
>
> Under the new legislation, access to the Bs 4.30 per U.S. dollar exchange rate will be limited to the first two quarterly payments of the five-year period for debts previously under this contract schedule, to the payments of debts guaranteed by foreign official agencies that fell due before July 7, 1986, and to debts of less than $500,000; all these obligations are estimated at about $1 billion. In addition, the Bs 4.30 per U.S. dollar exchange rate will continue to be used to determine the reimbursement in bolivares to former debtors who amortized their registered debt through the free exchange market in the period February 1983-February 1984 (approximately $1 1/2 billion).

For the remaining registered private external debt (estimated at $4 1/2 billion), the Government's Exchange Compensation Fund (FOCOCAM) will issue U.S. dollar denominated bonds, which debtors may purchase at Bs 7.50 per U.S. dollar. These bonds, carrying a government guarantee, will have a maturity of no less than 15 years and an annual interest rate no higher than 5 percent, and may be used to settle private sector external obligations.

Some creditor banks have taken issue with the provisions of the new regulations on private debt service. The authorities, however, have stressed that these regulations only changed the rules determining access to the controlled exchange rate and do not impose rescheduling terms or an interest rate ceiling on foreign creditors. According to the authorities, Venezuelan private debtors and their creditors may agree on additional payments to compensate for any differences that might arise from the application of the new bonds to settle the original debt obligations. Such payments would be effected through the free foreign exchange market.

Following the completion of the remaining payments eligible for the Bs 4.30 per U.S. dollar exchange rate: a controlled exchange rate of Bs 7.50 per U.S. dollar applicable to most current transactions and official capital transactions; and a free market exchange rate, currently around Bs 19 per U.S. dollar, applicable to exports other than oil and iron ore, a limited group of imports, tourism, and private capital transactions. The elimination of the Bs 4.30 exchange rate for private sector debt service removes an exchange subsidy on private sector debt that had been equivalent to about 1 percent of GDP a year.

Public finances

The President announced the Government's intention to increase public sector revenues, to establish new social programs and to restrain certain kinds of current public expenditure. New fiscal revenue measures, which are yet to be specified, will include a reform of the income tax system within the framework of the recommendations made by the 1983 Tax Reform Commission, and adjustments of stamp duties and of state enterprises' tariffs and prices. The Tax Reform Commission had recommended a change in the corporate income tax from a progressive system of tax rates to a flat rate, a reduction in the progressivity of the personal income tax, and an increase in personal allowances. Because of the time required by the legislative process, implementation of these revenue measures might take place only next year.

New social programs to be implemented include various direct subsidies, such as school meals, a low-income housing mortgage program, training programs for public employees, and a temporary employment program for young people. At the same time, instructions have been issued to reduce such public current expenditures as overtime payments and fringe benefits. In addition, a draft law will be sent to Congress for the privatization of certain public enterprises. The authorities are in the process of quantifying the impact of these programs on the public sector finances.

Government regulations

The President also announced changes in government regulations affecting various sectors of economic activity. The Foreign Investment Code will be reformed to further reduce restrictions on the inflow of foreign capital and to ease regulations on the conversion of external debt to equity. The regulations on exports are also being further simplified. At the same time, however, import controls are being tightened further, including prohibitions of imports of a further range of commodities that are produced locally. Also, the price freeze for essential commodities has been extended until further notice.

The staff welcomes certain features of the new regulations on private external debt, such as the reduction of the exchange subsidy for private amortization payments and the resulting simplification of the exchange system. However, it is a matter of concern that the approach adopted by the authorities may be interpreted as a change in the arrangements for the servicing of foreign debt without prior consultation with creditors; of particular importance in this regard is the setting of terms that are not market related.

The planned adjustments in public enterprise tariffs and prices, the proposed tax reforms, and the restraint on certain categories of current expenditure are in line with the recommendations of the staff and would constitute steps in the right direction. Major fiscal action is still needed to reduce the large domestic and external imbalances facing Venezuela.

The staff considers that the intensification of import restrictions and the persistence of price controls will further hamper private investment and economic diversification; on the other hand, the announced plan to reduce the scope of other regulations, including on exports and foreign investment, is welcome.

Mr. Pérez made the following statement:

On behalf of my authorities, I wish to express my appreciation to the staff for the excellent paper before us and for the very constructive and stimulating discussions during the latest visit to Caracas.

My authorities broadly agree with the staff analysis and interpretation of the recent economic developments in the Venezuelan economy. Hence, I shall limit my comments to highlighting the broad economic policy guidelines followed by the Government and to providing some information on economic developments that have taken place since the consultation.

Venezuela has come a long way since the first fall in oil prices in 1982. In record time and in a climate of social peace the country achieved sizable surpluses both in the balance of payments and the fiscal accounts, increased international reserves, reduced external debt, reduced inflation to a one-digit figure, improved the financial position of public enterprises, fostered nontraditional exports, expanded agricultural production, reduced idle capacity in manufacturing industries, attained positive real growth in non-oil GDP, began to reduce unemployment, and enhanced social coverage in the fields of health and education.

In the face of a second and deeper shock caused by the recent collapse in international oil prices, it may be useful for the Board to have an outline of the basic strategy that has guided Venezuelan economic policies since 1984.

The dramatic downturn experienced in the world oil market in 1982 compounded by the expansionary fiscal and monetary policies that the Government pursued in the early 1980s led to a severe deterioration both in public finances and in the country's external position. The Administration that took office in February 1984 designed and implemented an adjustment program aimed at correcting these external and internal disequilibria through a tightening of aggregate demand and the adoption of policies geared to promoting structural changes. Demand measures included drastic cuts in public expenditures (capital outlays in real terms were more than halved in two years), and a stringent monetary policy. In order to promote microeconomic reforms aimed at improving efficiency and resource allocation, the Government adjusted the most important relative prices of the economy through a marked devaluation of the bolívar; the elimination of exchange and tax subsidies; a freeze on wages and salaries of public sector employees; and a rise in agricultural prices with the specific aim of encouraging production in this sector. All these actions were framed and developed in the context of a social pact that has been a key element in the adjustment process.

As a consequence of this strategy, the financial situation of the public sector improved substantially (a surplus of 4.9 percent of GDP was registered in 1984, compared with a deficit of 14.9 percent two years earlier), while a dramatic turnaround in Venezuela's external position was achieved. The external current account shifted from a deficit of $3.2 billion in 1982 to a surplus of $4.5 billion in 1984. Even more remarkable was the evolution of the overall balance of payments: a $8.7 billion deficit in 1983 turned into a surplus of $1.8 billion the following year, contributing to an increase in net international reserves of $1.9 billion.

The improvement in the country's external position allowed a decline in the external debt of approximately $4 billion between 1982 and 1984.

These gains, however, entailed high costs in terms of output and unemployment. Following a recession in 1983, a year in which output fell 5.6 percent, GDP again declined 1.4 percent in 1984, while unemployment rose from 7.1 percent of the labor force in 1982 to 13.4 percent in 1984.

Economic performance in 1985 was characterized by the continuation of the adjustment effort, while allowing for moderate economic growth and employment creation. The quantified economic program approved by the Government for 1985 set as policy goals the attainment of a moderate rate of growth in real non-oil GDP, inducing a reversal in the trend of unemployment; a decrease in the rate of inflation; and the maintenance of an external current account surplus. To meet these goals, the Government's intention was to attain equilibrium in the consolidated public sector, giving the economy a moderate boost through an increase in public investment, while in the monetary field the Central Bank of Venezuela was to pursue a less stringent monetary stance than in the previous two years.

In the external area, the program set a timetable for the unification of all official exchange rates by December 1985.

The results of this program were better than expected in terms of adjustment, although my Venezuelan authorities were deeply concerned about developments in economic growth and employment. The outcome for the year as a whole, as compared with the targets in the quantified economic program, is as follows.

	1985	
	Projected in the QEP	Real
Non-oil GDP in real terms (percentage)	2-3	0.6
Consolidated public sector (surplus as percentage of GDP)	0	5
External current account (surplus in millions of U.S. dollars)	1,700	2,923
Net international reserves (in millions of U.S. dollars)	11,867	15,478
M2 (percentage change)	18.3	8.7
CPI (percentage change, Dec. to Dec.)	13	5.7

Source: Banco Central de Venezuela.

For the first time since 1982, real non-oil GDP registered modest growth in 1985. The economic recovery experienced by the agricultural sector and by a growing number of manufacturing industries was the main element contributing to the improvement in non-oil GDP. Nevertheless, service activity fell for the third consecutive year, and construction--which was the fastest growing sector during the demand surge of the 1970s and was responsible for the generation of a large part of total employment--has persistently declined since 1980. It is worth mentioning that the surge in agricultural production has been the result of supply-oriented measures implemented by the Government in recent years. The unemployment rate barely improved, as the sectors responsible for the recovery were not those making the largest contributions to employment.

In the fiscal area, the Government attained a consolidated public sector surplus of 5 percent of GDP. This suplus resulted from a level of total revenues slightly higher than targeted and from a lower than budgeted level of public expenditure. On the revenue side, the decline in oil earnings was more than compensated by the increase in stamp and customs duties as well as the improvement in income tax collection. In addition, improved management procedures in public enterprises contributed to increasing the operating surplus of the nonfinancial public sector. On the expenditure side, delays in implementing the public sector investment program, along with the lower level of outlays to service the public debt, were the most important factors that led to a lower than budgeted outcome.

The external current account surplus was larger than expected because imports remained below projections, due mainly to low aggregate demand; and interest payments were lower than envisaged. These factors more than offset the decline in revenues of Petróleos de Venezuela caused by the weakness of the oil market during the year. This better than expected performance of the external current account permitted both an increase in international reserves and a further reduction in external debt.

In the exchange area the Government, as scheduled, unified all official exchange rates in December 1985 by moving to the Bs 7.5 exchange rate the items that were still on the Bs 4.30 per U.S. dollar list. The unification entailed an additional depreciation of the bolívar. I wish to underscore that since 1983 the authorities have pursued a gradual approach to exchange rate management to reflect the special characteristics of production and exports in Venezuela, as well as to meet the conditions needed for broad acceptance of the adjustment effort. This approach proved to be successful, as witness the balance of payments performance and the moderate price and wage behavior.

As to prices, the results were encouraging since inflation, as measured by the CPI, reached only 5.7 percent at the end of the year. This reflected the cautious monetary policy implemented by the Banco Central de Venezuela and the awareness shown by trade unions in collective wage bargaining. As mentioned above, the gradual phasing out of exchange subsidies during the year, along with the policy of price control, were factors contributing to the excellent price behavior.

In spite of the huge adjustment carried out in the public sector and in the balance of payments in record time, the recent collapse of international oil prices has changed the Venezuelan economic outlook drastically. On the basis of PDVSA's scenario of an average export price of $13-15 per barrel, Venezuela's oil export earnings in 1986 will decline by about $5-6 billion from their 1985 level.

In his address to the nation on July 17, 1986 the President of the Republic outlined the main objectives and policies of a package of measures designed to cope with the country's economic situation. The main objective of this program is to foster adjustment without jeopardizing growth and employment. It is the Government's intention to bring about an equitable distribution of the economic burden among workers, entrepreneurs and creditor banks.

To attain this goal, further tightening of demand is envisaged through additional cuts in current outlays and through a set of revenue-raising measures. On the revenue side, the program contemplates a reform of the tax system as recommended in the report of the Tax Reform Commission. The fiscal package includes the reform of the income tax system, an increase in stamp duties, as well as an important realignment of public sector prices and tariffs. In addition, the President announced the approval of a special law authorizing the sale of nonstrategic public assets and enterprises under the principle that the role of the state in a modern economy is to create the conditions for production and not to enlarge the size of the public sector.

On the expenditure side, the program calls for a reallocation of resources from current expenditures to capital outlays. In this regard, both personal expenditures and purchases of goods and services will be reduced, and the three-year special investment program approved by the Government at the end of 1985 will continue, thus fostering activity in the construction sector and contributing to increased employment.

To reduce the public sector deficit and to widen the participation of private entrepreneurs in the fiscal effort, the President announced the simplification of the exchange rate system by eliminating the preferential exchange rate of Bs 4.30 per U.S. dollar for servicing the private sector debt. In the future, private external debt will be serviced at the official exchange rate of Bs 7.5 per U.S. dollar. This measure will entail a reduction in the consolidated public sector deficit by 1 percent of GDP a year over the next five years.

In the area of structural reforms, a set of deregulatory measures is to be implemented with the aim of removing administrative obstacles affecting economic activity, particularly in the field of exports and foreign investment. In regard to the latter, the Government is preparing a reform of the foreign investment legislation to further liberalize this area and to attract capital inflows directed to the promotion of growth-oriented export activities. The package also contemplates the rationalization of electric power production and distribution, and includes measures aimed at fostering the tourist industry.

The attainment of an equitable distribution of the economic burden among the different agents involved in the adjustment process will entail, as mentioned before, an increase of entrepreneurs' participation in the fiscal effort, the implementation of a cautious wage policy, and, within the agreement reached with creditor banks early this year, the adaptation of the maturity profile of Venezuela's external debt in accordance with the country's new economic conditions.

It is expected that this package of measures will contribute to correcting the macroeconomic disequilibria caused by the fall in oil prices and to restoring sustainable growth in a climate of social and financial stability.

Mr. Arias said that the Executive Directors had a better picture of the performance of the economy in 1985 than had been available during the previous Article IV consultation. It was clear that the economy had over-performed in comparison with the 1985 Quantified Economic Program, particularly with respect to the consolidated public sector, the external current account, and the rate of inflation. The authorities were to be commended for the performance of the economy in 1985.

He was pleased that the authorities had maintained a conservative attitude toward oil prices in 1986, Mr. Arias continued. They had indicated that they were working on the assumption that a large part of the decline in the oil prices would be permanent. There would apparently be no difficulty in financing the public sector deficit in 1986, as the level of reserves was more than comfortable and substantial adjustments in the economy had been made in recent years; per capita GDP had declined by about 15 percent over the previous three years. In addition, the revised program described by Mr. Pérez was aimed at providing only a moderate stimulus to economic activity, and the financing of the public sector deficit seemed to be adequately provided through the decline in deposits of the public sector in the banking system and the prudent use of foreign reserves.

He agreed with the authorities that there was a need to unify the exchange rate and thereafter to manage the exchange rate in a flexible manner, Mr. Arias said. The inflationary impact of such measures might be greater than the staff expected, but it was encouraging to note that the authorities were proceeding with caution, as they recently had in eliminating the preferential rate for servicing the private sector debt.

The authorities had had great success in controlling wage increases, Mr. Arias remarked. As the staff had noted, government white collar employees had not received any wage increase since 1981, and the average real wage of workers who were not subject to collective wage bargaining had declined by 15-20 percent over the previous three years. The authorities should be commended for approving the recent wage increase for those workers up to a level that was designed to offset the decline in real wages.

He agreed with the staff that there were no immediate problems facing the economy in 1986, Mr. Arias commented. The problems had to do with the medium-term outlook, as the oil market was not yet settled. It was clear that prudent policies could not ensure any improvement or stability in the terms of trade in the medium term. As a result, the authorities had correctly decided recently to introduce additional measures to increase public savings to a level exceeding the 11 percent of GDP that had been expected for 1986. The new policy of privatization that Mr. Pérez had described would undoubtedly provide further incentives for public savings.

The present staff report did not contain all the tables with the estimates and actual data that had been available for the midyear Article IV consultation under the enhanced surveillance procedure (SM/85/115), Mr. Arias noted. The presentation of that data had been useful and would have been particularly helpful at the present stage.

The performance of the economy clearly reflected the courage and determination of the authorities to improve the very difficult economic situation that they had faced in the recent past, Mr. Arias stated. Continuous adjustment efforts should not be interrupted until a sustainable growth rate was obtained.

Mr. Nebbia said that Venezuela had made substantial progress in recent years. The authorities were to be commended for the implementation of a comprehensive economic program that included a substantial devaluation of the bolívar, the introduction of an austerity program for the public sector, a cautious wage policy, and a general tightening of the fiscal and monetary policy. The authorities had achieved major improvements in the external accounts, an increase in international reserves, a reduction in the external debt, a decline in the rate of inflation, a significant improvement in the fiscal situation, and an increase in the confidence of the international financial community. However, Venezuela had paid high costs for those improvements in the form of a decline in output and an increase in unemployment that were not substainable in the medium term.

The economic performance of Venezuela in 1985 had been impressive, Mr. Nebbia noted. For example, there had been a surplus of $3 billion in the external current account, net international reserves had increased substantially, the rate of inflation had declined to 5.7 percent from 15.5 percent in 1984, and the consolidated public sector had registered a surplus that was equivalent to nearly 5 percent of GDP. Therefore, it was fair to conclude that Government had taken the necessary steps to correct the huge external and internal imbalances.

The recent collapse in international oil prices had substantially worsened the outlook for the Venezuela economy, Mr. Nebbia commented. The price of oil had a significant effect not only on Venezuela's external sector, but also on its fiscal performance. Fortunately, Venezuela's adequate level of international reserves might help to alleviate the problems facing the economy and could provide the authorities with some room in which to maneuver.

As a general rule, the Fund, the World Bank, and the commercial banks should react with flexibility and understanding in dealing with countries that suffered either a dramatic or sustained deterioration in its terms of trade, especially in cases in which the deterioration was the result of decisions that were not related to supply or demand factors in a given market, Mr. Nebbia considered. The approach to dealing with Mexico was a good starting point in devising a general approach to dealing with countries that faced a substantial or sustained deterioration in their terms of trade. The burden of dealing with Venezuela's external debt should be shared by Venezuela and its commercial bank creditors. He agreed with the authorities that the multiyear agreement with commercial banks should be modified to take into account the consequences of the decline in oil prices. It was his understanding that that possibility had been foreseen when the agreement with the commercial banks had been negotiated.

A crucial issue was whether the authorities were taking the proper steps to cope with the significant deterioration in the external environment, Mr. Nebbia commented. In his view, the objectives that had been announced by the authorities in 1986 and the policies that had been implemented thus far in the year were appropriate. Particular attention should be paid to ensuring that the additional adjustment that was required did not jeopardize the achievement in the growth and employment objectives. In the fiscal policy area, the authorities' intention to make further cuts in public outlays and the implementation of the tax reform were welcome. Given Venezuela's adequate level of international reserves and the need to achieve its growth objectives, he doubted whether the staff's recommendation that the authorities should make an extraordinary effort to reduce expenditures was appropriate; a more gradual approach seemed to be advisable. Nevertheless, the authorities should make an additional effort on the revenue side, where there seemed to be some room to maneuver.

The fiscal package included a significant realignment of public sector prices and tariffs, Mr. Nebbia noted. That the authorities planned to reduce the participation of public enterprises in the economy was encouraging. That effort should help to solve structural problems and to encourage economic growth. The authorities must bear in mind the likely effects of an increasing fiscal deficit on inflation, the external sector, and economic efficiency. Monetary policy should preserve the gains that had already been made in containing inflation and should avoid a deterioration in the balance of payments.

The simplification of the exchange rate system with the recent elimination of preferential exchange rate for servicing private sector debt should help to reduce the fiscal imbalance and to distribute the burden of adjustment more equitably, Mr. Nebbia remarked. If the authorities felt that special support for some private enterprises or financial institutions were needed, they should provide it on a case-by-case basis.

Structural reforms were important if Venezuela were to achieve growth in the medium term, Mr. Nebbia considered. Therefore, he welcomed the deregulation that was aimed at reducing administrative obstacles. The reform of the foreign investment legislation that the Government was preparing with a view to liberalizing further the regulation of foreign investment in order to attract capital inflows was particularly welcomed.

He agreed with the authorities and the staff that it would not be prudent to implement economic policies on the assumption that there would be a major recovery in oil prices over the coming several years, Mr. Nebbia said. Therefore, a viable medium-term outlook for Venezuela included the continuation of both prudent demand management policies and structural measures to encourage economic growth.

Venezuela had demonstrated in the past that it could deal effectively with problems facing the economy, Mr. Nebbia remarked. The challenge facing Venezuela at present as a result of the abrupt decline in oil prices should be met through the efforts of the Venezuelan people with the support of the international financial community.

Mr. Polak stated that he generally agreed with the staff appraisal. The Venezuelan economy remained highly sensitive to developments in the oil sector, which made it difficult to implement any economic program on a medium-term basis. Although the recent developments in the oil sector had had a strong negative impact on the economy, caution was required in applying any expansionary policies. Because of the remaining uncertainties and the great dependence on oil, the economy could be turned around in the direction of greater diversification only in the medium term.

Although Venezuela had a welcome buffer of international reserves that was equilavent to two years of imports, he agreed with the staff that the fiscal deficit in 1986 should be held at 6.8 percent of GDP in order to ensure that the fiscal position would be sustainable over the longer run, Mr. Polak continued. Priority under the three-year special investment plan should be given to investments that were aimed at export production. It was perhaps unfortunate that the economy had overadjusted in 1985, in the sense that the anticipated increases in the capital expenditure had not occurred, resulting in a fiscal surplus equivalent to 3 percent of GDP. Had the public capital expenditure program been fully implemented, the economy would have been more prepared--in the sense of maintaining an appropriate growth orientation--to withstand the present needed adjustment in the current, relatively constrained environment.

While he agreed with the staff on the fiscal targets for 1986, he was less convinced by the staff's argument on page 22 that the deficit should be reduced to 2.3 percent of GDP in 1987, Mr. Polak said. It was true that a fiscal deficit of 2.3 percent of GDP in 1987 would become compatible with the desired current account position if private sector investment recovered as the authorities hoped, but there was some question whether the recovery of private investment would occur. If despite the sharp fiscal adjustment the recovery did not occur, Venezuela might record large current account surpluses like those of 1984/85. A crucial question was how to ensure the recovery of private investment. That goal could not be achieved through the contraction of fiscal policy alone. There was no evidence that private investment was being crowded out and would increase as soon as the fiscal position created the necessary room. To encourage investment, heavy emphasis would have to be given to supply-demand side policies. It was clear that, although many steps had been taken in the right direction, the economy continued to suffer from excessive state control. He agreed with the staff's conclusion on page 26 that deregulation of the economy was needed to enhance Venezuela's growth prospects.

Further action on the exchange system, which still caused significant distortions, was imperative, Mr. Polak went on. The free market exchange rate was still far from the official rate and continued to account for only 15 percent of all foreign exchange transactions. Unification of the two exchange rates should obviously be a target, and the authorities should not wait too long to achieve it. Venezuela also had a long history of overregulation with respect to price controls. While the role of those controls in the context of the social compact in Venezuela was understandable, it was his impression that the distorting effects of the price controls were not adequately reflected in the authorities' policymaking. Policy in Venezuela had been controlled more tightly since the beginning of 1986; many prices had been frozen, and others were subject to notification of three or even six months.

There was a clear need for progressive import liberalization in Venezuela, Mr. Polak said. Venezuelan industry had been protected by import restrictions for an excessively long period.

There seems to be a fundamental ambivalence in Venezuela's policies, Mr. Polak commented. On the one hand, the authorities realized that non-oil exports and non-oil domestic growth were essential. On the other hand, the habits of a rich oil country that could afford wasteful domestic production were hard to change. Only a courageous move to closer economic integration with the world economy would give Venezuela the needed push for sustained growth.

Mr. Suraisry said that the adjustment policies that the authorities had introduced before 1985 had yielded very encouraging results. There had been an impressive turnaround in the fiscal and external positions, and inflationary pressures had been brought under control. Furthermore, the public sector's external debt arrears had been eliminated, foreign reserves had increased, and confidence in the domestic economy had been restored. The authorities were to be commended for those achievements.

However, the achievements had involved costs, Mr. Suraisry continued: investment had been sharply reduced; real economic growth had been negative for the third consecutive year in 1985; and the rate of unemployment had sharply increased to 13.5 percent in 1985. Those developments had clearly heightened the authorities' concern about the prospects for economic growth and had prompted a shift in the thrust of policies toward reactivating the economy.

The main policy challenge facing the authorities in 1985 had been to reverse the trend in unemployment without rekindling inflation, undermining confidence in the economy, or recording an excessive loss in foreign reserves, Mr. Suraisry remarked. That challenge had been further complicated by the steep decline in oil prices during 1986. The objectives of the 1986 Quantified Economic Program, which was designed to stimulate the economy while limiting the loss of official reserves to about $4 billion, had become much more difficult to achieve.

The basic policy choice available to the authorities was to find the appropriate mix between adjustment and financing, Mr. Suraisry considered. Uncertainties about oil developments and the unlikely full recovery in oil prices in the short run, at least to previous peaks, called for an economic strategy that emphasized adjustment. In any event, should oil prices strengthen more or faster than was expected, the higher than anticipated oil export receipts could be used to improve public finances and to strengthen official reserves. However, a policy mix that favored financing over adjustment involved risks and might prove costly. For example, should oil prices not recover, or should such a recovery take longer than expected, the needed adjustment would be more difficult and more costly. In addition, such a policy would lead to a drawdown in the country's reserves, thereby reducing the benefits provided by a comfortable level of reserves.

In the circumstances that he had described, caution was clearly required in attempting to revive economic activity, Mr. Suraisry commented. As the staff had noted, attempts to revive economic activity could create unsustainable fiscal deficits and place substantial pressure on the balance of payments. However, he shared the authorities' concern about the growing unemployment problem and the need to strengthen the non-oil sector. Hence, the emphasis in the investment strategy on labor-intensive activity and non-oil exports was appropriate.

The July 17, 1986 package of measures was welcome, Mr. Suraisry said. Those measures were designed to foster adjustment without compromising economic growth and employment. In particular, the Government's intention to further tighten aggregate demand through additional cuts in current government outlays and through a set of revenue-raising measures was commendable. The authorities' intention to privatize certain public sector enterprises and to reform the income tax system within the framework of the recommendations that have been made by the 1983 Tax Reform Commission was also welcome. However, given the inevitable delay in implementing such reforms, additional fiscal measures might still be required. In particular, it might be necessary to scale down the planned expansion of public sector capital expenditure in order to contain the fiscal deficit within manageable limits and to avoid strong pressure on the external accounts.

In the coming period, it would be important to consolidate the gains that had been achieved before 1985, Mr. Suraisry commented. To that end, the adjustment efforts should be broadened to include long-range structural measures. Policies aimed at creating the conditions for viable private sector activity and at attracting nondebt-creating capital flows were needed. The implementation of appropriate demand management policies was essential. Such policies, together with a cautious wage policy, would help to contain inflation and lower domestic costs, thereby improving the overall investment climate. The authorities' intention not to enlarge the size of the Government while stimulating output was a step in the right direction. Their intention to reform the foreign investment code should help to reduce restrictions on the inflow of foreign capital and to facilitate the conversion of external debt to equity, thereby easing the large debt burden.

As the authorities were aware, there was a need to streamline government controls and to reduce the reliance on quantitative restrictions, Mr. Suraisry remarked. Such controls tended to be cumbersome to implement and adversely affected the private sector initiative. Special attention should therefore be paid to phasing out such controls if the economy were to develop the dynamism and flexibility that was needed for future growth.

A simplification of the present exchange rate system, with a view to establishing a unified rate at a realistic level, was essential to ensure an appropriate relative price structure in Venezuela, Mr. Suraisry considered. An appropriate relative price structure would enhance the country's international competitiveness and lead to a more diversified export basis. The unification of the official exchange rates was an important step in the right direction. It was especially welcome because it would improve the fiscal situation by the equivalent of 1 percent of GDP.

It was important also to send the private sector a steady policy signal that would enable it to plan its activity in a medium-term context, Mr. Suraisry said. In other words, the authorities should maintain appropriate policies and stay the course in order to reassure the private sector of the Government's policy intentions. Continuity in policy was essential to private sector investment decisions and would be instrumental in encouraging private sector capital inflows.

The recent change in policy with respect to private sector external debt was puzzling, Mr. Suraisry said. Government policy was tantamount to favoring the substitution, at least in part, of new public sector debt for old private sector debt. That approach raised a number of issues. First, the scheme would surely increase both the stock of external debt and the volume of external debt payments. Second, the terms of bonds issued by the Government in connection with that scheme were not market related and appeared to be inadequate. In particular, the setting of a maximum interest rate of 5 percent seemed to be arbitrary. Third, the fact that the authorities' approach might be interpreted as a unilateral decision to change contractual private sector obligations to commercial creditors was a cause for concern. Such action might adversely affect the relationship between Venezuela and its creditors. In addition, it might affect the creditworthiness of the private sector in Venezuela and might have introduced an element of uncertainty. While the implications of the scheme for the fiscal position were likely to be positive, the staff could usefully shed some light on the implications for the balance of payments and for credit and monetary expansion.

The authorities had taken a number of impressive steps over the previous years to promote adjustment, Mr. Suraisry considered. Moreover, the recent package of measures, if fully implemented, should help to reduce the macroeconomic imbalances. However, at the present stage it was important to intensify the adjustment effort further in order to restore growth within the context of balance of payments viability.

Mr. Grosche recalled that during the previous Article IV consultation with Venezuela his chair had voiced considerable doubt about whether Venezuela had established a sufficiently solid foundation on which to launch a program of strong economic expansion. In light of the uncertainty about future oil receipts, it had seemed unlikely that the ambitious investment program could be financed without unduly large recourse to domestic or external credit, a view that had not been shared by Mr. Pérez and his authorities.

His doubts had been confirmed by subsequent developments, Mr. Grosche continued. Venezuela faced unsustainably large budget and balance of payments deficits. Of course, Venezuela had been particularly hard hit by the drastic drop in oil prices. During the previous Article IV consultation with Venezuela, his chair had expressed its symphathy with the Venezuelan authorities, who were concerned about the decline in economic activity and the rising unemployment in 1982-85, and it had agreed that a carefully designed investment program emphasizing projects with large multiplier effects could make an important contribution to solving domestic problems. However, the fall in oil prices had changed the picture drastically. In the absence of additional solid financing, the kind of pump priming program that the authorities had outlined would cause a rapid reversal of the adjustment gains that had been made with serious consequences for Venezuela's economic stability and for the prospects for the economy. Moreover, such a program would run the risk of jeopardizing both the normalization of relations with Venezuela's creditors and the restoration of the confidence that was needed to generate a steady inflow of foreign savings. There were considerable doubts that oil prices would be quickly reversed; that conclusion should caution the authorities against filling most of the financing gap by taking on additional debt. Although Venezuela could for the moment rely on its relatively large reserves, the avoidance of immediate corrective action by the authorities would merely postpone the necessary adjustment to some time in the future when the adjustment would be even more painful than at present. In addition, he was worried that the credibility of the Fund's enhanced surveillance process might suffer if large discrepancies between the staff's policy advice and the measures that the authorities implemented were to persist.

He agreed with the staff that a depreciation of the controlled exchange rate of the bolívar and the early unification of the various exchange rates were urgently required, Mr. Grosche said. The large non-oil trade deficit was due to a considerable extent to the overvaluation of the bolívar. The present spread between the preferential and free market exchange rates was approximately 150 percent. In addition, the present exchange rate system had resulted in resource misallocation and had contributed to inefficiencies and distortions in various sectors of the economy. He therefore welcomed the recently announced changes in the exchange system, including the devaluation of the subsidized rate for repayment of foreign debt and the introduction of a two-tier system; those changes were important steps in the right direction.

He also agreed with the staff that the authorities should complement those measures with the elimination of the various restrictions on international transactions, Mr. Grosche went on. While the recently announced easing of export restrictions and the liberalization of the foreign investment code were welcome, the further tightening of export restrictions was a cause for concern. Although it was intended to encourage import substitution, the extensive system of import controls was a heavy burden on the domestic productive sectors because of its impact on the availability of inputs. Moreover, the system of import controls together with the overvalued exchange rate provided excessive protection for inefficient sectors, thereby hampering the structural adjustment that was needed to increase the external competitiveness of the country's non-oil sector. The trade policy study should establish a foundation on which to make comprehensive reforms in that area.

As the staff had noted, inefficiencies and distortions were perpetuated partially by the existing price controls and the various regulations governing labor markets, housing, and the agricultural sector, Mr. Grosche commented. He doubted whether there would be a significant supply response within the economy to an expansionary fiscal and monetary policy. Even if the need for such policies were agreed, such a stimulus to domestic demand would probably result in higher inflation rates and a sharp deterioration of the external current account.

He had serious reservations about the planned course of fiscal and monetary policy, Mr. Grosche said. The dramatic shift in the public sector balance to a deficit of 9.5 percent of GDP in 1986 projected in the Quantified Economic Program was cause for serious concern. In addition, that projection already appeared to be outdated because a further decline in oil prices below that level had been assumed by the authorities. At the same time, the Government's intention to introduce a number of measures to raise revenues and to restrain certain kinds of current public expenditure was welcomed.

The authorities should undertake a comprehensive review of the public investment program, with a view to making a significant reduction in the planned spending levels and to concentrating resources on the most productive quick-yielding projects, Mr. Grosche went on. Only then could the authorities avoid unsustainable fiscal deficits and the re-emergence of serious balance of payments problems that had been experienced only a few years previously. Such changes on the expenditure side would be a precondition for achieving a slower than expected growth of the monetary aggregates by reducing the need for central bank financing of the public sector deficit. Apparently most of the treasury bonds issued in 1986 had

had to be purchased by the Central Bank because there had not been enough buyers on the domestic capital market. A more moderate expansion of the monetary aggregate, like the pace achieved in recent years, would facilitate the gradual elimination of price controls without rekindling inflation.

The authorities had reintroduced new legislation to change the rules on the access of private debtors to the controlled exchange rate, Mr. Grosche noted. As he understood it, subsidies through the exchange rate were being partially replaced by a low interest rate on 15-year government bonds, but that only part--the registered part--of the private debt was to be involved and the rest of the subsidies would have to be made up by private debtors via purchases of foreign currency in the free market. While in principle he supported a move away from the subsidization of debtors through the exchange rate, he was concerned about that unilateral measure, which could seriously affect the normalization of Venezuela's financial relations with foreign creditors, particularly at a time when the banks were being asked to be flexible in their treatment of Venezuela's debt. Apparently banks had to make substantial write-offs on their portfolios, and some banks had already cut short-term trade-related credit lines to Venezuela. While he did not favor subsidizing companies through the maintenance of incorrect exchange rates, companies had to be protected against inflation and depreciating exchange rates--factors for which they were not accountable. Finally, he agreed with the staff appraisal.

Mr. Zecchini said that recent price developments in the world oil markets had played a crucial role in drastically modifying the generally positive outlook for the Venezuelan economy in recent years. The sudden worsening of the external accounts and of public finances, which were estimated to show a deficit of about 11 percent of GDP in 1986 following a surplus of 3 percent of GDP in 1985, together with the stagnating GDP and the relatively high unemployment rate were to a large extent the results of the economy's excessive dependence on oil revenues and the authorities' unsuccessful attempts to diversify the production base. He agreed with the staff that the necessary process of diversification had been negatively affected by the far-reaching system of controls and regulations, the removal of which should be a major objective of the authorities.

Although he did not fully support the drastic fiscal measures that the staff advocated, he agreed with the thrust of the staff's recommendations, Mr. Zecchini remarked. Since the Executive Board had recently reviewed Venezuela's economy, he would concentrate on the medium-term outlook for the areas that were of crucial importance for the achievement of balanced and sustainable growth--namely, fiscal policy and regulations and external policies.

It was clear that Venezuela had to tackle the problem of fiscal deficit in a more forceful manner in coming years, Mr. Zecchini said. The country had to react to the adjustment implications of the temporary reduction in oil receipts. It was also clear that the major part of the fiscal adjustment effort should be concentrated on the expenditure side. In the present circumstances, the sharp expansion of domestic demand led by government expenditure would not be the appropriate instrument to use to encourage balanced economic growth. However, the recommended reduction of the fiscal deficit from 11 percent of GDP to 2 percent of GDP in little more than two years seemed to be somewhat drastic in view of the need to maintain the economy on a growth path, although at a slower pace than in the past. After all, the purpose of accumulating international reserves was to permit some smoothing of the adjustment pace.

On the expenditure side, the authorities' approach required some adjustment, Mr. Zecchini continued. Table II in the staff report showed that expenditure had increased significantly only in the capital account, from Bs 51.3 billion in 1985 to an estimated Bs 72 billion in 1986. In the past, capital expenditure had been directed mainly toward the restructuring of the economy along the lines of the three-year plan, but in the most recent package capital expenditure was concentrated in the social and housing areas. Although there was a useful role for the public sector in promoting the restructuring of the economy, and in providing partial relief from the consequences of the past recession, some caution should be exercised in expanding capital expenditure. That conclusion was warranted by the unsatisfactory effectiveness of public investment in the past, as was reflected in the persistent inability of the Government to implement fully its investment program. In that connection, it would be useful to have more detailed information of the present public investment plans and on the order of magnitude of the possible reduction in investment recommended by the staff in 1986 on page 22 of the staff report.

As to the other expenditure categories, the dynamics of current expenditure seemed to be under control; in that connection, the commendable wage moderation, which had led to some erosion of real wages since 1980, had played a crucial role, Mr. Zecchini said. Moreover, the recent elimination of exchange rate subsidies should provide some further relief to expenditures.

Additional efforts seem to be required on the revenue side, Mr. Zecchini remarked. The 23-point package that was recently presented by the President of Venezuela seemed to address that problem, although not to the extent required. Full implementation of the recommendations of the 1983 Tax Reform Commission should be accomplished given the still relatively low level of tax revenues, which represented an estimated 25-27 percent of GDP in 1986.

He strongly agreed with the staff that the excessive scope of regulations was a major cause for concern, Mr. Zecchini stated. The import, exchange, and price controls and regulations constituted a pervasive system for shielding the economy from external influences and distorted the allocative functions of relative prices. The resulting misallocation of resources was an important factor in the sluggishness of private investment, and abolition of the price controls seemed essential to foster economic growth and reduce supply-side bottlenecks. In that connection, the Government's recent initiative toward unifying the foreign exchange markets was welcomed. However, the mixed signals that had been sent by that initiative were a cause for concern: together with the liberalization of exports there had been new restrictions on imports and a tightening of price controls. It was not clear to him whether the authorities are aware that the relief that the restrictions could provide in terms of the availability of a larger amount of foreign exchange or decreased pressure on domestic prices was only temporary and involved substantial costs over the long run. In addition, the authorities must recognize that Venezuela's strong dependence on oil revenues, which represented about 90 percent of total exports, had to be addressed courageously as a major long-term policy challenge. The steps that the authorities had taken to promote a restructing of the productive base and of the economy as a whole were insufficient. For that reason, he agreed with the staff that Venezuela's exchange restrictions should not be approved.

For the time being, the comfortable reserve position--equivalent to two years of imports--guaranteed the economy a certain margin of maneuver, Mr. Zecchini commented. The staff should comment on the consequences of the recent conversion of one seventh of the external debt into government bonds for reserves and the sustainability of the balance of payments deficits.

Mr. Hodgson said that from 1983 to 1985 Venezuela had made significant progress in many respects in adjusting to the decline in its oil income. However, the recent large decline in oil prices had led to the re-emergence of large fiscal and external deficits. He agreed with the authorities that there would not be a major recovery in oil prices over the coming several years.

Nevertheless, he shared the previous speakers' concern about the delay in implementing further adjustment measures that appeared to be required in the present circumstances, Mr. Hodgson went on. The measures that were announced on July 17, 1986 dealt partially with the fundamental disequilibrium, but in some respects they actually intensified restrictions on trade and prices. The authorities' objective of promoting growth in 1986 was understandable, given the weak growth performance over much of the previous decade. However, the present strategy of fiscal stimulus, monetary accommodation, and price and trade controls was extremely risky. Such a policy mix could well result in a rapid decline in reserves, a buildup of inflationary expectations, and an increase in the distortions in the economy. That policy mix might even weaken the prospects for growth, given the likely negative effect on private investment, price distortions and uncertainty. Therefore, a set of policies that was aimed at bringing absorption more rapidly in line with the present level of income, while reducing regulations and restrictions, would be more likely to succeed than the present policy mix.

The authorities had taken some welcome steps over the previous year on exchange rates, including the recent decision to more or less eliminate the preferential rate for foreign debt payments, Mr. Hodgson remarked. However, further exchange rate action at the present stage would be appropriate, since it would be a more efficient means of adjusting the external accounts to the current fairly favorable environment than tightening import controls. He was disappointed that the measures that had just been introduced to ban imports of farm products that were already produced in Venezuela and to reduce imports of finished goods merely added to the controls and regulations in the economy. A move to a more realistic exchange rate policy would help to pave the way for a reform of trade policies and a progressive elimination of import and export restrictions, with the World Bank's assistance. Both exchange rate action and a shift from direct controls to a broadly based tariff system could help to strengthen the fiscal position.

The magnitude of the projected deterioration in public finances was a cause for considerable concern, Mr. Hodgson said. Improvements in income tax administration had been made in 1985, and he welcomed the plans to implement the tax reforms based on the recommendations of the 1983 Tax Reform Commission. However, the efforts to offset the decline in oil receipts needed to be strengthened. Further adjustments in prices and tariffs of public enterprises would probably be needed in addition to the price increases that had already been made. On the expenditure side, a re-evaluation of the capital expenditures planned for 1986 and beyond was called for. He recognized the authorities' commitment in their recent statement to a stricter program of expenditure control and reduction. Nevertheless, given the staff's view that a rapid reduction in the public sector deficit was necessary, any delays in strengthening the fiscal position would make the eventual adjustment that much more difficult.

The present monetary stance was very accommodative and carried a substantial risk of intensifying inflationary pressures and causing a more rapid depletion of official reserves, Mr. Hodgson noted. Therefore, the authorities should tighten their monetary policy stance in line with the strengthening of the fiscal balance. Similarly, the authorities should move to a system of market-determined interest rates and should eliminate interest rate subsidies for agricultural loans in order to improve overall resource allocation. A firm wage policy would also have to be maintained, as the decline in oil prices had resulted in a considerable loss in Venezuela's real income. If the line could not be held on real wages, even higher unemployment was likely to occur.

The authorities should proceed promptly to eliminate all the external arrears in order to restore access to credit lines, Mr. Hodgson said. It was regrettable that the process of normalization appeared to have suffered a setback with the recently announced new private sector debt scheme that was described in the staff's opening statement. That scheme was not the kind of measure that was needed to restore the confidence of external creditors.

Mr. Fujino commented that considerable progress had been made in reducing the external and internal imbalances in 1983-85. On the basis of that progress a debt rescheduling agreement had been reached under an enhanced monitoring arrangement with the Fund. The recent fall in oil prices, however, had substantially changed the economic outlook for Venezuela. The external current account was expected to move into a large deficit in 1986 and to remain in deficit for some years to come. Even excluding the net repayments to commercial banks that were a part of the 1985 rescheduling agreement, the overall balance would register a substantial deficit in 1987-90, and a sizable fall in external reserves was expected.

In the circumstances, it was increasingly clear that drastic adjustment to the new external environment was needed, Mr. Fujino continued. While he understood the need for more growth, the magnitude of the necessary adjustment called for not only a tightening of demand management but also a significant change in the industrial structure. The authorities seemed to be aware of those needs, and it was encouraging that additional measures in the right direction were to be taken in the area of public finance. However, as the staff had noted, major fiscal action was needed. The economy had long been beset by pervasive controls and regulations, and the interventionist policies had recently been intensified. The needed structural change could be facilitated only by removing the administrative controls and regulations. Such deregulation and exchange actions would represent a major reorientation of economic policy and, if accompanied by appropriate management policies, would constitute a comprehensive adjustment program that could be supported by the international community. He shared Mr. Grosche's concern about maintaining the credibility of enhanced surveillance when there were significant differences of view between the authorities and the staff.

Commenting on the overall objectives of the 1986 economic program, Mr. Fujino said that it was disappointing that excessive emphasis was placed on providing a stimulus to economic activity rather than to making the needed adjustments. Once implemented, an expansionary policy stance was difficult to reverse. In addition, the expected public and external deficits were not thought to be sustainable, even taking into account the new measures that had been implemented. It was particularly worrying that the program provided for a further tightening of import and exchange controls. Even with the additional measures, the thrust of the 1986 program seemed to be insufficient from the longer-term perspective.

The projected substantial swing in the fiscal position was a cause for serious concern, Mr. Fujino went on. A key element underlying the fiscal deficit was the implementation of the three-year special investment plan. While some of the planned projects could contribute to the needed diversification of the economy, the authorities should seriously review the priorities that were given to the various projects. The tax reform and restraint of certain types of current expenditure were to be implemented. However, the new social program seemed to include an increase in certain subsidies. He wondered what the overall effect of the various measures would be on the size of the public sector deficit. The staff recommendation to reduce the public sector deficit to about 2 percent of GDP within a couple of years was appropriate.

The projected increase in overall credit was much faster than was warranted and was likely to lead to an acceleration in the rate of inflation or to losses of reserves, Mr. Fujino commented. He agreed with the staff that the rate of expansion of broad money and overall credit should be reduced. Removing interest rate ceilings and subsidies would be an important step toward the overall liberalization of economic policies that would be essential for a smooth and efficient restructuring of the economy.

The heavy reliance on trade and exchange restrictions did not contribute to the efficient allocation of resources and was likely to impede the needed structural reform, Mr. Fujino remarked. Therefore, the restrictions must be phased out and replaced as soon as possible by a more realistic exchange rate policy that would include the rapid unification of the exchange system. The authorities were well advised to expedite the process of eliminating external arrears in order to regain the confidence of private creditors. He shared the concern of the staff and previous speakers about the authorities' new approach to debt, which might be interpreted as a unilateral change in the terms and conditions of loans, and he presumed that the issue would be clarified.

The importance of a structural approach in Venezuela could not be overemphasized, as the need for adjustment had been created by the drastic change in relative prices over a fairly long period, Mr. Fujino said. That the World Bank was reconsidering Venezuela's eligibility for Bank financing was encouraging. The World Bank's technical assistance would be very useful for the authorities, and the additional financing would help in the implementation of the needed structural reforms in various fields.

Mr. Fox recalled that during the previous Article IV consultation with Venezuela, and despite the substantial adjustment since 1982, the authorities had been urged to make significant policy changes, particularly structural changes, as an essential accompaniment to the planned expansion of public capital spending if growth in the non-oil private sector was to be revived. Developments in the oil market since the previous consultation had caused a significant deterioration in the immediate prospects for the economy and had made the implementation of such policy reforms, supplemented by measures to adjust the economy to the substantial loss of oil revenues, all the more urgent. Although Venezuela's reserves gave the authorities some room for maneuver, the staff report clearly showed that without a change in policies, even the ample reserves would come under severe pressure eventually and, meanwhile, the large public sector deficit would place pressure on the domestic economy.

The recently adopted package of policy measures went partially in the right direction, Mr. Fox continued. Its structural elements were particularly welcome, notably the income tax reform, the measures to encourage inward investment and privatization, and the simplification of the export regulations. However, the revenue and spending measures had not yet been completely specified and quantified, thereby making an assessment of the policies' adequacy difficult. However, full implementation of the policies might well be delayed until 1987, and while he recognized that there were difficulties in the area of implementation, it appeared that the policy package would fall short, particularly in comparison to the fiscal adjustment that was recommended in the staff report. Nevertheless, the measures were a step in the right direction. At the same time, the authorities should make every effort to expedite the implementation of those measures, which would have to be supplemented by additional measures if the fiscal and current account deficits were to be reduced to sustainable levels. He agreed with previous speakers that the authorities should reconsider their decision to press ahead with the special investment program, which had been excessively ambitious even before the oil price decrease.

The recent policy package was also disappointing because in a number of important respects it went further in the wrong direction; that was particularly true of the tightening of import controls, Mr. Fox said. The number of items that were subject to price controls had also increased over the previous months. While price controls had been a significant element of the social compact that had helped to restrain wages over the previous several years, the authorities' decision to increase the price controls at a time when some workers were being compensated for past wage restraint with large pay increases seemed to be inconsistent with the authorities' stated policies. Wage increases should be accompanied by price decontrol rather than by more extensive controls.

At the heart of Venezuela's sluggish growth were the extensive administrative controls that were associated with the exchange rate system, including the direct control of imports, the demand for which was encouraged by the artificially high, controlled exchange rate, Mr. Fox commented. The unification of the controlled rates by the end of 1985 and the elimination, with a few exceptions, of the preferential rate on private sector debt repayments in the latest policy package were therefore welcome. However, the differential between the new, unified controlled rate and the free market rate had continued to increase, and a substantial adjustment of the controlled rate was clearly needed. It was therefore unfortunate that the authorities had more or less ruled out that possibility for the time being, owing to uncertainties associated with the oil situation. It was precisely the loss of oil income that made rapid action in that area particularly important. Such action, combined with the import liberalization, would have a major impact on private sector incentives and efficiency, and the increase in domestic competition would mitigate the effect of the exchange rate adjustment on the domestic price level. The trade policy reform study that was being prepared with the help of the World Bank was encouraging, but that study made the tightening of import controls all the more regrettable, and the authorities should reconsider their approach in that area.

The staff report clearly showed that the authorities' objectives of stabilizing external debt from 1987 onward and maintaining reserves at about $8 billion would not be achieved without a sufficiently strong and comprehensive package of measures that went beyond the recently introduced package, Mr. Fox remarked. At the same time, the staff's medium-term scenario showed that Venezuela could cope with the consequences of the oil price fall if it introduced such measures at an early stage. Such a policy response would also be a positive factor in Venezuela's negotiations with its external creditors. In that connection, he shared others' concern about the unilateral introduction of the new scheme to service private debt, and he looked forward to hearing the staff's response to the comments on that point by Mr. Suraisry and Mr. Grosche.

Mr. Finaish said that it was unfortunate that after three years of strong financial adjustment and at a time when Venezuela appeared to be ready to move to a new phase of growth and recovery, the country had been hit hard by the collapse of oil prices that was expected to reduce export revenues by almost half. Although the contribution of the oil sector to GDP was relatively small in Venezuela compared with most other major exporters, the impact of the loss of oil revenue in Venezuela's external position was dramatic. According to the data provided in the staff report, the drop in export revenues in 1986 was expected to be only slightly less than the total import bill and was expected to exceed the total debt service payments for the same year. Under those conditions, it was unavoidable that the authorities' strategy and pace of adjustment and recovery would have to be reconsidered and adapted to the new circumstances. In addition, it was clear that difficult policy choices and decisions would have to be made to ensure that, despite the enormous shock to the economy, the objectives of medium-term balance of payments viability and recovery of economic growth would be achieved.

The pace at which further financial adjustment should proceed was obviously a critical question on which the staff and the authorities apparently did not agree, Mr. Finaish continued. That problem was understandable, since as a result of the strong balance of payments adjustment over the previous few years the authorities had been able to maintain and even increase the previous comfortable level of foreign exchange reserves. Because the reserves provided a cushion to the impact of the oil price shock, the most feasible pace of financial adjustment was a matter of judgment. Nevertheless, the authorities had stated that their minimum foreign exchange reserves target for the coming three years reduced substantially the scope for disagreement on what needed to be done in terms of financial adjustment over the medium term. However, the question remained how much of that adjustment, particularly in the fiscal area, could reasonably be achieved in the very short run. The staff clearly felt that the 1986 Quantitative Economic Program originally presented by the authorities fell somewhat short of what should and could be done.

The policy package outlined by Mr. Pérez in his opening statement and the staff's opening statement seemed to indicate that the authorities intended to strengthen their adjustment response to the new oil situation, but it seemed that the balance of payments measures that were announced by the authorities would have no significant impact on public finances in 1986, and that the targets in Table IX in the staff report remained essentially unchanged. A further comment on that issue would be helpful.

A major element of the 1986 economic program was that, despite the expected drop in revenue of more than 7 percent of GDP, expenditures were to be increased significantly in comparison with 1985, particularly capital outlays, which would result in a public sector deficit of about 10 percent of GDP, Mr. Finaish remarked. In order to mitigate the impact on the external balance and on prices, the authorities would continue--indeed, would strengthen--the trade and price controls. Although the reserves in losses would be substantial--about $4 billion--the authorities believed that the public sector deficit in 1986 and its impact on the economy were manageable. While that might well be so, given the leeway provided by the international reserves, the question arose whether the plan to increase capital spending could not be scaled down in 1986 in order to avoid a sharp cut in subsequent years if the oil market did not respond.

One could of course understand that the authorities' emphasis on investment as part of their effort to improve the growth and employment situation, and the three-year special investment plan seemed to be geared especially toward projects that could increase productivity and growth over the medium term, Mr. Finaish continued. Therefore, it was not clear to him whether the planned spending level provided a proper balance between those objectives and the financial implications of such a large increase in the fiscal deficit. The staff obviously had urged the authorities to make corrective revenue and expenditure measures equivalent to at least 7 percent of GDP in 1986. While there was probably some scope for some measures to reduce the projected deficit in 1986, there were doubts that it would be feasible to achieve the target that the staff had suggested. However, he agreed with the staff that the fiscal deficit projected for 1986 was not sustainable and needed to be reduced substantially over the next two or three years through both expenditure and revenue measures, including the implementation of the recommendations of the 1983 Tax Reform Commission. The authorities intended to expedite movement in that direction.

The authorities' emphasis on investment to improve the growth performance of the economy was understandable, especially in the light of the high rate of employment and the prolonged stagnation of economic activity, Mr. Finaish went on. However, it was clear that a sustained improvement in output and employment would depend on how much progress was made on the structural adjustment front. There was no question that the large degree of controls and restrictions in the economy were an important impediment to investment, growth, and employment over the medium term. Unfortunately, the pace of structural reform over the past several years had been slow, particularly in comparison to the degree of financial restraint that had been maintained since 1983. It was of course true that controls and trade restrictions had contributed to the substantial improvement in the balance of payments, and that relative wage stability would probably not have been possible without the maintenance of firm control over prices. However, there was little doubt that that approach had made economic stagnation and unemployment the direct costs of financial adjustment.

The change in the medium-term outlook owing to the recent oil market developments was all the more reason why the authorities should move faster to address the structural problems facing the economy and to improve the environment for investment and economic activity in general, Mr. Finaish said. To the extent that the relatively comfortable level of reserves could be used to reduce the pace of financial adjustment required for balance of payments viability over the medium term, those reserves also could be used as a cushion to speed up the pace of structual reform. The recently announced package and the simplification of the exchange system had led him to hope that a faster progress in the structural adjustment area would take place in the coming period. The shock to the Venezuelan economy of the collapse in international oil prices had been enormous, Mr. Finaish remarked. The authorities would face difficult choices in the coming period, but the record of the previous several years, when the authorities had shown courage in taking difficult decisions to deal with the financial imbalances in the economy, had led him to feel optimistic that the authorities would be able to respond to the new situation. The measures that constituted the new policy package might fall short of what the staff had considered necessary, but they were a positive movement along the policy course that the authorities had intended to follow in response to the new oil situation. Still, the fact remained that a large degree of uncertainty about the future would continue to make economic management a difficult task in Venezuela as long as the international oil market did not stabilize. Indeed, he wondered whether a significant drop in oil prices to the levels that some were predicting, especially during the previous several weeks, would be manageable within the feasible range of policies available to the authorities. The staff could usefully comment on the implications for Venezuela of such a development.

Mr. Salehkhou said that the economic and financial performance of Venezuela in 1985 was largely satisfactory, as nonpetroleum GDP had leveled off, the rate of consumer price increases and the unemployment rate had abated to 9 percent and 13 percent, respectively, and the external current account had recorded a considerable surplus. The medium-term outlook, however, appeared to have weakened, owing to the recent sharp fall in oil prices and the uncertainty about the oil market situation.

Like the economies of other oil exporting developing countries, Venezuela's economy was highly sensitive to oil prices, Mr. Salehkhou went on. With the decline in oil prices, the authorities had undertaken a comprehensive adjustment program at an early stage to correct the distortions that had appeared in the domestic and external positions. In

1983 and 1984, the implementation of prudent fiscal, monetary, and wage policies, together with import rationalization and price controls, had made a significant contribution to those achievements. Those policies, however, had deepened the prolonged stagnation in domestic activity and had led to an abrupt rise in the unemployment and inflation rates.

In 1985, the efforts that had been made through the Quantified Economic Program to stimulate economic activity, reverse the trend in unemployment, and curb inflationary pressure through the implementation of less restrictive fiscal and monetary policies had all been steps in the right direction, Mr. Salehkhou said. However, the economy had performed below expectations, owing mainly to the delay in implementing the public investment program.

On the fiscal side, there had been a public sector surplus, instead of the projected deficit, as a result of the lower than budgeted capital outlays and the higher than projected revenues, owing mainly to a considerable increase in revenues from income and excise taxes and stamp duties and to the larger than expected surplus of the parastatals, Mr. Salehkhou observed. Given the strengthening of the fiscal position, and despite the 3 percentage point cut in domestic interest rates, the demand for credit in the private sector had remained low, and, therefore, monetary policy had been less expansionary than had been projected under the program. As a reflection of those developments and despite the decline in receipts from petroleum exports, the external current account had registered a $3 billion surplus, well in excess of the projected $1.7 billion surplus. That development had helped the Government to repay part of the country's external debt, and had resulted in an increase in net official reserves to $15.5 billion, the equivalent of two years of exports.

In 1986, while the sharp drop in petroleum prices in recent months had adversely affected the economic outlook, the strong fiscal and external position of Venezuela had enabled the authorities to introduce the necessary adjustment measures with less austerity than would otherwise be necessary to resume economic growth and to reduce the rate of unemployment, Mr. Salehkhou said. The 1986 Quantified Economic Program appeared to pave the way for the economy to move in the right direction. External policies aiming at further foreign exchange conservation through the adoption of limits and priorities for allocation of exchange for imports, and the promotion of import substitution and foreign financing seemed to be appropriate. In that connection, while he welcomed the authorities' intention to unify the exchange rate, he had difficulty in supporting the staff's recommendation to ease import and exchange controls, given the uncertainty in the oil market, and the potential tendency in the private sector toward capital outflows in certain circumstances could result in a significant decline in the country's international reserves--in excess of $3.9 billion envisioned under the program. The staff's cautious scenario assumed an average oil price of $13.20 a barrel, which was less than the authorities' projected price of $15 a barrel and would result in a larger current account deficit and a loss of reserves of $4.75 billion; that scenario justified the authorities' plan to save foreign exchange through import rationalization.

There was room for some expansion of public sector spending, and the projected sharp shift in that sector from a surplus to a deficit equivalent to 9.5 percent of GDP appeared to inject sufficient stimulus to help the country to resume economic growth, Mr. Salehkhou remarked. However, the authorities should take into account the possibilities of inflationary repercussions of excessive expenditure and the unsustainability of the present fiscal policy stance in the long run, which would cause some difficulty when a reversal of that stance was needed. Like the fiscal stance, monetary policy should be less expansionary than was envisaged in order to curb the inflationary pressures and to avoid larger than targeted losses of reserves.

The authorities were to be commended for reducing Venezuela's external debt, including the arrears, particularly in the present difficult circumstances, Mr. Salehkhou considered. He was confident that their efforts would be continued, and that they would try to eliminate the remaining arrears in order to restore confidence in the economy and normalize Venezuela's relations with its creditors.

Mr. Dallara said that he shared previous speakers' deep concern about economic policies and developments in Venezuela. The present meeting was the third occasion on which the Executive Board had discussed Venezuela's economy under the enhanced surveillance arrangement that had been agreed in early 1985. It was useful to recall that that arrangement had been negotiated among the Fund, the authorities, and commercial banks with a view to facilitating the multiyear restructuring arrangement and to supporting and encouraging sound policies that could help to restore normal relations between Venezuela and its commercial creditors.

The extent of progress under the enhanced surveillance arrangement was a cause for serious concern, Mr. Dallara considered. The differences in opinion that had been evident in earlier discussions between the staff and the authorities on a number of important basic policy issues had persisted and might have increased. Those differences were particularly pronounced in the area of external policy. He shared the staff's views on Venezuela's fiscal and monetary policies. On the external side, exchange rate policy, while involving some modest movement toward an eventual unification, had eventually relied upon controls and restrictions to avoid market forces and to avoid sending market impulses to the economy at large. Urgent action to eliminate the multiple exchange rate regime and to move rapidly toward unifying the exchange rate, as recommended by the staff, seemed to be the essential steps that would enable the authorities to eliminate the array of restrictions on trade and payments, which unfortunately had recently been intensified.

The substantial differences of opinion between the authorities and the staff on the basic question of exchange rate and trade liberalization were reflected in the recent action by Venezuela's Congress on the repayment of private debt to external creditors, Mr. Dallara continued. The authorities had stated that they needed to reduce the subsidy involved in order to cut the fiscal deficit. The staff recognized that the reduction of the subsidy was in principle and in fact an appropriate move. However, the authorities had acted in a unilateral fashion with respect to the understandings on which the arrangement between Venezuela's external creditors and private debtors had been developed. In addition, if the elimination of such subsidies was a key objective, then more rapid movement toward unification of the exchange rate was even more urgently required, because such a movement could reduce the subsidies and the efficiencies that existed throughout the economy. Indeed, as the staff had noted, the structure of exchange rate, import and related restrictions tended to provide disincentives to sectors in the economy that might compete for resources and tended to provide inappropriate incentives to sectors that were not import competing, thereby fostering the inefficiencies in the economy.

He hoped that the authorities would view the recent actions concerning private debt and external creditors as a serious matter that called for some clarification by the authorities, Mr. Dallara said. His authorities viewed the actions as being basically inconsistent with an orderly solution to Venezuela's debt problem and an early restoration of more normal relations with external creditors, especially in the current circumstances, when the final understandings and agreements on the multiyear rescheduling had not yet been reached. Such action was serious, and the authorities should consider at an early stage steps to ameliorate the adverse effects of the recent legislation.

The enhanced surveillance arrangement with Venezuela had been in effect for approximately 18 months, Mr. Dallara noted. He recognized that the understanding with Venezuela had been reached at an early stage in the evolution of the enhanced surveillance arrangements. Indeed, there was still some experimentation with those arrangements, and there were inevitably some conflicting objectives. However, it was fair to say that some key elements of subsequent arrangements with members were not evident in the understanding with Venezuela. Specific policy commitments had been made in the context of more recent arrangements. What seemed to be missing in the arrangement with Venezuela was a clear assumption that the staff and the authorities would make every effort to reduce, if not eliminate, differences of view that might exist on important policy areas. During the initial discussion of the enhanced surveillance arrangement for Venezuela the staff had noted that the Fund's role was primarily to provide a frank evaluation of members' policies.

At the same time, Mr. Dallara went on, the staff had indicated that if the procedure were to be effective, the Fund and the authorities would need to reach broad agreement on major aspects of policies. It was evident that such agreement had not been reached in the case of Venezuela, which raised important questions concerning the Fund's role in enhanced surveillance. The significance of the question had been heightened because an element of enhanced surveillance was the understanding that the relevant staff reports would be made available to the commercial banks in order to facilitate the banks' monitoring of Venezuela's economy in the context of the multiyear rescheduling. As he understood it, the commercial banks had not yet officially received any of the enhanced surveillance reports on Venezuela that the Executive Board had reviewed thus far. That development was disturbing and led him to wonder what the Fund's obligations and role under the enhanced surveillance arrangement should be in the future. After all, if the Fund was asked to perform a role that was designed to facilitate the restoration of more normal relations with commercial banks, and if the Fund's analysis was not at least being shared in an official manner with the banks, he wondered how useful the Fund's role could be.

He wondered in particular whether the Fund was obligated to remain involved in the enhanced surveillance arrangement through the whole period that had been discussed with the authorities, Mr. Dallara continued. The lack of movement toward reaching a consensus between the authorities and staff on policy issues, the fact that the multiyear rescheduling arrangement had not yet been finalized, and the feeling in the Executive Board that enhanced surveillance should perhaps be limited to the consolidation period, at least brought to mind the question of whether the Fund was legally obligated or should feel morally bound to remain involved in the enhanced surveillance arrangement on the basis of the understandings that had been reached for the period through 1997. At the same time, he also wondered whether the authorities felt that the enhanced surveillance arrangement was clearly useful and, if so, how they felt that it would remain useful.

He agreed with previous speakers that a number of the recently adopted policy actions could be seen as steps backward, while others were positive, Mr. Dallara said. The authorities intended to move toward more open foreign direct investment, and, as the staff report noted, there were a number of other positive signs. The authorities should build on those more recent developments and steps and should reconsider whether their fundamental approach toward a highly controlled and highly restricted trade system would maximize potential growth in the medium term. Given the severe external shocks to the economy, the authorities could ill afford not to take steps that would maximize the benefits that could be realized from the use of Venezuela's economic resources. It was in that context that the authorities should reconsider certain aspects of their policy stance.

Mr. Jayawardena said that the authorities were to be commended for having remained within the parameters of the Quantified Economic Program that had been implemented in 1985. Although certain exogenous factors had contributed to the favorable outcome, the achievements were laudable.

The 1986 Quantitative Economic Program had been formulated in the context of the further softening of the oil market, Mr. Jayawardena noted. There were several positive aspects of that program and of the current thrust of policies, including the elimination of the preferential exchange rate and subsidies, the public enterprise and tax reforms, the reduction of regulatory measures in the fields of exports and foreign investment, and the wage moderation. Those elements were clearly welcome. The Government aimed to achieve adjustment with growth by financing itself out of the slump in oil prices in the hope that the oil market would stabilize at a later stage. In the process, the authorities must be cautious to avoid discouraging the growth of a viable non-oil sector, since it was that sector that would ultimately have to support the future growth of the economy, provide greater certainty and stability than the oil sector, and insulate the economy against exogenous shocks.

It was not clear to him why the authorities believed that the growth impulses should come mainly from investment outlays, Mr. Jayawardena said. The diversification of the economy probably could not be easily engineered through private incentives alone in the initial stage because of the economy's strong oil orientation and dependence on imports. That conclusion was consistent with the infant industry argument. The expectation was that the authorities would consider moving away from protectionist import and price controls as the non-oil economy gathered momentum. Of course, one of the great risks inherent in that approach was that the activities that were being encouraged tended to remain in continuous need of infancy protection. Hence, the authorities might consider a gradual reduction in protection over a reasonable period which would send an explicit signal to investors from the beginning that they could take into account in their investment decisions.

As to the modalities of the private external debt, it was unclear why some commercial banks had taken issue with the regulations after having received an additional governmental guarantee on private debt via U.S. dollar-denominated bonds, Mr. Jayawardena commented. If the fixed interest rate on bonds was the source of contention, he empathized with the authorities, who had said that supplementary payments by debtors would not be included. He hoped that any uncertainties in that field could be clarified.

He did not share Mr. Dallara's views on the elements of enhanced surveillance arrangements, Mr. Jayawardena remarked. It was clear that the Executive Board had not agreed to have the kinds of relationships that Mr. Dallara had described, in which there would be understandings with individual countries and the Fund would give stop-and-go signals to commercial banks during the period of the enhanced surveillance arrangement. It was his understanding that the Fund would comment frankly on the current thrust of a member's policies and leave the matter of financing to the authorities and creditors. In the case of Venezuela the Fund had made objective evaluations of the situation and should thenceforth leave matters alone, unless the authorities would wish to have clear understandings under a program supported by the Fund.

Mrs. Ploix commented that Venezuela's economic situation had changed drastically since the previous Executive Board discussion on the country in December 1985. The sharp drop in oil prices had placed additional strain on reserves and had aggravated the domestic problems. However, progress had been made in 1985, for which the authorities were to be commended. The results of the adjustment program were better than had been expected in the areas of public finance, the external accounts, and the rate of inflation. At the same time, developments with respect to growth and unemployment had fallen substantially short of expectations.

In response to the changed situation, the authorities had introduced a 21-point program on July 17, 1986 that aimed at arresting the trend in unemployment and at encouraging growth, Mrs. Ploix continued. The recent distribution of the supplementary report by the staff had given her little time in which to assess the appropriateness of the new measures. She broadly agreed with the thrust of the staff appraisal, and the observations that she had made during the previous discussion on Venezuela were still applicable. However, she wished to pose questions in a number of areas.

She wondered what the impact on GDP would be of the recent expenditure and revenue measures and how large the public sector deficit in 1986 and beyond was expected to be, Mrs. Ploix said. In his opening statement Mr. Pérez had outlined the authorities' views on revenue raising measures and expenditure cuts. The staff should comment on those measures. She wondered whether the staff should continue to recommend reducing the public sector deficit to 2-3 percent of GDP in 1987. What monetary policy would be consistent with the objective of containing inflation?

The decision to adopt a uniform exchange rate of Bs 7.5 per U.S. dollar was welcome, Mrs. Ploix commented. Given the large discrepancy that still existed between the official and free market rates, she wondered whether further adjustment in the rate should not be considered. The exchange rates should be unified, and the staff should comment further on what was considered to be a realistic exchange rate policy for Venezuela.

The diversification efforts that had been made in recent years to move the economy away from its dependency on oil had been fruitful, Mrs. Ploix remarked. However, more remained to be done, since oil still had an excessively large share in export revenues. The potential of the country was impressive, and she welcomed the World Bank's involvement in several areas, including the study on trade policy, which should help the country to reach its full potential. The staff had noted the rigidities that impaired productive capacity as well as public and private investment. Accordingly, the authorities' intention to remove administrative obstacles, attract foreign investment, and emphasize capital outlays and construction activity were welcome.

She shared previous speakers' concern about the delays in registering Venezuela's private external debt, Mrs. Ploix said. The delays threatened Venezuela's private sector credit. Moreover, the recent law that was aimed at refinancing part of the private sector was cause for concern to creditors. The staff, too, had expressed its concern, and a further comment on the law would be helpful.

The recently adopted program had far-reaching consequences in many areas, Mrs. Ploix continued. The staff should comment on the way in which enhanced surveillance for Venezuela would be affected by the new measures. The authorities had introduced commendable measures to cope with the oil situation, and she hoped that the authorities would approach the external sector in the same spirit.

Mr. Romuáldez remarked that the issue that divided the staff and the authorities was clear and simple: in the wake of the developments in the oil market, the staff recommended prompt adjustment so that a significantly harsher adjustment at a later stage could be avoided; however, the authorities preferred to avoid abrupt adjustment at the present stage, as they were worried that the present thrust of the economy toward growth and the reduction of unemployment might be lost. According to the latest newspaper reports, which seemed to be confirmed by Mr. Pérez's opening statement, the authorities had apparently moved more decisively in some respects, albeit in a more limited sense, closer to the staff's position since the writing of the staff report. The authorities had announced a partial devaluation of the bolívar with respect to the repayment of some foreign debts, although his authorities had mixed reactions to that move. In addition, the authorities had liberalized the foreign investment code, had begun the modernization of the tax system, and had taken steps to promote nontraditional exports more vigorously.

The authorities were to be commended for those steps but they should take more fundamental and far-reaching actions--in the exchange rate and pricing areas, for example--in order to increase the efficiency of the allocation of resources and to increase international competitiveness, especially by encouraging export diversification and non-oil private sector activity, Mr. Romuáldez said. In the area of fiscal restraint, the authorities planned to make some reductions in the capital outlays in 1986. Their credit policy was designed to prevent pressure from intensifying on official reserves and on prices. The unification of the exchange rate was essential if the adjustments were to bring about more lasting improvements in the price structure. The staff had correctly suggested that administrative regulation of prices, the trade and exchange system, and interest rates should be eliminated. Retaining controlled interest rates served only to diminish or nullify the effectiveness of the adjustment measures that already had been introduced to restore momentum toward adequate and sustainable growth. Significant gains had been made in 1986 and the present stage was not an appropriate one at which to relax the authorities' efforts. Developments in Venezuela's environment, particularly the precipitous drop in oil prices and the uncertainties about the outlook for the economy, underscored the need to maintain caution and the adjustment effort. He fully agreed with the staff's appraisal on those points. Finally, his authorities shared the concern expressed by previous speakers, particularly Mr. Dallara, about the enhanced surveillance arrangement for Venezuela.

The staff representative from the Western Hemisphere Department recalled that questions had been asked about the impact of the new private debt scheme on the balance of payments and domestic monetary conditions. Under the existing scheme of five-year contracts for private sector debt, amortization payments on that debt were to be about $1.1 billion a year. Stretching those payments out to 15 years would reduce the annual payments by about one third from the previous programmed amount, resulting in a saving of $0.7 billion a year if there were no other changes in the terms and conditions of the debt. The staff could give only preliminary indications of the impact of the new private debt scheme on domestic credit. There was some question how the domestic banks in Venezuela would react to taking over the entire credit risk of the foreign debt portfolio, as the banks would be asked to extend credit to Venezuela's debtors to buy bonds in 1986; the total amount of credit involved would be about Bs 38 billion, which was equivalent to approximately 10 percent of GDP and exceeded the total lending to the private sector that had been expected under the authorities' program for 1986. Implementing that arrangement might well be difficult. It could probably be handled in a way that would not be disruptive, since the resources borrowed by the private sector to purchase the new external bonds would cover the public sector deficit in 1986. The amount of domestic financing that was expected to be required to cover the public sector deficit in 1986 was about Bs 38 billion, which was similar to the amount that would be required for the private sector to buy the new government bonds.

It was too soon to say for certain how the latest fiscal measures would affect the outturn for 1986, the staff representative commented. Many of the measures had not yet been specified or implemented, and the staff did not know about the timing of the implementation of the measures in detail. However, at the present late stage, the new measures were unlikely to have much effect on the public finances in the rest of 1986. The staff expected oil revenues to be slightly lower than the authorities projected. But that might be offset by a reduction in investment expenditures and in subsidies on the private debt. The special public sector investment program was lagging somewhat behind target, though not because of a policy decision to slow the implementation of the program, the staff representative explained. The total amount of expenditure under the special investment program planned for 1986 was approximately Bs 13 billion, and about 80 percent would be executed. The savings would perhaps be the equivalent to 1.5 percent of GDP in 1986. All in all, the fiscal deficit might therefore turn out to be about 9 percent of GDP, which would be lower than the worst case projection in the staff report.

The staff continued to believe that it was in that context that the staff had recommended early action to set the stage for an improvement in the fiscal position in 1987 and beyond, the staff representative remarked. In the absence of significant net new foreign financing (although assuming new borrowing to offset amortization of public external debt), a gradual reduction of the fiscal deficit to 2-3 percent of GDP in about three years would imply substantial use of reserves to smooth the adjustment process. By the end of the three years, according to the staff's projections, reserves would fall to the minimal level that the authorities consider comfortable and would be close to the minimum level envisaged in the multiyear arrangement with the commercial banks.

The financial prospects for Venezuela will depend heavily on developments in the oil market. The staff's projections for 1986 were based on an oil price of $13.2 a barrel, the staff representative said. The medium-term projections in the staff report were based on prices of $13 a barrel in 1987 and $15 a barrel in 1988. An increase in the price by one dollar yielded approximately $0.5 billion in additional revenue for Venezuela. A decline in the price to $9 a barrel, which had been mentioned by Mr. Finaish, would imply a resource loss of about $2 billion a year, which would obviously pose a serious problem.

The staff considered that a process to reduce the scope of the present exchange and import controls could be effectively started only after the exchange rate system was reformed, the staff representative remarked. Many of the exchange and import controls were required in order to operate the multiple exchange rate system. Thus, many of the policy initiatives that the staff had recommended could not be made without an adjustment of the controlled exchange rate and elimination of the wide spread between the two exchange markets.

Commenting on the question of what was a realistic exchange rate for Venezuela, the staff representative said that even after the adjustment of the controlled rate to Bs 7.5 per U.S. dollar, the real effective exchange rate was still 20 percent above the level prior to 1973, while oil export receipts in real terms were now back at the 1973 level. Moreover, in considering an appropriate base period, it should be noted that the real exchange rate in 1973 had not contributed to a rapid diversification in the economy. In addition, the pervasive use of controls throughout the economy served to maintain an overvalued exchange rate. In the absence of controls, the rate would probably be further depreciated. Moreover. the large spread between the official and free market exchange rates was giving a strong signal to the economy about future exchange rates and about the equilibrium unified rate that would be needed. All those factors had a bearing on what the staff considered to be a realistic exchange rate policy at the present stage.

The Deputy Director of the Exchange and Trade Relations Department remarked that from the start of the enhanced surveillance process there had been different views on what was to be expected from enhanced surveillance. The authorities had stated that "Venezuela will request from the Fund an enhancement of those (Article IV) consultations as set forth below in order to complement the country's own procedures to monitor economic performance and the implementation of economic and financial policies." The enhanced surveillance procedure was seen as a helpful supplementary means of explaining Venezuela's national policies to the country's creditors. The enhanced surveillance was not seen as a substitute for an arrangement with the Fund. The staff had adhered to the principle of ensuring that as a minimum its reports under enhanced surveillance were adequate and frank. There would be an opportunity to discuss the general issues of enhanced surveillance of September 2, 1986, when the Executive Board was scheduled to consider staff papers on international banking and related matters.

Venezuela's multiyear rescheduling arrangement with the commercial banks was not yet in effect, the Deputy Director of the Exchange and Trade Relations Department explained. Therefore, the relevant staff report had not yet been made available to the banks. In addition, the Fund was not a signatory to the arrangement; the signatories were the banks and the national authorities. That statement summarized the legal position. In fact, however, the Fund was clearly a party to the agreement in the sense that the staff report was reviewed by the parties to the agreement, and the approach that was being used was supported in a general sense by the Fund.

Mr. Dallara said that he understood the clarification of the legal status of the Fund's participation in the enhanced surveillance for Venezuela. However, he continued to wondered whether the lack of the provision of the staff reports to the commercial banks was consistent with the spirit of the arrangement as well as with the legal requirements under the arrangement. After all, the Fund had not said to Venezuela or to its commercial bank creditors that the Fund would not engage in the enhanced surveillance discussions with Venezuela until the multiyear rescheduling arrangement was signed. In fact, the Fund had stepped forward to initiate the enhanced surveillance procedures and had cooperated with the authorities toward that end. In addition, he wondered whether it was reasonable to hope that, once the agreement had been formally reached, the authorities' approach to enhanced surveillance would change.

Mr. Pérez commented that the Venezuelan authorities were willing to distribute the staff report to the commercial banks. Unfortunately, the banks had not yet signed the relevant agreement; it would be inconsistent with the principles in the rescheduling agreement to send the report to the banks until the signing had occurred.

Venezuela had made a substantial adjustment effort over the previous two years in the macroeconomic and microeconomic fields, Mr. Pérez continued. The results in the fiscal and external sectors and in the rate of inflation clearly showed that Venezuela had corrected in record time all the macroeconomic disequilibria that had been evident in 1982 as a consequence of the fall in oil prices. Furthermore, Venezuela had overshot the targets in the Government's program and the staff's estimates of the objectives for the macroeconomic variables.

It was important to remember that that adjustment had been made without resorting to new financing from creditor banks or multilateral institutions, Mr. Pérez stated. Moreover, during the period in question, and despite the overwhelming economic difficulties in the country, Venezuela was one of the Fund's largest creditors. That fact was evidence of Venezuela's collaboration with the international community.

Venezuela was one of the few debtor countries that had reduced the amount of external debt during the period concerned--by $5 billion--while increasing the level of reserves substantially, Mr. Pérez noted. Those achievements had helped to reinforce the country's ability to service its external debt.

Commenting on the private debt, Mr. Pérez said that he would describe the attitude of the Government and the way in which the financial scheme had evolved. When the problem of Venezuela's debt had erupted, the Government had made it clear that private and public debt negotiations should not be linked. Nevertheless, the Government had established a facility through which Venezuelan private sector companies were to be given preferential access to dollars to service the private debt under specified conditions--namely, that the financing would be devoted to activities that were in the national interest and that the debt would be renegotiated on appropriate terms. Under that scheme, dollars had been provided to borrowers at the exchange rate of Bs 4.3 per U.S. dollar for payments of principal and Bs 7.5 per U.S. dollar for interest payments. In addition, the Government, together with the Central Bank, had established a free dollar market, access to which was given to any firm, institution, or individual for all types of transactions, including payment of interest and principal linked to the foreign debt. As those developments had shown, the Government had been committed at the outset to help the private sector to finance its debt and adjust to the new exchange rate.

The scenario on the basis of which the scheme had been designed had changed drastically in early 1986, and the Government had considered it appropriate to adjust the scheme to the new circumstances both by increasing the effort the private sector should make and by stretching the profile of private debt that was serviced through the official market, Mr. Pérez continued. In recent months, there had been two changes in the scheme. First, access to the preferential exchange rate by debtors for the servicing of the registered private debt had been limited to the purchase of the foreign currency-denominated bonds issued by the FOCOCAM. Those bonds would have a maturity and interest rate that were determined by the Government, as they carried a government guarantee. Second, on July 17, 1986, the President of the Republic had announced the elimination of the preferential exchange rate of Bs 4.3 per U.S. dollar, moving the servicing of the external public debt to the official exchange rate of Bs 7.5 per U.S. dollar. Accordingly, under the new circumstances, creditor banks and private borrowers had agreed to liquidate their financial agreements through either the FOCOCAM or the free market. He would convey the concern that was expressed by Executive Directors about the scheme to his authorities.

Commenting on the content and implications of the enhanced surveillance exercise, Mr. Pérez said that it was important to remember that the exercise had been started in response to the requests of some of the members that had seen the need for such a procedure in order to make progress toward addressing their debt problems. To that end, enhanced surveillance had been established as a special policy within the broad policy of surveillance and was therefore different from the Fund's policies concerning Fund-supported programs. That distinction was clearly reflected in the fact that, under enhanced surveillance, the Quantified Economic Program was an integral part of the country's policymaking process, which reflected the autonomous character of the country's objectives and policy intentions. In that connection, the Fund's role was to collaborate with the country by providing technical assistance and by helping to formulate and support the Quantified Economic Program. However, unlike a program in support of use of resources in the upper credit tranches, the objectives and economic policy package under enhanced surveillance were not part of an arrangement with the Fund. He agreed with Mr. Dallara that under the enhanced surveillance procedures, as under the general policy on surveillance, the differences of opinion of the authorities and the staff on any aspect of economic policy should be narrowed, and the differences had been narrowed in the case of Venezuela.

As to the effectiveness of the enhanced surveillance for Venezuela, on the basis of the economic results thus far it was clear that the Fund had succeeded in advising the Government about the appropriate course to follow to deal with the economic difficulties in Venezuela, Mr. Pérez remarked. That was not to say that Venezuela had followed all the Fund's recommendations, but some Executive Directors had overemphasized the fact that in some areas progress had been slower than had been recommended and had underestimated the areas in which the Government had overshot the targets. In general, Venezuela had performed very well under the enhanced surveillance arrangement.

The wide differential between the official and free market exchange rate was clearly a cause for concern, but the suggestion that the exchange controls should be eliminated and that the exchange rate should be unified were different issues altogether, Mr. Pérez said. The uncertainties about the current economic outlook made it necessary to isolate exchange transactions from the potentially disturbing movements in the capital account. In considering the issue of exchange rate unification, Executive Directors should bear in mind the particular characteristics of Venezuela, which was highly dependent upon a single export--oil. A movement in the exchange rate would have only a limited effect on performance in the short run in Venezuela, while the consequences for the rate of inflation could be devastating. A unified exchange rate system in a country like Venezuela, where uncertainties about the international oil market had led to wide exchange rate movements, could be incompatible with efficient resource allocation.

The authorities' perception of the public sector stance in 1986 and beyond was different from that of the staff and some Executive Directors for several reasons, Mr. Pérez commented. First, the overall public sector surplus in 1985 was larger than had been previously estimated. The surplus in 1985 was 5 percent, compared with the 2.8 percent that had been estimated by the staff at the time of its visit to Venezuela. Accordingly, the base for the 1986 projections had changed dramatically, and the deficit for 1986 was smaller than had been expected. Second, the pace of the implementation of the public investment program in 1986 was slower than had been planned, while current expenditure on personnel and purchases of goods and services had been cut. Both actions would result in a lower level of expenditure than had been budgeted. Third, some of the revenue raising measures announced by the President of the Republic would take effect in 1986; they would include increases in prices and tariffs of some state enterprises. In addition, the elimination of the preferential exchange rate of Bs 4.30 per U.S. dollar entailed a reduction in the overall public sector deficit of 0.5 percent of GDP in 1986 and 1 percent of GDP a year over the coming five years. Those elements would result in a smaller deficit in 1986 than had been expected--about 6 percent of GDP--which was in line with the staff recommendation of reaching a deficit of 2-3 percent of GDP in 1986.

The Chairman made the following summing up:

Most Executive Directors were in broad agreement with the thrust of the staff appraisal in the report for the 1986 Article IV consultation with Venezuela.

Directors commended the authorities for the substantial progress made during 1983-85 in reducing domestic expenditure in response to a major drop in Venezuela's export earnings. They stated that a strong improvement in the public finances, a restrained monetary policy, a substantial real depreciation of the bolívar, and a cautious wage policy had led to a major improvement in Venezuela's external position. However, concerned about the prolonged stagnation of output and increased unemployment, the Government had shifted the thrust of policies in late 1985 to seek a reactivation of the economy through a substantial expansion in public investment.

Directors observed that the sharp drop in world oil prices since early 1986 had drastically changed Venezuela's economic outlook. Export earnings and public sector revenues were expected to fall by over 10 percent of GDP, and thus a renewed adjustment effort was required to re-establish a sustainable external position. The authorities' Quantified Economic Program for 1986 projected a major shift from surpluses to large deficits in both the public finances and the overall balance of payments. The program also envisaged a further tightening of import and price controls as well as maintenance of a wide spread between the controlled and the free market exchange rates.

Directors noted the policy measures announced by the President of the Republic on July 17, 1986, which were designed to foster adjustment without sacrificing growth and employment. In that context, a few Directors noted that Venezuela's high level of international reserves together with external financing gave Venezuela some margin for maneuver. However, most Directors held the view that the policies included in the authorities' program were not sufficient to deal with the country's large fiscal and external imbalances. Accordingly, they urged the authorities to adopt promptly a comprehensive program that would set the basis for a resumption of sustainable economic growth. Delays in the adoption of corrective measures, Directors warned, would require a much harsher adjustment at a later stage.

Directors noted that a comprehensive program would comprise demand management policies aimed at significantly reducing the public sector deficit and the rate of expansion of domestic bank credit to levels that would be consistent with a sustainable external position and price stability over the medium term. Adoption of revenue measures, including adjustments in prices and tariffs of public enterprises, and restraint on expenditure, were needed to improve the public sector performance. Cuts in the public sector investment plans were also called for. Directors noted that the fiscal measures foreshadowed in the recent announcements of the President of Venezuela were a step in the right direction, but stressed that a large fiscal imbalance would remain that should be tackled without delay.

Directors were of the view that the targeted growth for broad money was too high, given the inflation and balance of payments targets, and would need to be lowered. Several Directors also encouraged the authorities to move toward market-oriented interest rates in order to promote the growth of domestic financial savings.

In the light of the recent sharp decline in external income, Directors emphasized the importance of wage restraint in promoting adjustment without unduly increasing unemployment and in containing the inflationary pressures.

While welcoming the progress that has been made toward a simplification of the exchange rate system, Directors generally stressed that the present exchange system still gave rise to distortions, particularly because of the wide differential between the exchange rates, and they emphasized the need to advance rapidly toward a unified exchange rate that would encourage export diversification and efficient import substitution. Implementation of restrained demand management and realistic exchange rate policies would facilitate the progressive elimination of import restrictions, export licensing, and exchange controls. In this respect, Directors noted that the trade policy study, initiated with the assistance of the World Bank, would be helpful in setting a revised import tariff structure.

Several Directors stressed that stagnation of the domestic economy in recent years might be attributable to some extent to the excessive reliance on government controls and regulations in most areas of the economy. They felt that a reduction in the scope of regulations and controls, particularly on prices, was urgently needed to help promote conditions conducive to private sector investment and to the much needed economic diversification. In this respect, they were encouraged by the authorities' efforts to streamline regulations, particularly on exports, and to promote foreign investment, but they regretted recent moves toward an intensification of import restrictions.

Directors noted the authorities' intention to reopen negotiations with creditor banks on the February 1986 rescheduling arrangement for public debts in the light of changed external circumstances. Directors welcomed the completion of the process of registration of private external debt. While welcoming the recent elimination of the exchange subsidy on private external debt payments, several Directors expressed concern that the approach adopted by the authorities could adversely affect the normalization of Venezuela's relations with its foreign creditors at a time when those creditors were being asked to show increased flexibility.

Finally, in the light of the enhanced surveillance arrangements between Venezuela and the Fund, a number of Directors expressed concern regarding the significant differences of view on appropriate economic policies that persist between the Venezuelan authorities and the Fund staff. Taking into account the views put forward during the discussion, Directors expressed the hope that a convergence of views on economic policies between Venezuela and the Fund would occur soon.

The 1986 midyear consultation with Venezuela is expected to be held in about six months.

3. INCOME POSITION - PRINCIPLES OF "BURDEN SHARING," INCOME TARGET FOR FY 1987 AND FY 1988, RATE OF CHARGE, AND RATE OF REMUNERATION; AND RATE OF CHARGE AS OF MAY 1, 1986

The Executive Directors considered a proposed decision on "burden sharing," the Fund's income target for FY 1987 and FY 1988, the rate of charge, and the rate of remuneration (EBS/86/162, 7/23/86).

The Chairman noted that the proposed decision had been prepared on the basis of the Executive Directors' informal meeting on July 17, 1986. The agreed principles governing burden sharing and the compromise that had been reached on the financing mechanism for FY 1987 and FY 1988 was contained in his summing up of that informal meeting. 1/ Executive Directors might wish to take up the proposed decision paragraph by paragraph and make any technical amendments necessary to make it fully consistent with the agreement reached at that informal meeting.

Section I - Principles of "Burden Sharing"

Mr. Polak suggested the deletion of the reference in paragraph 2 to the principle of burden sharing being applied "...insofar as the Articles of Agreement make possible the full application of this principle." The decision could not invalidate the Articles, but that clause might lead to an inconsistency between the requirement in the Articles that the rate of remuneration should not be less than 80 percent of the rate of interest on the SDR, and the proposal in Section V on burden sharing in FY 1987 and FY 1988 that no reduction in the rate of remuneration should reduce the average remuneration coefficient below 85 percent of the SDR interest rate.

Mr. Sengupta asked why the first two paragraphs of the Chairman's summing up on the agreed principles could not be inserted in Section I. Those paragraphs provided a more comprehensive description of the agreed principles of burden sharing, and indicated that both the increase in the rate of remuneration and burden sharing would apply as long as the problem of overdue obligations existed.

The Chairman observed that he would have no objection to adding a reference in the decision to the increase in the remuneration coefficient to 100 percent, which was mentioned in his summing up. Nor would he have any objection to mentioning that the principles governing burden sharing would remain in effect only as long as the problem of overdue financial obligations gave rise to the need for such sharing.

The Director of the Legal Department noted that the increase in the rate of remuneration to 100 percent was covered in Section IV, paragraph 2; the increase was to be permanent, with effect from February 1, 1987, and did not apply only to FY 1987 and FY 1988. Thus, there was no need to repeat the content of the provision in the context of Section I on the principles of burden sharing.

Mr. Fujino noted that the increase in the remuneration coefficient, while part of the overall package, did not fall under the principles of burden sharing as such.

1/ Reproduced in Annex.

The Chairman, in response to a point raised by Mr. King, said that in fact he had referred in his summing up of the informal meeting to the temporary nature of the understanding in order to meet Mr. Lankester's concern that the duration of burden sharing should be only for the period during which the problem of overdue obligations remained. His summing up would not have the same status as a decision, although it could be incorporated in the record of the meeting.

Mr. Grosche said that it was clear from paragraph 1 of Section I as drafted that the problem of burden sharing was being dealt with only in relation to the problem of overdue obligations.

Mr. Dallara said that he had no difficulty with incorporating the summing up in the records of the present meeting rather than formally incorporating the understanding described in the summing up in the proposed decision. The summing up would then have the same status as any other summing up of a Board discussion.

Mr. Nebbia considered that in order to avoid repeating the wording of the summing up in full in the proposed decision, Section I could be redrafted to refer briefly to the two agreed principles with respect to burden sharing and the increase in the remuneration coefficient.

Mr. Sengupta said that he could agree that the Chairman's summing up should be accepted as a reference point. It would serve as an aid in understanding the nuances of the agreement that had been reached when the basic principles of burden sharing and the financing mechanism were reconsidered in two years' time.

Mr. Massé considered that it would be useful to include the summing up in the minutes, which would provide a fuller explanation of the decision itself.

Mr. Zecchini said that the summing up and the minutes would clarify the intention of the decision.

Mr. Polak observed that the agreed principles described in the summing up, which were useful but had not been discussed fully, could not be a substitute for a precise decision.

The Chairman remarked that that was no reason for not including the summing up in the records as the basis on which the Board had reached an understanding, in line with the Board's normal procedures.

Mr. Pérez said that he was in favor of including the summing up in the minutes. Many statements made in the Board were imprecise but that did not negate their usefulness.

Section II - Income Target for FY 1987 and FY 1988

Mr. Massé said that no specific agreement had been reached at the informal meeting on whether additional supplemental income would be generated in FY 1988. Therefore, paragraph 2 should be amended to read "during FY 1988, the Board may decide to add supplemental net income to be generated and used in accordance with the provisions of Section V."

The Director of the Legal Department noted that since there would be corresponding liabilities to the supplemental income, owing to its refundability, it was necessary to refer to supplemental income rather than to supplemental net income.

Mr. Polak remarked that it was incorrect to refer to the use of the supplemental income because Section V mentioned only the distribution of supplemental income.

The Director of the Legal Department confirmed that the words "and used" should be deleted because the distribution mechanism was spelled out in Section V. Paragraph 2 as amended should read: "For FY 1988, the Fund may decide to add supplemental income to be generated in accordance with the provisions of Section V."

Mr. Dallara said that his understanding, and the basis on which he had joined the consensus at the informal meeting, was that the increase in the Fund's net income target from 5 percent to 7.5 percent of the Fund's reserves at the beginning of each year would be a permanent increase and not an increase for FY 1987 and FY 1988 only. He did not believe that the financing of the increase beyond those two financial years had been discussed, although it might have been implicit in the discussion that the increase would be financed under the existing rules, namely, by charges.

The Chairman commented that that had not been his understanding; otherwise, he would have included a paragraph in his summing up stating specifically that the income target would remain at 7.5 percent for financial years subsequent to FY 1987 and FY 1988.

Mr. Pérez recalled that during the afternoon informal meeting his understanding that the income target would revert automatically to 5 percent after FY 1987 and FY 1988 had been confirmed by the Chairman.

Mr. Dallara recalled that a number of Directors had argued at the informal meeting that the problem of arrears underlay the need for an increase in reserves, in line with positions that they had taken in earlier discussions. But it had not been clear that the action proposed to meet that need for a reserve increase was as directly related to the cost of arrears as was the action to be taken on sharing the burden of nonaccrued income. That point was borne out by the potential cost of the arrears problem, as illustrated by the fact that 15 percent of the total overdue obligations of members that might be in arrears on payments of principal to the Fund by October 1986, and for a period of more than two years, would amount to approximately SDR 107 million. Furthermore, if the action to be taken was not only a reflection of the arrears problem but of other underlying considerations--such as the ratio of Fund reserves to outstanding borrowing, which had fallen from 20 percent in 1982 to 7 percent in 1986, quite apart from the fall in relation to the ratios of other international organizations--then it was even less clear that the proposal in the draft decision with respect to the reserve target was in proportion to the potential size of the arrears problem.

Mr. Grosche remarked that rapid progress toward a consensus had been made at the end of the informal meeting. Like Mr. Dallara, he had approached the issue of reserves from a longer-term perspective, although the Chairman's summing up at that meeting had in fact not mentioned the longer-term need for reserves as a principle on which agreement had been reached. Therefore, his mind remained open.

Mr. Nebbia said that the summing up reflected his understanding of the meeting. Although some mention had been made of the Fund's other underlying financial problems, the discussion had focused on whether or not the increase in the net income target from 5 percent to 7.5 percent would be refundable. The agreement reached was that the reserve position of the Fund would be strengthened permanently by that amount by virtue of the fact that it would not be refundable. But that did not mean that the income target was to be increased permanently to 7.5 percent. The Chairman had made it clear that burden sharing was in order as long as the problem of overdue obligations existed. Directors had agreed that an appropriate contribution toward the sharing of the burden would be not to refund the additional 2.5 percent net income but to contribute it to reserves.

Mr. Massé said that his understanding was in line with that of Mr. Nebbia. Mention was made in paragraph 3 of the summing up to the reserve effort to be made in 1987--although he noted in passing that reference should also have been made to 1988--consisting of an increase in the target from 5 percent to 7.5 percent, with burden sharing but without refunding. In paragraph 4, it was stated that the FY 1988 reserve target of 7.5 percent might be raised beyond that figure if needed, with burden sharing applying above 5 percent and amounts in excess of 7.5 percent being refundable. Those two paragraphs reflected the agreement that had been reached for the two financial years of 1987 and 1988. The governing agreed principle, which had already been stated in the summing up, was that part of the increase in the reserve target would be nonrefundable and part would be refundable, with the understanding remaining in effect temporarily as long as the problem of overdue financial obligations continued to exist; a decision would be taken for the first two financial years, although the underlying principles would normally continue to operate as long as the problem of overdue obligations remained, with provision being made for a review of the decision in 1988.

The Chairman said that he agreed with Mr. Massé that the consensus of the Board had been to share the burden of increasing the net income target beyond 5 percent as a manifestation of the cooperative spirit that had animated the informal discussion. The concession made had been to share the increase in the net income target above 5 percent for two years. The same guiding principles would underly the concept of burden sharing beyond 1988. It was not possible to predict that the right target for net income in 1988 would be 5 percent; if the problem of overdue financial obligations remained serious, a net income target of 7.5 percent would remain necessary, and would be acceptable, as the agreement to share the burden had shown. He would be quite willing to add that gloss to his summing up if necessary.

Mr. Parmena reiterated that his recollection of the consensus at the informal meeting was that the principles of burden sharing would apply as long as the problem of overdue obligations lasted. However, specific figures had been agreed upon for only two financial years.

Mr. Zecchini remarked that the effort to reach an agreement at the informal meeting had succeeded because not all the details of the compromise had been considered in precise terms. His understanding had been that the reserve target would be increased to 7.5 percent for as long as the problem of overdue obligations confronted the Fund. To that extent, he had assumed that there was a presumption that the reserve target would remain at 7.5 percent after FY 1988 unless agreement was reached on a different target. Therefore, he considered that the target of 7.5 percent should have a less transitory and more permanent status. In that light, he had some doubts about the insertion in paragraph 1 of Section II of the reference to recording the additional net income separately in the Fund's financial statement. The function of such a separation for FY 1987 was not immediately obvious, since there would be no refunding in that year.

The Chairman responded that as he had said in his summing up, net income above 5 percent would be placed in a special line of reserves. The advantage of that separate accounting was also to show the External Auditors--as pointed out by Mr. Nimatallah and other Directors--that a special effort was being made to cope with the problem of overdue obligations, a net income target of 5 percent being the threshold at which burden sharing started. Of course, the accounting might be simpler if only the part of the net income above 5 percent that was refundable were put into the special account, and the nonrefundable part into the Fund's normal reserves, but it was technically possible to set up two subaccounts rather than to place only the refundable part in the special reserve. The proposed decision had been drafted to reflect the compromise that had been reached.

Mr. Fujino said that it was his strong expectation that the increase in the net income target would be maintained for a longer period. He had also expressed a strong reservation at the informal meeting about burden sharing on the increased portion of the reserve target. He had understood the temporary nature of the increase in the net income target to have been the result of a very difficult compromise. His strong preference was to return to the matter after two years, at which time the increase in the net income target would become a permanent feature without further negotiation.

Mrs. Ploix said that as she understood the situation, after two years, a new decision would be required to maintain any increase in the net income target, and from a base of 5 percent.

The Chairman confirmed that that had been the understanding. However, if the Executive Board wished, there could be a strong presumption that the net income target would be set at 7.5 percent if arrears continued to pose a problem. Notionally, the target would revert to 5 percent after two years, on the presumption that it would be increased if necessary. The fact that that part of the increase between 5 percent and 7.5 percent was burden shared should make such a presumption acceptable.

In response to a question from Mr. Nimatallah, the Chairman confirmed that the agreement reached was that the 2.5 percent above 5 percent to be burden shared would not be refundable, and that only amounts in excess of 7.5 percent, if agreed for the second year, would be refundable.

Mr. Nimatallah remarked that there was thus a strong presumption, even if the Executive Board reconsidered the matter after two years, that the increase in the net income target would be maintained as long as the problem of overdue obligations existed.

Mr. Grosche remarked that there was indeed a certain awkwardness in the 2.5 percent that was to be burden shared but not refunded. It might have been better to have agreed on refunding.

The Chairman remarked that such awkwardness was inherent in compromises. The nonrefundability of a certain part of the reserve increase gave some satisfaction to certain Directors who were in favor of building up the reserves, although it was noteworthy that that element had been linked to a concession with respect to sharing the burden of that 2.5 percent layer.

Mr. King commented that although he recognized that the outcome had not been fully clear, the understanding of his chair had been closer to that of Mr. Dallara--namely, that the net income target would remain at 7.5 percent.

Mr. Zecchini remarked that, unlike Mrs. Ploix, he had understood that the starting point for a reconsideration of the net income target after two years was 7.5 percent and not 5 percent, and that in the event that agreement could not be reached, the target of 7.5 percent would be retained.

The Chairman said that by including in the summing up of the present discussion a strong presumption that the net income target would be 7.5 percent if the problem of overdue obligations remained serious, sufficient leeway should be provided to enable those Executive Directors who were in favor of maintaining the net income target at 7.5 percent on a more permanent basis to accept the compromise that had been reached.

Mr. Doe reiterated his understanding that the decision on increasing the net income target was to be taken anew in 1988, or after two years, from the base of 5 percent. Any decision to increase the target beyond 5 percent would be taken at that time.

The Chairman said that Mrs. Ploix and Mr. Doe were right that the compromise had been to revert after two years to a net income target of 5 percent. But since any increase above 5 percent was burden shared, and since it had been agreed that the seriousness of the problem of overdue obligations justified a strengthening of the Fund's financial position, it should be possible for the Executive Board to agree that there was a strong presumption that, should the problem of arrears continue to exist, a decision would probably be taken to increase the net income target to 7.5 percent. The addition of that understanding to the summing up should not be difficult to accept.

Mr. Dallara said that he appreciated the effort of the Chairman to move toward meeting his concerns. Unfortunately, two aspects of the direction of the discussion raised a serious problem for him. First, he saw no reason why the proposed decision could not be amended to increase the Fund's net income target from 5 percent to 7.5 percent of reserves. Second, his position at the outset of the informal meeting had been based on the principle of burden sharing, focusing primarily on the problem of nonaccrued income. In moving in the direction of sharing the burden of the increase in reserves, his understanding had been that such sharing would be for two years only. A permanent reserve increase to 7.5 percent that was permanently burden shared from 5 percent to 7.5 percent would be tantamount to asking creditor members to accept permanently remuneration at less than 100 percent because that was the only way in which the increase could be burden shared. The understanding that had been reached on moving toward a remuneration coefficient of 100 percent, effective early February 1987, would have little meaning if it were to be agreed that the increase in reserves from 5 percent to 7.5 percent were to be burden shared beyond FY 1988. Therefore, in light of the substantial movement toward an agreement at the informal meeting, he asked Executive Directors whether they would indulge his apparent misunderstanding of the outcome, and agree to increase the reserve target permanently from 5 percent to 7.5 percent, with burden sharing of the increase for the two years ahead, and with the normal provisions for financing a reserve increase operating beyond FY 1988.

Mr. Fugmann said that his understanding was exactly the same as the one outlined in the Chairman's summing up of the informal meeting, although he could accept the Chairman's proposal for an additional element of compromise. Without taking an immediate final stand on Mr. Dallara's request, he wished to draw attention to the risk that the compromise reached might be unraveled because of Mr. Dallara's proposal.

Mr. Sengupta requested Mr. Dallara not to reopen the issue. It should be accepted by all that the increase in the net income target was for a limited period of two years, subject to extension for a longer period. For the period during which arrears remained a problem, there would be burden sharing; the increase in the remuneration coefficient would be permanent.

Mr. Fujino said that Mr. Dallara's position was the same as his own original position. Irrespective of the agreement in the informal meeting, he was willing to support Mr. Dallara's request, if there was a consensus in its favor.

Mr. Parmena said that he supported Mr. Sengupta's position. An additional point to be borne in mind was that the agreed package for the two financial years included what was in effect a contribution on the part of the developing countries--namely, the fact that SDR 26 million in excess of the target income for FY 1986 would remain part of reserves and not be deemed as income for FY 1987. The entire compromise would have to be renegotiated if any part of it was thrown open for renegotiation.

Mr. Dallara said that he was not attempting to reopen the issue. As far as he recalled, the manner of financing a reserve increase from 5 percent to 7.5 percent beyond FY 1988 had not been discussed.

The Chairman considered that the maximum that could be agreed at the present meeting was to add to the compromise agreement that had been reached the presumption that the net income target would be raised beyond 5 percent when the whole issue was reconsidered in 1988. Whether or not there was burden sharing of any increase in the reserve target that might be needed at the time of that review could also be considered at that time.

Mr. Dallara said that he had no problem with the principle stated in the summing up that the consequences for the Fund that stemmed from the problem of overdue financial obligations should be shared between debtor and creditor countries. His difficulty arose from the reluctance of the Board to face the issue of provisioning. He would be quite prepared to "burden share" the consequences of overdue financial obligations to the Fund by tackling the issue of provisioning. But other Directors seemed unprepared to face up to the question of whether or not the proposed increase in reserves was related directly to the need to provision while at the same time they were making an implicit but modest gesture in that direction. The issue had to be squarely faced. He did not think that it was unreasonable to look for a general increase in the Fund's reserves over time in light of the growth of its financial operations.

The Chairman said that the financial consequences of a decision on provisioning would have to be tackled if and when that decision was taken. As long as no decision on provisioning had been agreed, the increase in reserves would reinforce the Fund's financial position, not as a substitute for provisioning, but possibly as a step toward provisioning. The need for reserves might have to be reassessed if a decision on provisioning were adopted. Meanwhile, the Fund's reserve position had been strengthened by the addition to reserves of SDR 26 million of income exceeding the target. The compromise had been reached thanks to the willingness of some Directors to retain SDR 26 million in the reserves and thanks to the agreement of other Directors to accept a net income target of 7.5 percent. Therefore, it could not be said that there was not a general willingness to contribute to the strengthening of the Fund's financial position.

Mr. Dallara commented that he would not be at all surprised if, when the time came to raise the issue of provisioning once again, the discussion and decisions to be adopted at the present meeting on an increase in reserves were taken as having to some degree taken care of the need to strengthen the Fund's financial position to deal with the problem of overdue obligations. He had accepted the management's view that it had not been possible for the staff to review the issue of provisioning prior to the present round of discussions and that ongoing discussions with the external auditors were also making it difficult to bring the issue before the Board for the time being. Therefore, he had agreed that provisioning should not be included in the discussion of burden sharing of nonaccrued income. His concern was that the proposed decisions before the Executive Board would be viewed as an important step also in the direction of protecting the Fund against arrears of principal; indeed, the wording of the summing up suggested as much. After all, the Fund was not currently incurring costs resulting from arrears of principal.

The Chairman said that he agreed with Mr. Dallara that the issue of provisioning had to be addressed. Any proposals for provisioning that were made would have to be integrated in an overall approach that took reserve increases into account. If a system could be devised that took full account of the nonaccrual of charges--under the methods being applied at present--and that also included ways of dealing with the problem of provisioning against arrears of principal, then the target for increase of reserves would also have to be reviewed.

Mr. Grosche considered that the fact that net income above 5 percent would be placed in a special line of reserves, or in a special account, gave a signal that the Fund was aware of the problems facing it, not necessarily only on the side of overdue charges but on the capital side as well. The Board was not postponing consideration of the issue of provisioning; rather, in approaching that issue it had to be aware of the need to finance provisioning, inter alia, by raising the rate of charge and by simultaneously reducing the rate of remuneration as part of the overall burden sharing effort. Once the cost of provisioning had been considered, on the expenditure side of the Fund's accounts, and if provisioning were introduced, the need to increase the net income target might have to be reconsidered.

Mr. Nimatallah stated that in the interest of good management, the issue of provisioning would have to be taken up soon, as Mr. Dallara had stated. The package under discussion was a good beginning because it showed that the Fund's members were ready to share the burden of the cost of covering both overdue charges as well as delays in the repayment of principal, with the latter to be taken up at a later stage. As Mr. Grosche had noted, the fact that net income above 5 percent would be placed in a special account was also evidence that the Fund was moving in the right direction. But if the issue of provisioning was not faced squarely, as Mr. Dallara had said, a net income target of 7.5 percent might be insufficient, and even 10 percent might not be adequate.

Mr. Dallara suggested that one possible formulation that went some distance toward meeting his concern but that might not foreclose all options would be to amend Rule I(6)(4)(a), to state that the net income target for FY 1987 and FY 1988 would be raised from 5 percent to 7.5 percent, and that the net income needed for that purpose would be generated according to the provisions of Section V of the decision on burden sharing. The question of financing any future increase in reserves would thus be left open.

The Chairman remarked that it seemed inconsistent to make a definitive change in the net income target before a decision on provisioning was taken because that decision might include an element of protection against the risk of principal. It might not be necessary to increase the net income target to 7.5 percent.

Mr. Dallara remarked that it was also not possible to envisage the outcome of the Board's consideration of provisioning. However, he would be happy to agree to a statement that the target of 7.5 percent would be reviewed if a decision was reached on provisioning. The increase should perhaps be of a permanent nature but with a provision for review, should a decision on provisioning be reached.

Mr. Sengupta stated that the time had come to recognize what had been agreed to was for the sake of compromise and in order to ensure the acceptance of the principle of burden sharing. Views on whether or not to increase the reserve target differed greatly, and a 70 percent majority of the voting power was required to approve the increase. The increase in the remuneration coefficient required a similar majority. It had been agreed that there would be burden sharing as long as the problem of overdue obligations remained, but the increase in the remuneration coefficient to 100 percent would be permanent. In the first instance, it had been decided that the increase in the reserve target should apply for two years; if there was a consensus that it should apply for three years, he would have no objection. But it was imperative not to open up the basic debate on the package on which a compromise had been reached--namely, the increase in the reserve target; the increase in the remuneration coefficient; burden sharing of both the increase in reserves and deferred income; the element of nonrefundability; and the placement to reserves of the excess net income from FY 1986 of SDR 26 million. That compromise represented great progress, and as others had stated, it must not be unraveled. No doubt Mr. Dallara's points would remain as cogent and as rational in 1988 when the matter would be reviewed.

The Chairman reiterated that he was ready to add to the summing up, with the aquiescence of the Board, that if the problem of overdue obligations remained serious at the end of the two-year period, and even though the net income target would revert to 5 percent, there would be a presumption again to raise the net income target for the same reasons that had led to the increase in that target from 5 percent to 7.5 percent at the present time. If an attempt was made to establish that the net income target should remain indefinitely at 7.5 percent, the compromise would unravel.

Mr. Dallara said that he took the Chairman's point but he hoped that other Directors recognized that the other elements of the understanding were not presumptions but clear agreements. A presumption of action to be taken two and a half years into the future had to be weighed against the requirement of a 70 percent majority to reach a decision at that time; viewed in those terms, the question would remain wide open. He appreciated Mr. Sengupta's position, but he recalled that the U.S. authorities had come a long distance over the past nine months. The very concept of burden sharing had been anathema to his authorities, who had made a number of important concessions in accepting the principle of burden sharing, not to mention the mechanisms for implementing it. The considerable progress that had been made could be preserved under the approach he had outlined, which would change the amount of the net income target by an amendment of the relevant rule. He would be happy to agree that if an approach to provisioning was developed, the amendment to the rule would be reviewed and the net income target adjusted downward to 5 percent, unless a 70 percent majority favored retaining the income target at 7.5 percent when a decision on provisioning was adopted. Such an approach would give him the assurance of permanence, and yet retain the element of temporariness that others might need.

Mr. Parmena observed that amending the agreed package would call for further negotiations, which would take time. Moreover, if a change in the rules was to be considered, consultation with authorities might be necessary, leading to further delay.

Mr. Nebbia considered that Mr. Dallara's new request took the negotiation back a long way. As the Chairman had indicated at the informal meeting, had it not been for the problem of overdue obligations, the net income target might well still be 3 percent. There had been no other reason for increasing the target; yet it was being increased not only to 7.5 percent, but in effect to 10 percent, if account was taken of the SDR 26 million being placed to reserves instead of being deemed as income for FY 1987. Likewise, for FY 1988, it was being agreed that the reserve target might well be increased beyond 7.5 percent. The agreement that had been reached at the informal meeting should be implemented.

The Executive Directors agreed to turn to Section III of the proposed decision.

Section III - Rate of Charge

Mr. Zecchini asked whether the proposed rate of charge in paragraph 1(a) of 6.0 percent was consistent with the proposal in Section IV, paragraph 2, stating that "as of February 1, 1987, the rate of remuneration shall be equal to 100 percent of the SDR interest rate." Although he had been expecting a higher rate, presumably the rate of 6 percent was based on the most recent data.

The Deputy Treasurer confirmed that the normal procedures for calculating the rate of charge had been followed, with one exception. The three elements that had been taken into account, in accordance with the staff papers discussed by the Executive Board in April and June (EBM/86/73 and EBM/86/74, 4/30/86; and EBM/86/100, 6/20/86) were the increase in the rate of remuneration to 100 percent as of February 1, 1987, the actual SDR rate for the first quarter of the current financial year and an estimate for the remainder of the year at the SDR rate of 6.1 percent, and the 1.25 percent of the increase in the reserve target that would be borne by the debtor countries. The one significant change from the normal procedures was that it had not been possible, at such a late stage in the financial year, to ignore the change in the SDR interest rate. The SDR interest rate had been fluctuating, and if the calculations were redone, the rate of charge might be quite different. In response to a question from Mr. Nebbia, he confirmed that the figure of 6 percent had been rounded.

Mr. Polak remarked that he had had some difficulty also with the statement in Section III, paragraph 1 that the rate of charge would be 6 percent, and the statement in Section V, paragraph 2 that the rate of charge--and the rate of remuneration--would be adjusted.

The Deputy Treasurer added that further adjustments would be made to the rate at the end of the first adjustment period, namely, at the end of October.

The Director of the Legal Department noted that when the provision in paragraph 1(a) had been drafted, the staff had been thinking in terms of a rate that had already been adjusted as of the beginning of the current financial year. He suggested that it would be preferable to delete subparagraph (a) and to take a separate decision on the rate of charge, stating that the rate was being determined in accordance with the provisions of Section III.1 of the overall decision. It would then be clear that the rate of charge of 6 percent had been calculated pursuant to those provisions, and in accordance with Rule I-6(4). Paragraphs (1)(b) and 1(c) would then become paragraphs 1(a) and 1(b).

Section IV - The Rate of Remuneration

The Chairman noted that Section IV amended Rule I-10 and gave permanence to a rate of remuneration equal to the SDR interest rate as from February 1, 1987.

Section V "Burden Sharing" in FY 1987 and FY 1988

Mr. Zecchini asked whether it was necessary for the sake of clarity to add a reference in paragraph 2(b) to the fact that the rate of charge and the rate of remuneration would be adjusted retroactively.

The Director of the Legal Department explained that paragraph 2(d) stated that the adjustments would be made as of May 1 and as of November 1 for the preceding six-month periods.

The Deputy Treasurer added that it was a postperiod adjustment, not a retroactive one; it would be made before the collection of charges and the payment of remuneration, and no refunds would be necessary or additional charges collected.

Mr. Polak remarked that the fact that the rate of charge, effective May 1, was being determined at the present meeting, one quarter into the current financial year, suggested that it would not be possible to predetermine the amount of the adjustments precisely on those dates. He asked whether the 2.5 percent of additional income to be distributed between debtors and creditors could be determined ex ante, especially as the total amount of outstanding obligations to be taken into account in calculating the rate of charge and the rate of remuneration would not be known in advance.

Mr. Fugmann asked whether the rate of charge of 6 percent, to become effective May 1, was the basic rate of charge.

The Deputy Treasurer confirmed that the proposed rate of charge of 6.0 percent included half of the additional amount needed to meet the reserve target for the financial year. Half of the increase in the reserve target for FY 1987--1.25 percent of reserves as of the beginning of the financial year--had been incorporated into the basic rate, together with the increase in the remuneration coefficient from February 1, 1987. The need for the postperiod adjustment arose from certain elements of uncertainty--mainly the amount of deferred charges, the burden of which was to be shared by creditors and debtors, and which would be known only at the end of the period.

Mr. Polak and Mr. Fujino said that they wondered whether Section V, paragraph 2(b) did not require an additional adjustment of the rate of charge for the increase in the reserve target to be borne by debtor countries of 1.25 percent, which had already been included in the basic rate of charge of 6 percent. Some redrafting of the wording of the decision seemed desirable.

The Director of the Legal Department indicated that the adjustment under paragraph 2(b) was qualified by the provision in paragraph 2(d), that made the adjustment "subject to the provisions of Section III.1(a)...." Section III.1(a) stated that the calculation made at the beginning of the financial year would include a prospective adjustment to cover the part of the net income increase borne by debtor countries. However, the staff would look at the text again.

Mr. Polak considered that the draft decision missed one aspect that might not be in the summing up of the informal meeting but that had been rather clearly understood in the earlier meetings--namely that charges which had been deferred before FY 1987 when settled would accrue to debtors only, as it was the debtors who had paid for them in those earlier years. If that could not be done for debtors individually--and he understood there were legal difficulties--it should be done for debtors as a group. Appropriate language could be added to Section V.

The Chairman said that he recalled the discussion. In response to a question from Mr. Zecchini, he indicated that he was not sure whether he had actually included the understanding in the summing up. It would appear logical that debtors should benefit when charges deferred in FY 1986 were discharged. However, charges deferred in FY 1985 might reasonably accrue to the Fund as the income target had not been met in that year and the Fund in fact had incurred a deficit.

Mr. Dallara inquired what would be done with the income resulting from the settlement of deferred charges in the absence of an agreement on the issue and in what way that income would affect charges in the future. In particular, if settlement took place before the end of October, would it not lead to a reduction in the rate of charge?

The Deputy Treasurer said that some discharge of charges deferred in FY 1985 and FY 1986 could be expected during the first adjustment period, although it was difficult to predict to which of those two years the charges would be attributable. If the Executive Board agreed, it could be used to reduce the adjustment necessary at the end of October and thus would not be reflected in net income for the period. If there was no decision that those settlements should be taken into account, the discharge would increase net income pro tanto.

The staff representative from the Treasurer's Department added that under Rule I-6(4) charges were not reduced automatically when net income exceeded the target amount. The settlement of charges deferred before the current financial year--which would not be included in income projections--would represent additional income. There was only one set of circumstances in which such additional income could automatically affect the rate of charge: if it were received before the end of the first half of the financial year and avoided an activation of the safeguard clause that otherwise would have led to an automatic increase in the rate of charge in order that the net income target would be met. Of course, Executive Directors would take the additional amount of income into account when considering the Fund's income position and could take a decision to reduce the rate of charge. A reduction would not be automatic, however. The treatment of charges deferred before May 1986--namely, before the adoption of burden sharing--thus differed from that of charges deferred in FY 1987 and FY 1988, which under the decision being discussed would accrue to members that paid an adjustment.

The Chairman, after some further discussion, said that it appeared that the treatment of charges deferred before the current financial year did not form part of the agreement reached at the informal meeting, and it was for Executive Directors to decide that issue.

Mr. Dallara suggested that it might be helpful to take up that issue in connection with the proposal that he had made with respect to amending Rule I-6(4)(a). He recalled that his proposal had been to replace the first two sentences of Section II, paragraph 1 with the following sentences: "the Fund's net income target shall be raised from 5 percent to 7.5 percent of the Fund's reserves. For FY 1987 and FY 1988, the additional net income shall be generated in accordance with the provisions of Section V." In addition, a separate sentence or paragraph would be necessary to state that: "should the Board take a decision to establish provisioning, the net income target, as stated in Rule I-6(4)(a), would be automatically reduced to 5 percent." In that way, the increase in the reserve target for FY 1987 and FY 1988 to 7.5 percent would be temporary and would be burden shared, but the permanence of the increase from 5 percent to 7.5 percent would be withdrawn, should a move be made to establish loan loss provisions, and the income target would revert to 5 percent. The notion that the issue would have to be reconsidered would be captured by such a text, and as the Chairman had stated, it might no longer be necessary at that time to maintain the reserve target permanently at 7.5 percent.

Mr. Pérez stated that to accept Mr. Dallara's proposal would be a major departure from the agreement reached at the informal meeting because it involved a permanent increase in the reserve target that would not be burden shared after FY 1988. Certainly, the summing up of the informal meeting had not mentioned the issue of provisioning. If Mr. Dallara wanted to extend the period covered by the agreement on burden sharing, he would have no difficulty in extending the agreement to cover the increase in the net income target to 7.5 percent beyond 1988, either until 1989, or for the period during which there was a problem of overdue obligations. The basic principles of the agreement reached should not be altered.

Mr. Zecchini asked whether it was essential to include in such a reformulation the reference to the net income target reverting to 5 percent. If a scheme for loan loss provisioning was worked out, reserves might not need to be accumulated at such a high rate as in FY 1986.

The Director of the Legal Department noted that establishing a linkage between a change in the net income target and the introduction of loan loss provisioning would create a legal problem because the two decisions required a different majority. A decision to change the net income target, which would determine the rate of charge, called for a 70 percent majority of the total voting power, whereas a simple majority of the votes cast was sufficient to decide on provisioning. It would imply that, technically, a decision on provisioning taken by a simple majority of the votes cast led to a change in the rate of charge.

Mr. Dallara said that it might be possible for the Executive Board to agree at the present meeting, by a 70 percent majority, to establish the conditions under which it would reduce the reserve target from 7.5 percent to 5 percent.

Mr. Huang, Mr. Nebbia, Mr. Polak, Mr. Sengupta, Mr. Doe, Mr. Hospedales, and Mr. Parmena said that they could not accept Mr. Dallara's proposal.

Mrs. Ploix and Mr. Fugmann said that they could not accept Mr. Dallara's proposal although they could go along with the suggestion by Mr. Pérez to extend the period of burden sharing.

Mr. King recalled that it would be very difficult for his chair to accept a longer period than two years.

Mr. Sengupta considered that the Chairman had clearly established the point that there was no disagreement in principle to extending the period although some Directors wished to take the decision to extend it after two years. He would have no difficulty agreeing that the period could be extended for another year or two, or as long as the problem of overdue obligations remained.

The Chairman confirmed that as he had noted at the end of the first informal meeting, during which many Directors had expressed a preference for one year whereas others had sought a permanent arrangement, he had proposed two years as a compromise, which had been acceptable, although Mr. Lankester had continued to have some difficulties in that respect.

Mr. Nimatallah said that as much as he sought an increase in reserves, and on a permanent basis, he wished to appeal to Mr. Dallara not to delay approval of the package that had been agreed. A good beginning had been made, the issue would be taken up again, and the need to move toward provisioning at an early date had also been stressed by several Directors, including himself and Mr. Dallara.

Mr. Grosche said that while he could certainly go along with Mr. Dallara's proposal, there was obviously no majority in its favor. Therefore, he strongly supported Mr. Nimatallah's position. In addition, he did not consider an extension of the agreement as being equivalent to Mr. Dallara's proposals. A great deal might change in the two years ahead. If the problem of overdue financial obligations remained serious, the Fund would move much closer toward provisioning, and the present discussion of the reserve target would no longer be valid.

Mr. Massé said that he would also have no problem with a permanent increase in the reserve target from 5 percent to 7.5 percent because that had been part of his original proposal. However, it was clear that a 70 percent majority for such an increase would not be attained. The trade-offs that had been made in order to reach the compromise agreement had been sufficiently important to lead him to conclude that the only chance of solving the problem for at least the next two years was to accept that agreement.

The Chairman observed that the majority was clearly in favor of approving Section II of the proposed decision as amended during the discussion so far. He repeated that he was ready to state in an additional summing up, first, that the issue of provisioning would have to be faced soon, and second, that after the two-year period, and subject to what was decided on provisioning, the presumption would be that an increase of the net income target of more than 5 percent might well be needed if the problem of overdue financial obligations remained serious. Mr. Dallara could then rest assured that the issue of provisioning would be addressed and, depending on the nature of the provisioning, the net income target would remain at 7.5 percent if the potential for a serious problem with respect to overdue financial obligations to the Fund existed. It seemed to him that those Directors who were reluctant to accept a net income target of 7.5 percent as a permanent feature might be willing to accept such an addition to the summing up. An effort to go any further than that was not likely to be successful.

Mr. Dallara said that while he appreciated the Chairman's effort to arrive at a compromise, he had not previously detected a broad enough sentiment on the issue of provisioning to make it easy for him to report the Chairman's proposal to his authorities. He had gone beyond the instructions of his authorities at the informal meeting. He recognized that other Directors did not feel as strongly on the matter as he did, but he asked them to consider the importance of the decision. Although it could be adopted legally without the support of his authorities, he considered that it would be highly regrettable if the decision were taken without the support of a member, fully 40 percent of whose creditor position in the Fund would be affected by it. He asked whether Directors were firmly wedded to burden sharing in the first year of the reserve increase, namely, for FY 1987.

Mr. Grosche, Mr. Nimatallah, Mr. Massé, Mr. Zecchini, and Mr. King said that they were ready to forgo burden sharing for the first year.

Mr. Huang, Mr. Nebbia, Mr. Polak, Mrs. Ploix, Mr. Sengupta, Mr. Alhaimus, Mr. Fugmann, Mr. Doe, Mr. Hospedales, and Mr. Parmena stated that they were firmly bound by the consensus reached in the informal meeting.

The Chairman remarked that the basic issue was of course whether Directors were ready to change part of the package that had been agreed in order to facilitate Mr. Dallara's acceptance of the overall package, which was difficult for him to accept on account of the duration of the increase in the net income target to 7.5 percent.

Mr. Sengupta commented that to continue to open up one or two specific parts of the package would destroy the consensus that had been reached. That package should be accepted as having been agreed. The various aspects that had been suggested for reconsideration could be discussed at a later stage, for instance, provisioning, and the size of the net income target. His understanding of the Chairman's summing up was that there was a consensus in favor of the package, on which a decision should be taken at the present meeting.

The Chairman added that it was clear that the modification of the agreement with respect to burden sharing that Mr. Dallara had suggested in an effort to achieve a further compromise and a new consensus did not seem likely to be conducive to a consensus.

Mr. Dallara said that he recognized that although a number of Directors were willing to move in the direction he had suggested, they were not at the present stage in the majority.

Mr. Fujino said that he reserved his position, which he had stated clearly. Nevertheless, he recognized that as unanimous a consensus as was possible had been reached at the informal meeting. Of course his reservations about the concept of burden sharing were long standing.

The Chairman responded that he had appreciated the willingness of Directors who had strong reservations about certain aspects of the burden sharing package to transcend those reservations because they felt that the overall package on which agreement had been reached at the informal meeting was worth supporting.

Mr. Dallara recalled that his chair had been among those that had been willing to accept some of the suggestions made by other Directors toward the end of the informal meeting that had facilitated the development of the consensus. His proposal had been put forward in the hope that others might share the importance that he attached to a true consensus.

Mr. Nimatallah suggested that the serious concerns of Mr. Dallara--which were shared by others, including himself--could be met if the Board accepted the Chairman's proposal to make an addition to the summing up that would place greater emphasis on the priority that the Board should give to provisioning.

The Chairman said that he would draft several sentences, along the lines that he had previously suggested, for purposes of the summing up and the record.

Mr. Dallara said that the Chairman's proposal would not meet his concerns with respect to provisioning.

The Chairman then asked if other Directors could accept his proposal with respect to the summing up and whether the proposed decision, with the amendments that had been agreed during the discussion, was acceptable.

The Executive Board accepted the Chairman's proposal and understanding of the agreement reached with respect to the proposed decision.

Mr. Dallara said that he recognized that there was insufficient support for his proposal. He reiterated that he considered it highly regrettable that the Board would take a decision on the whole issue of burden sharing that could not be supported by a major creditor member that had made every effort and that had moved a considerable distance in order to meet the concerns of the debtor countries. He recalled that in late 1985, when he had been asked by some Directors to consider burden sharing on the occasion of the need for a substantial increase in charges, he had asked for time to present their case to his authorities, who had not been prepared to accept burden sharing. In the intervening months, he had laid the groundwork for the quite significant movement of his authorities toward an agreement. But it appeared that he had laid that groundwork in vain. The broad principles articulated in the compromise that had been accepted was not likely to attract the support of his authorities.

The Chairman said that he too regretted that the consensus that had been developed at the informal meeting had not enabled the Board to carry the positive spirit of that discussion into the present meeting.

Mr. Dallara remarked that he also appreciated the spirit in which that agreement had been reached. Unfortunately, a number of Directors other than himself had come away from that informal meeting with a different interpretation of the outcome, which he sincerely regretted.

The Executive Directors then returned to the text of Section V.

Mr. Nimatallah suggested that the reference in paragraph 4(a) and 4(b) to "members that have paid additional charges or have not received remuneration" should be amended to read "...or have received reduced remuneration."

Mr. Polak said that it would be preferable to state in paragraph 2(f) that the operation of the decision "shall be reviewed when the remuneration coefficient is reduced to 85 percent," rather than before the coefficient was reduced. The review would have to take place at the end of a half year because the data would not be available earlier; it was then that a conclusion would need to be reached on whether full adjustment should be allowed to take place which would lead to a reduction below the 85 percent limit.

Referring to paragraph 2(e), Mr. Polak asked whether the fact that the burden borne by the creditors, which could not be calculated in time to affect the rate of remuneration already earned in the first quarter of the current half year and would have to be distributed over a shorter period, would affect the application of the rule requiring that the rate of remuneration not fall below 80 or 85 percent of the SDR interest rate.

The Director of the Legal Department explained that the calculation would be based on the first two quarters of FY 1987, namely, the first adjustment period.

The Executive Directors then turned to the summing up of the informal meeting held on July 17, 1986.

The Chairman noted that paragraph 3 should be amended to refer to both FY 1987 and FY 1988. On the matter of substance, he asked Directors whether they wished to add several sentences referring to provisioning and to the strong presumption that the net income target would return to or remain at 7.5 percent after two years if the problem of overdue financial obligations still existed.

Mr. Nimatallah and Mr. Zecchini stated that they were in favor of adding a sentence referring to a strong presumption that a reserve target of 7.5 percent would be maintained.

Mr. Ismael, Mr. Massé, Mr. Nebbia, Mr. Polak, Mrs. Ploix, Mr. Fugmann, and Mr. King said that they could go along with additional wording to reflect the two points made by the Chairman.

Mr. Sengupta said that he could go along, on the understanding that no discussion or decision had taken place on provisioning but that the issue would be taken up, on the basis of a staff paper to be prepared.

Mr. Fujino said that he was not very keen on the concept of provisioning but he had no objection to continuing to study the matter.

Mr. Grosche said that he too did not like the idea of provisioning, but thought that it would have to be discussed.

Mr. Dallara said that he would report the thrust of the discussion to his authorities. At the same time, he wished to reiterate his regret that a decision having such significant effects on one particular creditor could be taken without that creditor's participation in the decision. That outcome was basically inconsistent with the entire approach outlined for handling the issue by Mr. Massé, Mrs. Ploix, and other Directors over the preceding months, an approach that he had made every effort to have accepted by his authorities.

Referring to the summing up of the informal meeting, Mr. Dallara recalled that there had been a brief exchange toward the end of the discussion concerning the special approach to be taken in the context of the operational budget to meet the concerns of the United States with respect to the extent of the burden sharing that it would have to assume.

The Chairman said that reference should have been made in the summing up to that matter. An additional paragraph would be added to remedy the omission.

Mr. Dallara explained that his concerns would not be so great if he could believe that the problems under discussion had been resolved. While the Executive Board could take whatever decision it wished, by the required majority, it would take a cooperative effort by all members to resolve the problem of overdue obligations to the Fund. It was in that context that he regretted the unwillingness of the Board to reflect further on the outcome of their informal meeting. A broad consensus on the basic principles of the way in which the problem of overdue obligations would be tackled was imperative if the problem was to be resolved satisfactorily. While he recognized that the differences of view among Directors might not be that great, he wondered whether the financial gain obtained under the proposed decision was worth having, particularly in light of the distance that his authorities had gone.

The Chairman remarked that there had been compromise on all sides. Moreover, the Board had gone a long way toward meeting Mr. Dallara's concerns by agreeing to an effective rate of reserve increase of 10 percent in the first year, 7.5 percent and possibly more in the second year, and a strong presumption that the net income target would remain at 7.5 percent in the third year, depending on what action was taken on provisioning. The one point which the Board in its entirety had been unable to accept was the requirement that the net income target be permanently enshrined in the rules at 7.5 percent, on the grounds that the disappearance of the problem of overdue financial obligations would remove the need for a target of 7.5 percent.

Mr. Dallara remarked that the notion of burden sharing with respect to the increase in the Fund's reserves had not been part of the discussion until the previous week's informal meeting, yet he had taken it upon himself to accept it. If, as the Chairman had mentioned, it was the general sense of the meeting that the reserve target would remain at 7.5 percent, if the problem of overdue financial obligations still existed, he wondered whether it was really that difficult to reflect that sense of the meeting in the relevant rule. The outcome of further discussions on some of the issues raised might well turn on the careful gradual introduction of innovations.

The Chairman said that the contribution by Mr. Dallara in accepting the notion of burden sharing had been a major contribution that was greatly appreciated.

The Executive Directors agreed to look at the text of the summing up, as amended, on July 30.

The Executive Board then took the following decisions:

Income Position - Principles of "Burden Sharing," Income Target for FY 1987 and FY 1988, Rate of Charge, and Rate of Remuneration

Section I. Principles of "Burden Sharing"

1. The financial consequences for the Fund which stem from the existence of overdue financial obligations shall be shared between debtor and creditor member countries.

2. This sharing shall be applied in a simultaneous and symmetrical fashion.

Section II. Income Target for FY 1987 and FY 1988

1. During financial year 1987 and financial year 1988, the Fund's net income target shall be raised from 5 percent to 7.5 percent of the Fund's reserves at the beginning of each year. The additional net income shall be generated in accordance with the provisions of Section V. It shall be recorded separately in the financial statements of the Fund.

2. For financial year 1988, the Fund may decide to add supplemental income to be generated in accordance with the provisions of Section V. It shall be recorded separately in the financial statements of the Fund.

Section III. Rate of Charge

1. (a) The rate of charge referred to in Rule I-6(4) shall be determined at the beginning of financial year 1987 and financial year 1988. This determination shall be made on the basis of the estimated income and expense of the Fund during the year and the target amount of net and supplemental income for the year, and shall include the adjustment necessary to generate one half of the additional net income and of the supplemental income for the year.

(b) During financial year 1987 and financial year 1988, when estimating income, no deduction shall be made for projected deferred income.

2. During financial year 1987 and financial year 1988, the rate of charge shall be further adjusted in accordance with the provisions of Section V.

3. The rate of charge in force as of the end of a financial year, as adjusted under Section V, shall continue to apply subsequently unless it is otherwise decided.

Section IV. Rate of Remuneration

1. Effective August 1, 1986, Rule I-10(d) shall cease to apply.

2. Effective February 1, 1987, Rule I-10 shall read as follows:

I-10. (a) The rate of remuneration shall be equal to 100 percent of the rate of interest on holdings of SDRs under Rule T-1 (hereafter referred to as "SDR interest rate").

(b) The relationship of the rate of remuneration to the SDR interest rate will be referred to as the "remuneration coefficient."

3. During financial year 1987 and financial year 1988, the rate of remuneration shall be adjusted in accordance with the provisions of Section V.

Section V. "Burden Sharing" in FY 1987 and FY 1988

1. In financial year 1987 and financial year 1988, and notwithstanding Rule I-6(4)(a) and (b) and Rule I-10, the rate of charge referred to in Rule I-6(4), and the rate of remuneration prescribed in Rule I-10 shall be adjusted in accordance with the provisions of this Section.

2. (a) In order to generate the additional net income referred to in Section II.1, and the supplemental income referred to in Section II.2, the rate of charge shall be adjusted in accordance with the provisions of Section III.1(a), and the rate of remuneration shall be adjusted, subject to the limitation in (c), in accordance with the provisions of this paragraph, so as to produce equal amounts of income.

(b) If income from charges becomes deferred during an adjustment period as defined in (d), the rate of charge and the rate of remuneration shall be further adjusted, subject to the limitation in (c), in accordance with the provisions of this paragraph, so as to generate, in equal amounts, an additional amount of income equal to the amount of deferred charges. For the purposes of this provision, special charges on overdue financial obligations under Decision No. 8165-(85/189) G/TR, adopted December 30, 1985, shall not be taken into account.

(c) No reduction in the rate of remuneration under this paragraph shall be carried to the point where the average remuneration coefficient would be reduced below 85 percent for an adjustment period.

(d) Subject to the provisions of Section III.1(a), the adjustments under this paragraph shall be made as of May 1 and as of November 1 of each year:

shortly after October 31 for the period from May 1 to October 31; shortly after April 30 for the period from November 1 to April 30.

(e) Notwithstanding the provisions of (d), any adjustment made in respect of the first half of financial year 1987 shall affect the rate of remuneration only as of August 1, 1986.

(f) The operation of this decision shall be reviewed when the remuneration coefficient is reduced to 85 percent under (c).

3. A midyear review of the Fund's income position shall be held shortly after October 31 of each year. If, after any adjustment under paragraph 2, the actual net income for the first six months of the financial year, on an annual basis, is below the target amount for the year by an amount equal to, or greater than, 2 percent of the Fund's reserves at the beginning of the financial year, the Executive Board will consider how to deal with the situation. If on December 15 no agreement has been reached as a result of this consideration, the rate of charge shall be increased as of November 1 to the level necessary to reach the target amount of net income for the year.

4. (a) An amount equal to the proceeds of any adjustment made under paragraph 2(a) in order to generate supplemental income in financial year 1988 shall be distributed, in accordance with the provisions of this paragraph, to members that have paid additional charges or have received reduced remuneration as a result of the adjustment, when there are no outstanding overdue charges and repurchases, or at such earlier time as the Fund may decide.

(b) An amount equal to the proceeds of any adjustment made under paragraph 2(b) in financial year 1987 or financial year 1988 shall be distributed, in accordance with the provisions of this paragraph, to members that have paid additional charges or have received reduced remuneration as a result of the adjustment, when, and to the extent that, charges, the deferral of which had given rise to the same adjustment, are paid to the Fund. Distributions under this provision shall be made semi-annually.

(c) Distributions under (a) or (b) shall be made in proportion to the amounts that have been paid or have not been received by each member as a result of the respective adjustments.

(d) If a member that is entitled to a payment under this paragraph has any overdue obligation to the Fund in the General Department at the time of payment, the member's claim under this paragraph shall be set off against the Fund's claim in accordance with Decision No. 8271-(86/74), adopted April 30, 1986, or any subsequent decision of the Fund.

Decision No. 8348-(86/122), adopted
July 25, 1986

Income Position - Rate of Charge as of May 1, 1986

Effective May 1, 1986, the rate of charge referred to in Rule I-6(4), determined in accordance with the provisions of Section III.1(a) of Decision No. 8348-(86/122), adopted July 25, 1986, shall be 6.0 percent.

Decision No. 8349-(86/122), adopted
July 25, 1986

APPROVED: April 14, 1987

JOSEPH W. LANG, JR.
Acting Secretary

Managing Director's Concluding Remarks at Informal Meeting
on the Fund's Income Position
July 17, 1986

Although we need to look at the language, the principles I outlined at the outset of this afternoon's meeting are accepted, but the mechanism for FY 1987 and FY 1988 is different.

The agreed principles are:

First, the consequences for the Fund which stem from the problem of overdue financial obligations should be shared between debtor and creditor member countries. Second, the burden sharing in principle should be applied in a simultaneous and symmetrical fashion inasmuch as the Articles of Agreement make possible the full application of this principle. Third, the remuneration coefficient would be raised to 100 percent of the interest rate on the SDR.

The principles governing burden sharing would remain in effect as a temporary understanding, as long as the problem of overdue financial obligations which gave rise to the need for burden sharing at present continues.

The compromise on the financing mechanism for FY 1987 and FY 1988 is as follows:

1. The remuneration coefficient will be increased to 100 percent, effective February 1, 1987; until that time the coefficient will move according to the existing formula.

2. The income for FY 1986 in excess of target--SDR 26 million--remains part of reserves; it will not be deemed as income for FY 1987.

3. As a reserve effort in FY 1987 the target will be increased from 5 percent to 7.5 percent; there will be burden sharing, without refunding.

4. The FY 1988 reserve target of 7.5 percent may be raised beyond that figure if needed; burden sharing will apply above 5 percent and amounts in excess of 7.5 percent will be refundable.

5. Net income above 5 percent will be placed in a special line of "reserves."

The mechanism will be in place for two years; afterward, the Board will take a new decision.

As for the 85 percent floor to the rate of remuneration, if the remuneration coefficient is moving toward that limit the situation will be reviewed in advance to determine what action the Fund should take; the Board will reach a decision in light of the circumstances at that time.