

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/93

3:00 p.m., June 15, 1988

M. Camdessus, Chairman

Executive Directors

A. Abdallah

Dai Q.

J. de Groote

M. Finaish

G. Grosche

Y. A. Nimatallah

J. Ovi

H. Ploix

G. A. Posthumus

A. K. Sengupta

K. Yamazaki

Alternate Executive Directors

C. Enoch

D. C. Templeman, Temporary

R. Morales, Temporary

B. Goos

A. Iljas, Temporary

J. E. Zeas, Temporary

C. L. Haynes, Temporary

A. R. Ismael, Temporary

I. A. Al-Assaf

L. Filardo

C.-Y. Lim

O. Kabbaj

S. Yoshikuni

S. Rebecchini, Temporary

L. Van Houtven, Secretary and Counsellor

S. Woolls, Assistant

1. Saudi Arabia - 1988 Article IV Consultation; and  
General Arrangements to Borrow (GAB) - Borrowing  
Agreement Between Saudi Arabia and Fund - Renewal. . . . . Page 3
2. Designation Plan and Operational Budget for  
June-August 1988 . . . . . Page 51
3. Guyana - Overdue Financial Obligations - Review  
Following Declaration of Ineligibility - Postponement. . . Page 52
4. Sri Lanka - Technical Assistance . . . . . Page 53

Also Present

Exchange and Trade Relations Department: C. F. J. Boonekamp, S. Kanesa-Thanan. Fiscal Affairs Department: A. Ouanes, K. Nashashibi. IMF Institute: S. El-Khoury; I. Al-Oyed, Participant. Legal Department: F. P. Gianviti, General Counsel; T. M. C. Asser, R. S. J. Martha, J. V. Surr. Middle Eastern Department: A. S. Shaalan, Director; S. H. Hitti, Z. Iqbal, B. K. Short, S. von Post, C. A. Yandle. Research Department: G. Hacche. Secretary's Department: B. J. Owen. Treasurer's Department: D. Williams, Deputy Treasurer; M. N. Bhuiyan, W. L. Coats, Jr., D. Gupta, F. F. J. Lin, M. F. Moustapha, T. Voulgaris, B. B. Zavoico. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. B. Chatah, W. N. Engert, K.-H. Kleine, G. Pineau, A. Vasudevan. Assistants to Executive Directors: F. E. R. Alfiler, D. Barr, H. S. Binay, R. Comotto, Di W., B. R. Fuleihan, S. Guribye, M. Hepp, M. A. Kyhlberg, C. Noriega, S. Rouai, G. Schurr, G. Seyler, C. C. A. van den Berg, E. L. Walker.

1. SAUDI ARABIA - 1988 ARTICLE IV CONSULTATION; AND  
GENERAL ARRANGEMENTS TO BORROW (GAB) - BORROWING  
AGREEMENT BETWEEN SAUDI ARABIA AND THE FUND - RENEWAL

The Executive Directors considered the staff report for the 1988 Article IV consultation with Saudi Arabia (SM/88/107, 5/13/88), together with a background paper on recent economic developments in Saudi Arabia (SM/88/118, 6/1/88). They also had before them a staff paper on the renewal of the borrowing agreement between Saudi Arabia and the Fund in association with the General Arrangements to Borrow (EBS/88/109, 6/3/88).

Mr. Nimatallah made the following statement:

The continued sharp decline in oil revenues from more than \$100 billion in 1981 to about \$20 billion in 1987, has strengthened the resolve of the Saudi authorities to continue to adjust the economy further to a more manageable and sustainable level. Their commitment to adjustment is firm and unwavering. The question has been of pace and quality.

The authorities chose a consistent and gradual pace of adjustment and implemented a policy of fiscal retrenchment that did not fully match the drastic fall in oil revenues. That led to large fiscal deficits that have been financed by drawing down reserves, accumulated intentionally for smoothing out the impact of oil revenue fluctuations on the economy. However, despite this relatively gradual pace of public expenditure cuts, the extent of the adjustment of the economy, in general, and government expenditure, in particular, has been sizable over the past five years. The 1988 budget, for example, estimates total government expenditure to be about one half that of 1982/83.

Concerning the quality of adjustment, my authorities' foresight in adopting certain appropriate policies very early on has helped them in pursuing what could be characterized as good quality adjustment. These policies include an open economy, free of controls and regulations, on the one hand, and the avoidance of burdening the economy with debt, on the other. This foresight has paid off by leaving the economy inflation free during the difficult period of adjustment. The competition and the openness of the economy helped in controlling inflation to even negative levels. That meant that the lower-income groups in the society did not have to suffer twice: once through a general slowdown in economic activity, and again through an erosion of real incomes. Furthermore, the reduction in imports was achieved not by controls, but simply through the impact of reduced demand, and, of course, the maintenance of an appropriate exchange rate policy.

The staff points out that the fiscal deficit has grown even larger because of the temporary fiscal relaxation of 1987. My

authorities agree with the staff that the relatively large fiscal deficit incurred in the past year is not sustainable in the medium term. They are aware that usable reserves have declined to a level which is now causing concern. They intend to slow down markedly the rate of depletion of such financial reserves. My authorities want to emphasize that they are committed to the reduction and eventual elimination of the fiscal deficit, but mainly through reduction in government spending. They are also attempting to increase non-oil revenues. In addition, the Government has already put in place legislation authorizing the Ministry of Finance to borrow domestically up to SRls 30 billion during this fiscal year.

The limited fiscal relaxation in 1987 was meant to be an experiment in combining adjustment with growth. The authorities sensed some positive signs in the private sector that indicated growing confidence and accelerated activity. They wanted to supplement those signs by an additional boost, mainly through investment expenditure. Apparently that helped, as the economy resumed growth in 1987 for the first time in four years. It is hoped that the private sector is now convinced that the present pace of activity is the normal one, and no additional government boosts would be necessary. Therefore, my authorities reiterate their commitment to both the continuation of adjustment and the reduction of the fiscal deficit.

The achievements of the Saudi Arabian authorities can best be crystallized within two stages: first, before the decline in oil revenues in 1983, and second, after. During the decade 1974-1983, the economy of Saudi Arabia was transformed into a complex and increasingly sophisticated one. By 1983, intricate networks of infrastructure had been put in place throughout the country. The authorities had laid out effective and farsighted policies, with a view to insulate the economy from fluctuations in oil revenues and to prepare it for export diversification. These achievements have paved the way for the private sector to expand its role from less than 25 percent to about 40 percent in the economy today. The private sector was able to finance its business activities from public and private lending institutions.

Achievements after 1983 can be seen in several areas. As an early sign of success in export diversification, non-oil exports have nearly tripled in the past five years. Another sign is that domestic non-oil revenues have more than doubled in the past few years, and, as a result, their share in total government revenues has increased from about 5 percent in 1983 to about 20 percent in 1987. Furthermore, consumption excesses and economic waste have been drastically reduced. Today, the economy is more efficient and resources are better allocated.

My authorities are intent on continuing the appropriate adjustment policies to consolidate these achievements and put the economy back on a sustainable growth path.

My authorities feel that they have done a great deal to help the private sector expand and play a larger role in the economy. They have been following two processes of reducing the size of government and enhancing the role of the private sector. One process is by selling the equity of the heavy industrial conglomerates established by the government to the private sector, as in the case of the Saudi Arabian Basic Industries Corporation (SABIC). The other is by extending loans to the private sector for establishing smaller industrial and agricultural businesses. This is a lending policy that enables entrepreneurs to obtain a one-time loan for each qualified project or business to match the private equity invested in such businesses. These one-time loans extended to private sector entrepreneurs through the Specialized Credit Institutions (SCIs) are tantamount to equity participation by the Government in these businesses. Entrepreneurs, however, have to borrow the needed working capital in the market on commercial terms. My authorities intend to continue these policies, but with a view to providing the private sector only with the essential incentives. Unavoidably, these incentives include temporary and limited subsidies. However, with the further strengthening of the private sector over time, naturally these limited subsidies will gradually disappear.

Since the reduction of the size of government is, in itself, an objective, it is more consistent to bring about a decrease in the deficit through more emphasis on expenditure reduction and less on increase in revenue. Oil revenue is assumed to belong to all citizens, and to a certain extent it is received directly by the Government in lieu of tax revenues. Thus, within a given level of economic activity, it is not expected that the Government will impose much taxation. However, my authorities are trying diligently to speed up the pace of raising more non-oil revenues, keeping in mind a delicate balance between the two conflicting objectives of reducing the fiscal deficit and revitalizing the private sector.

On international matters, Saudi Arabia will continue to play its international role effectively. Its oil policy will continue to support stability of oil markets and prices. Saudi Arabia is convinced that this is in the best interest of consumers and producers alike. It is heartening that Saudi Arabia's position on oil price stability is spreading steadily, even among non-OPEC oil producers. As it has been reported recently, some non-OPEC oil producers have proposed to join

efforts for that objective. It is hoped that all producers and consumers would eventually cooperate in stabilizing oil markets.

Saudi Arabia's record on foreign aid is well known, and there is no need to state it again. I would only highlight that it will continue its support to the needy countries through its arm for development assistance, the Saudi Fund for Development. Its support to international organizations, particularly the Fund and the World Bank, continues to be strong. My authorities are convinced that these organizations are helpful to the world economy, in general, and to the promotion of adjustment and growth, in particular, and therefore should be strongly supported.

Finally, my authorities are grateful to the Board, management, and the staff for their professional conduct of the Article IV consultations with Saudi Arabia over the years.

Extending his comments, Mr. Nimatallah said that further to his statement that the Government had put in place legislation authorizing the Ministry of Finance to borrow domestically up to SRls 30 billion during that fiscal year, that borrowing had recently started, as Directors might have gathered from press reports. The total borrowing was divided in amounts of SRls 1.5 billion each, the first of which had been taken up very quickly and there was competition for five others, amounting to SRls 9 billion, to be undertaken within the coming weeks.

In his opening statement, he had indicated that oil revenues were assumed to belong to all citizens, and to a certain extent, they were received directly by the Government in lieu of tax revenues. Private sector industry was not directly involved in the oil sector, which was the responsibility of the Government. However, it was assumed that land and the oil belonged to the people, and that the earnings achieved from sales of oil belonged to the people. Therefore, instead of taxing domestic private corporations, the Government put oil revenues directly into the budget. Since the decline in oil prices, the Saudi Arabian people expected the same kinds of services from the Government, such as defense, health, education, and other infrastructural needs. However, in light of the diminished revenues, if the high level of services were to be maintained, the people would have to supplement oil revenues with taxes.

The Saudi Arabian public did not seem ready to accept taxation; instead they were accepting reduced public sector services. For example, there were more private hospitals, particularly in the cities, than public hospitals. Therefore, the Government was getting smaller and services were being taken over directly by the private sector. Of course, there would eventually come a time when a decision would have to be made as

to who would provide which services, but the current trend was toward gradually obtaining more revenue from non-oil sources.

His authorities were happy to renew the borrowing agreement between Saudi Arabia and Fund in an amount up to SDR 1.5 billion. Despite Saudi Arabia's difficult external position, the authorities were ready to offer their continued strong support, both financial and moral, to the Fund and its membership.

Mr. Finaish said that the sharp decline in oil revenue over the past few years had made economic management in Saudi Arabia a challenging task. Although the foreign exchange reserves that had been accumulated in the preceding decade had provided an important adjustment cushion, the authorities still had to chart a delicate policy course, balanced among seemingly conflicting objectives. On the macroeconomic level, the pace of adjustment had to be consistent with the medium-term prospects of the oil market, which were uncertain at best, and to be managed in such a way as to avoid a disruptive shock to the domestic economy. On the other hand, the authorities' long-standing objectives of rationalizing public sector operations and enhancing the role of the private sector had become not only more urgent, but also more difficult at a time of financial contraction and negative economic growth. The record of the past few years indicated that the authorities had been largely successful in meeting that formidable challenge. That could be seen not only in the magnitude of the fiscal and exchange rate adjustment that had occurred, but also in the fact that that substantial adjustment had taken place in an orderly manner, which had avoided undue disruption of the domestic economy. Although the sharp decline in government expenditures had inevitably led to a significant slowdown in economic activity, there was every reason to believe that the private and public sectors had, through the adjustment process, become more efficient and more cost conscious than before.

A crucial policy question that had faced, and continued to face, the authorities was finding the appropriate balance between financial retrenchment and external reserve depletion, Mr. Finaish continued. That obviously depended, among other things, on the outlook of the international oil market. Given the recent market developments and the current expectations of many observers of a soft oil market for the foreseeable future, it had become clear that a slower rate of reserve depletion and, therefore, some strengthening of adjustment would be required in the period ahead. As Mr. Nimatallah had indicated in his opening statement, the authorities were fully aware of that fact and intended to adjust their policies accordingly. Although a further tightening of aggregate demand would not be an easy task given the substantial reduction in government expenditures that had already occurred, the authorities' record so far provided confidence in its ability to again meet that policy challenge.

While other policies were obviously important, the fiscal deficit remained the central policy question, Mr. Finaish pointed out. Although

the fiscal expansion in 1987 had probably contributed to the small recovery in non-oil economic activity during the past year, he agreed with the authorities that the 1987 deficit was unsustainable. The authorities' effort to enhance domestic economic activity and the role of the private sector through selective incentives for investment was therefore welcome. He also shared the authorities' view that the emphasis of fiscal policy needed to be placed on reducing expenditures. The 1988 budget indeed had included a substantial reduction in government spending. Particularly noteworthy were the substantial cuts expected in subsidy outlays, as well as in operations and maintenance. Although the staff was projecting a total expenditure level in 1988 that was in excess of budget allocations, it was encouraging to note that even in the staff's forecast significant reductions in subsidies and maintenance were likely to be achieved. With respect to outlays for operations and maintenance, he had noted the projected increase over the medium term, which had called for increased efforts to achieve further economies in that area without, of course, jeopardizing the quality and performance of the economy's productive base.

Although the focus of fiscal adjustment in the immediate future would be on expenditures, he welcomed Mr. Nimatallah's statement that the Saudi Arabian authorities were trying diligently to increase non-oil revenues, Mr. Finaish went on. He recognized the difficulties involved in such an effort, as had been clearly demonstrated in the recent attempt to implement a number of revenue measures. However, the medium-term outlook suggested that unless the oil market improved substantially, the authorities would have to make difficult choices between deeper expenditure cuts and measures to raise domestic revenues. In that connection, he noted the staff's interesting calculations which had shown that a gradual increase in the ratio of domestic revenue to GDP from 9 percent to 15 percent over the next five years would reduce the domestic borrowing requirements by 40 percent during the same period.

Whether the actual fiscal deficit in 1988 turned out to be close to the budgeted amount or larger, as forecast by the staff, a significant amount of domestic borrowing would obviously be necessary, Mr. Finaish observed. Indeed, the authorities' intention was to offer bonds of varying maturities totalling SR130 billion for commercial banks and other institutions during 1988. In that connection, the staff analysis in Appendix I of SM/88/118 was quite interesting. Since that would be the first sale of government bonds in Saudi Arabia, and given the likelihood that fiscal deficits over the next few years would be partly financed through that mechanism, he welcomed the authorities' intention to manage the scheme pragmatically and to ensure that the budget was not financed indirectly by the Saudi Arabian Monetary Authority (SAMA). The burden on monetary management was likely to increase with the introduction of government bonds, and the authorities would have to be diligent in utilizing the instruments available to them, including Bankers' Security Deposit Accounts (BSDA) to control the growth and distribution of liquidity and to help achieve the balance of payments objectives. The authorities' initiative to establish the Banking Disputes Committee to facilitate the settlement of disputes between banks and debtors was also welcome. The progress

that had already been achieved since the establishment of that Committee had undoubtedly contributed to the improvement in the banking environment.

Turning to the external sector, the fiscal and exchange rate adjustments in the past few years had obviously been instrumental in reducing imports and thus mitigating the impact on the balance of payments of the sharp decline in exports, Mr. Finaish stated. Although the volume of imports was again projected to decline significantly in 1988, a further sizable loss of external reserves was expected. The staff's analysis of the medium-term outlook of the balance of payments showed that a containment of the reserve loss could be achieved either through further substantial cuts in the fiscal deficit or by absorbing foreign exchange holdings of banks and autonomous government institutions (AGIs) or through a significant increase in private capital inflows. In the immediate future it was clear that all three avenues needed to be utilized given the relatively large borrowing requirement and the sizeable holdings of foreign exchange assets by the private sector and AGIs. However, the focus of policy over the medium term should be more on reducing the fiscal deficit. Although the foreign assets of banks and AGIs were relatively large, they were obviously not unlimited and substantial absorption of such assets from banks might lead to a crowding out of credit to the private sector. Furthermore, while private capital inflows should be encouraged, such inflows were motivated by many factors, not all of which could be directly controlled by the authorities. He, therefore, welcomed the authorities' determination to strengthen fiscal adjustment in the period ahead.

As he had said earlier, exchange rate adjustment had played a useful role in the past few years, and the authorities intended to keep the exchange rate under constant review, Mr. Finaish reiterated. It was interesting, however, that despite the substantial depreciation of the riyal and the openness of the Saudi Arabian economy, domestic prices had declined significantly over the past few years. On page 9 of its report, the staff had indicated that the decline in prices which had been associated with the economic slowdown reflected mainly the substantial fall in the prices of services and nontradables and a narrowing of profit margins. However, it would have been useful for the staff to analyze the implications of those price developments more fully. For example, what was the implication for monetary policy given the apparent decline in the velocity of money associated with the declining price level? Also, had there been an impact on investment in the high real return on monetary assets? Had there been a shift in production toward tradables as a result of the large change in relative prices? He realized that it might be difficult to address such issues in detail during the current discussion, but any views or insights the staff might have on those questions would be welcome.

The substantial real effective depreciation of the riyal could be expected to strengthen the trade balance by encouraging export activity and import substitution, Mr. Finaish remarked. However, that was clearly not a sufficient condition, as exports also depended on the availability of outside markets. He, therefore, shared the authorities' concern about

the threat of protectionist pressures against petrochemical exports in particular, a concern which was shared by some countries in his constituency. It was hoped that the current negotiations with the European Community on trade liberalization would be concluded successfully. Indeed, it would be unfortunate if the efforts of Saudi Arabia and other oil producing countries to expand their productive base into areas which they had a natural comparative advantage were to be impeded by protectionist barriers abroad. Such a development would be detrimental not only to the exporting countries themselves, but to global resource allocation as well.

Saudi Arabia had continued to play a constructive role on the international level, both with respect to the oil market and in its development assistance program, Mr. Finaish said. The Saudi Arabian authorities had clearly aimed their oil policy at supporting a stable international oil market. He had noted in that regard the authorities' statement that Saudi Arabia would not resume its earlier role as a swing producer. Indeed, it was questionable whether even the Organization of Petroleum Exporting Countries (OPEC) group could play the role of a swing producer in order to support market stability. It was therefore important that the effort to avoid price disruptions be a collective one that included OPEC, as well as non-OPEC countries, as suggested in Mr. Nimatallah's statement.

The authorities' intention to reorganize the domestic oil industry with the objective of improving efficiency and enhancing profitability was noteworthy, Mr. Finaish remarked. That, together with the effort to expand downstream activities, should contribute to mitigating the effects of fluctuations in crude oil prices on export revenues. A more integrated oil industry should also be helpful in reducing market instability.

On that issue, the intention of the Saudi Arabians to acquire stocks in foreign companies was a new and interesting phenomenon which had not received enough interest or attention, Mr. Finaish commented. The point was that an increasing number of oil producers were trying to acquire equity participation in refineries and distribution networks abroad, which would have significant implications for the producers, consumers, and the industry as a whole.

There were different types of such activities, Mr. Finaish went on. The Kuwaitis had started that practice in 1983 when they had acquired full acquisition of two refineries and 2,000 gas stations in Europe from Gulf Corporation.

Another example was Venezuela, which, following the 50-50 formula, had acquired two refineries in the United States. Through those refineries Venezuela provided directly to its U.S. partners 400,000 barrels of oil a day. Also, Abu Dhabi and Libya had foreign stakes abroad.

Non-OPEC countries were also active in overseas operations, particularly Mexico and Norway, Mr. Finaish continued. It was likely that Nigeria would also be looking for the same type of investment. The oil

producing countries were clearly trying to secure marketing outlets abroad. And, in that connection, it should be remembered that OPEC agreements did not extend to the sale of petroleum products, which left those products free to be priced according to prevailing market conditions.

There was some resistance to that sort of activity from major oil consuming countries, Mr. Finaish said. For example, according to press reports, the United States was concerned about that trend. In addition, the U.K. authorities were examining Kuwait's 23 percent stake in British Petroleum, and they had consulted the Monopolies and Mergers Commission to determine whether the U.K. public interest could be jeopardized by such investment activity and to determine what action would be appropriate.

In the meantime, the Fund was advising developing countries to encourage foreign direct investment, Mr. Finaish noted. Although he had not studied the phenomena of oil producers' overseas investment in detail, it seemed that the benefits for oil consumers were greater than for producers. The consumers would not only benefit from the inflow of foreign capital, they would also have secure oil supplies. In light of the oil price increases of the 1970s, that was a significant advantage, particularly for a country like the United States. As in the case of Venezuela's investment abroad, the United States was assured supplies of foreign oil and thus a decreased rate of depletion of the United States' reserves of that strategic commodity.

In addition, as the oil producing countries' investment activity in the host country increased, so would its interest in the health of the host's economy, Mr. Finaish pointed out. Moreover, the oil producers that became active in overseas markets would gain from equity participation and they would strengthen their linkages with the multinational corporations they dealt with and with the Governments of oil consuming countries. Many refineries in oil consuming countries in Europe and the United States were not currently producing at maximum capacity, but they would do so if they had secure oil supplies. That increased activity would, of course, increase competition for petroleum products; thus, prices for those products would decline. Many advantages could be achieved by all the parties involved in such international investment activity.

With respect to external assistance, Saudi Arabia's record spoke for itself, Mr. Finaish stated. The fact that the ratio of foreign aid to current account receipts had increased to 9 percent at a time when foreign exchange earnings were declining rapidly reflected the authorities' strong commitment and the priority they attached to assisting other developing countries in development and adjustment efforts.

He commended the Saudi Arabian authorities on their prudent management of the economy and he was confident that they would continue to adapt successfully to the changing circumstances in the period ahead, Mr. Finaish concluded. He supported the proposed decision regarding the renewal of the borrowing arrangement with the SAMA in association with the

General Arrangements to Borrow. The authorities' willingness to begin the renewal of that arrangement was another indication of the priority they attached to the role of the Fund in the process of global adjustment.

Mrs. Filardo made the following statement:

Having two oil exporting countries in my constituency, I find it interesting to observe the uniqueness of Saudi Arabia, especially in light of its level of oil reserves; its production share within OPEC and within total world production; its economic potential in terms of natural resources; the staggering amount of international assets accumulated during the oil boom; the smaller size of its population; and the importance of the Government as the main owner of wealth. Furthermore, Saudi Arabia has the privilege of being a kingdom. With these special characteristics, it is evident that in the aftermath of the oil market crisis the authorities have had to face a serious challenge; namely, to adjust the economy to a completely new situation. As Mr. Nimatallah pointed out in his opening statement, oil revenues declined from \$100 billion in 1981 to \$20 billion in 1987. A reduction of 80 percent of receipts in a country mainly dependent on oil exports would seem difficult to accommodate if the Saudi Arabians did not have those exceptional peculiarities. Thus, the authorities have responded in a very sensible manner to the responsibilities imposed by its uniqueness in the international community, and they are to be commended.

In his opening statement, Mr. Nimatallah emphasized that the commitment of the authorities to adjustment is firm and unwavering, but a question remains as to the pace and quality of reform. To this end, Mr. Nimatallah said his authorities have chosen a gradual and qualitative pace of adjustment, and we agree with that approach, given Saudi Arabia's dependence on oil and the magnitude of the oil price shock.

However, in assessing the effectiveness of the adjustment, many factors have to be taken into consideration, such as the country's economic situation at the time of the price shocks, and its economic evolution; the policies that have been implemented; the accomplishments to date; the prospects for the economy in the medium term, given the actual situation of the oil market; the small basis of nontraditional exports; and the restrictions imposed on Arab products in international markets.

With respect to the economic situation of Saudi Arabia at the time of the first oil shock, real GDP was growing at an average annual rate of 6.2 percent during 1980-81; it then fell at an average rate of approximately 6.4 percent during the following four years; it grew 7.3 percent in 1986, and fell again 3.2 percent in 1987. The contraction responded to a sharp

reduction in government expenditure during the period as an answer to the staggering decline in oil revenues. By the same token, all balances--trade, current account, and global--that were showing tremendous surpluses in 1981-82, experienced a dramatic deterioration after the shock, which has persisted since that time, as reflected in the depletion of foreign assets held by the authorities.

It is clear that in the case of Saudi Arabia the magnitude of adjustment is significant. Nevertheless, in the process of adjustment, one of the most important issues is the impact of adjustment on employment; namely, how the population is going to be affected. In the case of Saudi Arabia, it would seem that given the limited national labor force, the contribution of expatriate labor to the domestic economy has been considerable as can be seen from Table 36, Appendix II of the background paper on recent economic developments, which shows figures for 1980-86. Although there are no data given for expatriate labor for 1982 and 1983, the share of the total labor force in 1986 was higher than 62 percent. The background paper also highlights that the recent economic contraction had led to a repatriation of some expatriate manpower and replacement of those workers by indigenous manpower. In this respect, it will be interesting to hear comments from the staff or Mr. Nimatallah on the Saudi Arabian authorities' experience in dealing with the problem of unemployment and social cost.

On assessing the selection of policies and the pace of adjustment, it should be considered that the Government is the owner of oil revenues, abundant resources, and wealth. Thus, such an assessment would depend on the selection of an appropriate balance between the speed of expenditure restraint and the drawdown of international reserves, together with the authorities' intention to diversify the economy in the future. Given the enormous room for maneuver available to the authorities, the efficiency of the steps chosen to reduce the fiscal deficit, substitute imports, and diversify exports would depend on the implications for the overall economy. For instance, whether or not the reduction of capital outlays is affecting the accomplishment of important projects, or whether import substitution and import diversification are being executed efficiently. In this regard, we note from Table 40 of SM/88/118 that all kinds of subsidies and incentives exist in the economy to promote nontraditional sectors. Although these direct subsidies have been decreasing in recent years, apparently there are other sectors that seem not to have been quantified in this table; for example, concessional loans, supported prices for agriculture, tariff protection, exemption from import duties for input, and tax holidays. Therefore, the question is whether the increase of nontraditional exports from \$0.9 billion in 1981 to

\$42.6 billion in 1987 and the sharp decline and substitution of imports have been based on a genuine comparative advantage supported by essential incentives.

In assessing the medium-term outlook, we have observed that the staff has made projections based on certain assumptions, such as a moderate increase of oil prices and the implementation of domestic measures to increase revenues. While we agree with the staff that given the uncertainties of the oil market, the projections are subject to a wide margin of error, it will be interesting to hear Mr. Nimatallah's comments on the expectations of his authorities regarding the medium-term outlook in view of the actual adverse situation of the oil market and the statement that the decrease in the deficit would be achieved through more expenditure restraint and less through revenue. Furthermore, he emphasizes: "It is not expected that the Government will impose much taxation."

In conclusion, I commend the authorities for their generosity with respect to foreign aid. We support the proposed decision in document EBS/88/109.

Mr. Yamazaki made the following statement:

Before addressing specific points, I should like to say a few words on the role of Saudi Arabia in managing the world oil situation. As the world's largest exporter of crude oil, Saudi Arabia has maintained a policy aimed at providing a long-term stable supply of oil even after it discontinued its role of swing producer in 1985. As the Japanese economy is dependent on imported oil, this chair welcomes this long-term approach in view of the limited supply of oil and the growing concern over the safety aspects of nuclear power. Nonetheless, the developments in the past several years have not been favorable for oil producing countries. In this connection, I appreciate the comments of the staff on the results of the very recent OPEC meeting. Since I am in broad agreement with the staff report, I will limit my comments to several current economic issues.

First and foremost, we agree with the staff that the Saudi Arabian authorities have made strenuous efforts in adjusting the economy to reduced oil export earnings. In particular, as Mr. Nimatallah rightly pointed out, they have so far maintained an inflation-free economy, despite the strong incentive to offset the deflationary impact of the oil price decline by expansionary monetary and fiscal policies. This is quite an achievement, particularly if we recall that, after the first oil crisis in the early 1970s, oil importing countries tried to offset the deflationary impact of the oil price increase by expansionary policies that brought about worldwide inflation.

Second, notwithstanding the aforementioned adjustment efforts, the weakness in the budgetary position last year should be a cause for concern. In my view, the economy of Saudi Arabia can accommodate a fairly large shock to the external sector, owing to its originally low absorptive nature. In other words, even after the reduction in oil prices, the relatively small population of the country provides the authorities with room for maneuver in reducing the budget deficit. The problem is the choice of specific measures to reduce the deficit. In this connection, the view of the authorities, as expressed in Mr. Nimatallah's opening statement differs somewhat from that of the staff in that the authorities place more emphasis on the expenditure side. I agree with Mr. Nimatallah that, due to the unique nature of Saudi Arabia's fiscal structure in which part of the oil revenue is channeled to the Government in lieu of tax revenues, a limit exists on increasing tax revenue, given the level of economic activity. On the other hand, however, it would be equally important for the authorities to foster the economic activities of the private non-oil sector in an attempt to decrease the economy's dependence on oil. To this end, a broadening of the domestic revenue base suggested by the staff merits due consideration. In sum, the authorities need to strike a delicate balance between the need for maintaining the distribution system of oil revenue established through long experience and the need to reorganize the economic structure to that of more industrialized economies.

Third, apart from the medium-term consideration of the budget, the authorities should tackle the immediate problem of financing the expected budget deficit for 1988. In view of the limited room for a further drawdown of the government deposits with SAMA, a certain amount would need to be financed through the sale of bonds to financial institutions. In this respect, I fully concur with the staff's conclusion that monetary policy should not be accommodated to monetize the budget deficit. This, in turn, implies that, to some extent, a crowding out of the private sector is inevitable. The authorities are, therefore, strongly encouraged to find a medium-term solution to the budget deficit as soon as possible, so that the dependence of the public sector borrowing does not give rise to a vicious circle of debt service and further borrowing.

Fourth, turning to the external situation, the flexible management of the exchange rate policy aimed primarily at the orderly depreciation of the riyal in real effective terms has so far contributed to the adjustment process. On the other hand, the BSDA system successfully prevented the large outflow of capital by offering relatively attractive investments. In view of the aforementioned need to forestall the monetization of the budget deficit, the interest rate on the BSDA should continue to be competitive.

I welcome the Saudi Arabian authorities' continued assistance of other developing countries despite the deteriorating external balance. In this connection, their strong support to international organizations, particularly the Fund and the World Bank, as endorsed by Mr. Nimatallah should be commended. I have no difficulty in going along with the proposed renewal of the borrowing arrangement between Saudi Arabia and the Fund in association with the General Arrangements to Borrow.

Mr. de Groote said that he commended the staff for its report, which was comprehensive and mercifully succinct, two features which previously had been regarded by colleagues as incompatible.

The main feature of Saudi Arabia's situation was that the authorities had successfully implemented adjustment policies with minimum social costs during a period when the main source of government revenues had been reduced by 80 percent, Mr. de Groote noted. Most striking was the persistence in forming the oil dependent economy into a more complex, diversified economy, which was less vulnerable to fluctuations in oil prices. The agricultural sector, though heavily subsidized, had made Saudi Arabia self-sufficient and even a net exporter of certain agricultural products, while the efficiency and cost competitiveness of Saudi Arabia's petrochemical and steel industries had been, so to speak, awarded international recognition in the form of import quotas and increased customs duties.

The time had come to promote the private sector's involvement in the production of exports in sectors where Saudi Arabia seemed to have a comparative advantage, Mr. de Groote commented. One of the prerequisites to enhancement and diversification of the industrial base, and appropriate exchange rate policy, had been vigorously implemented for several years and it could be expected that other ways of supporting nascent industries would be applied with the same vigilance. One of those, the support of domestic activity through fiscal stimulus, should be accompanied by changes in the asset composition of commercial banks and autonomous government institutions in the opposite direction. He hoped he was correct in assuming the ability of those financial intermediaries to convert part of their stock of foreign assets into riyals would eliminate the risk that the private sector could be crowded out during the process of revitalizing the domestic economy. More generally, Mr. Nimatallah had convincingly put forward the case that at the present stage of development a well-controlled and limited fiscal relaxation was called for to provide investment opportunities to private business in selected sectors and to help build the industrial base on which Saudi Arabia would rely in the future. It seemed to contest that view, given the fact that such a policy carried no immediate balance of payments risk. To use Mr. Yamazaki's words, but to the opposite effect, the fact that Saudi Arabia would have ample room for maneuver in reducing the deficit also implied that there was little danger in limited fiscal relaxation.

The recent measures aimed at enhancing government revenues was welcome, Mr. de Groote remarked. A question came to mind, however, with respect to the decision to suspend some of the new revenue measures. Although the subject was not explicitly discussed by Mr. Nimatallah or the staff, he supposed that those measures, mainly consisting of surcharges, had been suspended because they had a direct effect on income distribution. Whatever the reason, the suspension could not be linked to the need to support the private sector, since the suspended measures only affected household expenditures. In any event, the graduated pricing of electricity and water would better serve the goal of income redistribution and be more feasible socially than flat surcharges.

The evolution of the Saudi Arabian economy extended beyond the countries' boundaries in more than one respect, Mr. de Groote observed. Together with other countries in the Gulf Cooperation Council, Saudi Arabia was a major employer of workers from low-income countries as far away as Sri Lanka and the Philippines. The disruption to the balance of payments of several countries that would follow a curtailment of domestic activities in Saudi Arabia motivated by narrow budgetary considerations should not be disregarded. Given Saudi Arabia's exceptional wealth of natural resources and of potential export income, some increase in the effective rate of protection to stimulate domestic activity might even be justified because Saudi Arabia was uniquely situated to act as an engine for progress for other, more populated countries that were less generously endowed with resources.

His authorities appreciated the generosity shown by the Saudi Arabian authorities in granting official development assistance on concessional terms, and he commended the Saudi Arabian authorities for their exemplary cooperation with the Fund, which had found its clearest expression today in the decision to renew, for another term of five years, the borrowing arrangement with the Fund under the General Arrangements to Borrow, Mr. de Groote concluded. Mr. Nimatallah's personal contribution to that cooperation was well known, and his authorities were grateful for it.

Mrs. Ploix said that economic developments and prospects in Saudi Arabia remained highly susceptible to oil market movements. It was against that background that the authorities had been following a successful adjustment path since 1983. In the past year they had tried to take advantage of higher oil prices to bolster shrinking private sector activity. For 1988, less favorable oil market conditions had prompted the authorities to contemplate a further strengthening of the adjustment process. Major stabilization measures were being taken in the fiscal area, which should contribute to improving the external position.

The fiscal stance for 1988 seemed to be adequately tight, after the temporary relaxation experienced in 1987, Mrs. Ploix noted. In his opening statement, Mr. Nimatallah had made it clear that his authorities remained fully committed to a prudent policy stance, which the very instability of the oil market vindicated. Mr. Nimatallah seemed to support the view that under the current circumstances, the benefits of

past adjustment efforts should not be risked. To that end, new reflationary measures aimed at preserving a more satisfactory level of activity should be avoided in the foreseeable future. In rejecting the fine-tuning approach and reasserting the need for steady fiscal retrenchment, the authorities had clearly expressed concern about the continued deterioration of the countries' financial position.

The medium-term scenarios developed in the staff report showed that, given its sheer size, the fiscal deficit had to be tackled if some policy leeway was to be kept for the years ahead, Mrs. Ploix remarked. The continued depressed level of oil revenues was leading the authorities to seek a lasting and substantial reduction in the fiscal deficit, mainly through expenditure cuts. The authorities' determination was commendable, even if, as the staff had noted, the objective for the year looked rather ambitious.

In particular, it seemed that there had been delays in introducing some measures, and Mr. Nimatallah or the staff should comment on the likelihood of reaching the fiscal target for the year, Mrs. Ploix went on. In that connection, she wondered how far spending reduction measures could go without endangering the maintenance of the important infrastructure networks developed during the 1970s.

According to Mr. Nimatallah's opening statement, at that stage, the Saudi Arabian authorities did not contemplate any revenue measures, Mrs. Ploix continued. Even if their intention to reduce the size of Government appeared commendable, the growing difficulty to act on the expenditure side could perhaps induce them to show more flexibility on the issue of taxation. In particular, the very good price performance of the economy could facilitate the introduction of a value-added tax. Likewise, given the present low level of tax burden, the introduction of income or property taxes should not be ruled out altogether. Mr. Nimatallah should comment on those points.

A more pressing problem, for the time being, concerned the financing of the deficit, Mrs. Ploix commented. The substantial drawdown of government deposits with SAMA was forcing the authorities to issue bonds in the domestic financial market. However, private savings held domestically or abroad could be tapped through financial institutions, only if the financial sector could not refinance itself to the Central Bank through a rediscount facility. The fact that SAMA could not cover fiscal deficits was a safeguard, but the staff was right in stressing the crucial importance of avoiding any monetization of the deficit. Another condition which was essential to facilitating capital inflows involved the financial terms offered on government bonds. Perhaps Mr. Nimatallah, or the staff, could provide the Board with specifics on that aspect.

On the external side, the flexible exchange rate policy followed over the recent period remained appropriate, given the prevailing uncertainties, Mrs. Ploix noted. The efforts made by the authorities to develop better procedures for settling disputes with foreign contractors had to be

praised. Nonetheless, as the staff had stressed, caution seemed necessary to ensure that headway was not jeopardized by the cost-cutting measures taken to reduce project spending.

The remarkably high level of development assistance that Saudi Arabia had been able to maintain, in spite of a worsening external position, was noteworthy, Mrs. Ploix concluded. Likewise, the renewal of SAMA's associated lending under the General Arrangements to Borrow must be seen as additional evidence of the major role played by Saudi Arabia in international monetary cooperation.

Mr. Kabbaj made the following statement:

Saudi Arabia, like most other developing oil exporting countries continued to face tremendous adjustment problems brought about by the sharp fall in oil prices. Oil export receipts declined from a peak level of \$111 billion in 1981 to below \$20 billion presently. The nominal rate of GDP fell at an average rate of almost 14 percent for the past five years, and it registered a less than 2 percent increase in 1987. This is to be compared with an average annual rate of growth of about 32 percent during 1980-81. These figures are well known by the Board and there is no need to expand on them. The reason I mentioned them is to put into perspective the commendable achievements of the Saudi Arabian authorities in tackling such a massive downturn in economic activity.

It is true that the task of the authorities has been made more manageable by a few features--already mentioned by other speakers--which include the completion of the bulk of an impressive infrastructure before the crisis and the constitution of sizable reserves during the period when oil prices were at higher levels.

It is also to be recalled that the international financial community had in the recent past encouraged Saudi Arabia to increase sharply its budgetary expenditure for the sake of recycling. The authorities have responded to these calls speedily and with relative efficiency and success. This background should be kept in mind in evaluating the present policies of Saudi Arabia and in formulating our recommendations which are generally well received by the authorities.

There are no major differences between the staff and the authorities, and I am in broad agreement with the staff appraisal.

As evidenced by the staff report and Mr. Nimatallah's opening statement, the commitment of the authorities to

adjustment is firm and unwavering. The results so far are impressive and the question now concerns the pace and quality of reform measures.

The trend, despite the small setback in 1987 is clearly in the right direction. The focus put on the continuation of budgetary adjustment complemented by a flexible exchange rate policy and a restrained monetary policy has proven to be the right mix to attain a viable external position.

The efforts aimed at diversifying the non-oil sector should be pursued and the private sector should continue to be encouraged to take charge of a larger share of the economy. However, I do not share the too optimistic view of the staff in this regard. Like in other developing countries, the private sector in Saudi Arabia, for historical reasons, has generally centered its interventions around public sector activities, and I agree with Mr. Nimatallah that it will take more time for market forces to play a greater role in the allocation of resources.

I agree with the staff with respect to the budgetary deficit. The authorities have no quarrel that the size of the budgetary deficit should be further reduced, but this should be done in an orderly fashion so as to smooth out the transition to a more privatized economy. I agree with the staff that the fiscal policy stance should be supported by the continuation of prudent monetary policy so that autonomous government institutions (AGIs) or commercial bank financing of the budget deficit is not accommodated.

On the external front, I have few comments to add, except to reiterate my calls for a more understanding position by Saudi Arabia's partners on trade issues particularly regarding petrochemicals, and I fully agree with the authorities' position on the protection of some of their domestic activities in view of the stance taken by their partners and also of their budgetary situation. Nevertheless, Saudi Arabia continues to be a very open economy, and it is hoped that its partners will take a more open position to keep it that way.

I commend the authorities for the assistance they provide to developing countries, which--despite its slightly declining trend, owing to the budgetary and balance of payments conditions--remains at a high level representing, in terms of percentage of GDP, more than ten times the official development assistance provided on average by industrial countries.

In addition, the authorities' cooperation with the Fund is commendable, the latest manifestation of this cooperation being

the renewal of the borrowing arrangement in association with the General Arrangements to Borrow. In this respect I support the proposed decision contained in EBS/88/109.

Mr. Enoch made the following statement:

First, I commend the staff for an informative Article IV consultation report, which gives a frank account of the effects on the economy of the deterioration in the external position since 1981. I was particularly pleased to see--for the first time--budget projections for five years. This is an extremely helpful development, and presents a candid picture of the effects of the medium-term adjustment the authorities are undertaking. I can endorse the staff appraisal, which highlights the commendable policy adjustments which have been achieved while emphasizing that the continuation of a strong fiscal stance is central to the strengthening of the Saudi Arabian economy in the medium term.

The Saudi Arabian authorities' realistic approach to tackling budgetary problems is particularly appropriate, because of the difficulties of planning on the basis of oil price volatilities, given the effects of oil price changes on external and domestic revenues. Significant progress has been made on controlling expenditure, with an emphasis on reducing the size of the government sector and focusing on measures to improve efficiency. However, notwithstanding the achievements to date, there was an overrun on the 1987 budget, and there remains a significant budget deficit in 1988; as the staff noted, the deficit could be as much as SRls 20 billion higher than the budget forecast. This suggests a need for vigilance in the pursuit of the stated policy of expenditure control, supported by further measures to increase non-oil revenue--and in particular, I urge the authorities to give further consideration to a broadening of the income tax base and the introduction of a consumption tax.

I strongly support the authorities' objective of expanding the private sector's role in the economy. However, the private sector has suffered from the overall contraction in oil revenues, and the budgetary efforts in the last year to stimulate the private sector seem to have had only very limited success. A more market-oriented approach to assisting the private sector, as the authorities have indicated they intend to adopt, seems appropriate, within the constraints imposed by the difficult fiscal position. As Mr. Nimatallah has on several occasions reminded this Board, the quality of adjustment, as well as its quantity, is important. This would imply a more selective use of subsidies combined with further incentives for capital repatriation.

I welcome the steps being taken to finance the deficit from domestic sources, including drawings from SAMA and sales from bonds to the commercial banks. Recent press reports regarding the sale of these bonds and the information given to us at the beginning of the meeting by Mr. Nimatallah are very interesting. The press reports seem to suggest that the pricing on these bonds is perhaps a little more aggressive than some prospective purchasers might have liked. Given the importance of making the first issues a success, it would seem to be unfortunate if any lack of enthusiasm for the bonds because of the pricing were to be confused with lack of enthusiasm for the bond issue itself. I agree with the staff that it would be preferable to limit the rediscounting facilities available on the bonds with SAMA both to strengthen the internal capital market and promote the repatriation of assets from abroad. The appendix to the background paper on recent economic developments gives a very useful analysis of how the impact of the bond sales will differ depending on the sector that purchases them. It has been reported that a first tranche of the bonds has already been allocated to the General Organization for Social Insurance and to the Pension Fund. To the extent that these institutions are the purchasers of the bonds, this allocation will not serve the purpose of reducing the authorities' reliance on outside financing. That objective apparently could be achieved most fully by sales to the commercial banks and the private sector, and I presume that the further tranches are likely to be directed toward those sectors. I would be interested in any comments either Mr. Nimatallah or the staff might have on these matters. In any case, as the staff report emphasizes and other Directors have said, these bond sales, while welcome, are not a substitute, over the medium term, for further measures to reduce the fiscal deficit.

The authorities have achieved a great deal in controlling domestic liquidity. I welcome the continued success of the bankers' security deposit accounts as a means of controlling domestic liquidity--and discouraging the further accumulation of foreign assets. Further measures to promote confidence in the domestic financial system would be helpful and would complement the success of the Banking Disputes Committee and SAMA's achievements in strengthening the domestic banking sector. This is very necessary to ensure that the emphasis on domestic borrowing to finance the deficit does not crowd out private sector investment. In this connection, I wonder whether the recent establishment of the first Islamic bank, the Al-Rajhi Banking and Investment Corporation--which will rank third largest in terms of assets--is likely to provide further competition for the existing banks.

On the external accounts, the improvement in export earnings during 1987 was encouraging, but the economy remains

vulnerable given the projection of only a slow recovery in oil revenues over the next few years. Further expansion of the non-oil sector is therefore prudent, and the flexible management of the exchange rate continues to play a very helpful role in controlling the external imbalance and fostering non-oil growth. The maintenance of an open economy is central to ensuring growth in the medium term, and I welcome the first-stage trade agreement between the European Community and the Gulf Cooperation Council. In addition, the authorities' interest in full accession to full participation in the GATT is welcome.

In conclusion, I welcome the adjustment path which has been set and the significant achievements to date. I hope that the authorities will build on this progress and continue to strengthen the underlying fiscal position.

I welcome the authorities' agreement to an extension of the renewal of the borrowing agreement between Saudi Arabia and the Fund in association with the General Arrangements to Borrow. This is an important contribution to strengthening the Fund's liquidity position, and I fully support the proposed decision in EBS/88/109.

Mr. Lim said that he endorsed the general thrust of the staff appraisal, and agreed that the adjustment effort that had been undertaken by the Saudi Arabian authorities were commendable. His chair had, on several previous occasions, characterized those efforts as both farsighted and prudent, in that resources had been built up and institutions had been created in good times against the certainty that times would not remain good forever.

After remarkable growth fueled by oil revenues in the late 1970s, real GDP started to decline at rates that would have had disastrous consequences, were it not for the prudent resource management that had been implemented earlier, Mr. Lim remarked. With the rebound in oil prices in 1986 the economy had again recovered only to recede again in 1987. That indicated that the task of adjustment toward a more diversified and stronger based economy was far from complete.

Under the current circumstances and given the previous and prospective deterioration of the balance of payments position, certain developments which previously had not been matters of imminent concern should be given more serious consideration, Mr. Lim suggested. In that connection, it was particularly encouraging to note from Mr. Nimatallah's opening statement that the authorities were committed to the eventual elimination of the fiscal deficit, and that the total government expenditure budgeted for 1988 would be just about one half that of 1982-83.

However, the relaxation of the fiscal stance in 1987 might prove to be a backward step from those intentions, Mr. Lim continued. While it was

certainly understandable that the authorities would want a resumption of growth in the face of the adjustment effort, reliance on fiscal stimulation might not be a sustainable strategy. In that respect, he wondered whether there was scope for implementing policies that would encourage private capital inflows and whether under the present circumstances that would be a better approach to stimulating the economy.

The authorities should be encouraged to recover lost ground as a result of delays in earlier-planned expenditure cutting measures and to consider measures that would raise the revenue effort, Mr. Lim said. As Mr. Nimatallah and the staff had noted, substantial cuts in fiscal expenditures had already been effected over the previous five years, except in 1987. The data provided in the staff report showed that the non-oil sector had been very sensitive to those cuts, which indicated that in the medium term, expenditure cuts alone may no longer be the most efficient means to achieve the stabilization objectives of the authorities. In addition, he fully agreed with the staff that the need to finance a large deficit would result in a debt service burden that could constrain the effectiveness of fiscal policy in the future. Therefore, the authorities should consider measures that would increase fiscal revenues.

On another point, the Saudi Arabian authorities' effort to diversify its economic base would absolutely benefit from the removal of protectionist barriers imposed by some countries against Saudi Arabian exports, Mr. Lim stated. Page 54 of SM/88/118 had provided examples of restrictions imposed on Saudi Arabian exports, such as urea exports to EC countries. He agreed with the staff that a relaxation of those restrictions would be beneficial not only to Saudi Arabia, but also to the global economy as a whole.

He supported the proposed decision on renewal of the borrowing arrangement between Saudi Arabia and the Fund, Mr. Lim continued. He agreed that the General Arrangements to Borrow had served to strengthen the Fund's capacity to respond to potential financial difficulties. However, the Fund should rely principally on quota-based resources.

Finally, as in previous years, his constituency commended Saudi Arabia for its extraordinarily generous official development assistance efforts and for its continuing strong support of multilateral institutions.

Mr. Templeman made the following statement:

During the 1987 Article IV consultation with Saudi Arabia (EBM/87/99, 7/8/87), we commended the authorities for the progress that had been made in the adjustment of the economy to the financial impact on the budget and balance of payments of the weakness in the world price of oil, as well as for their achievements in diversifying the economy toward less dependency on the oil sector. These two challenges still confront the authorities and fairly good performance in both areas has

continued. Still, the margin for maneuver has narrowed, as accumulated financial surpluses have been greatly depleted and the medium-term outlook for both the budget and the balance of payments raises some questions about the scope and pace of adjustment, as seems to be recognized by the authorities. In that connection, like Mr. Enoch, we welcome the staff's preparation for the first time of medium-term projections for the budget and balance of payments. We found them to be very helpful in assessing the economic outlook for Saudi Arabia.

Over the longer run the more important challenge is the need to encourage balanced development of the non-oil sector as a source of future growth and prosperity. National income data suggest that the contraction of the private non-oil sector, in large part, owing to the sharp slowdown on the expansion of public sector activity, may have run its course. It seems clear that the main task ahead for the Government is to provide a favorable overall climate for private investment, both domestic and foreign, without depending on protective devices or subsidization. Current uses of tariff protection, input and production subsidies, preferential government procurement, and concessional credit do not seem to constitute a major departure from the authorities' basic emphasis on open markets and efficient resource allocation. In the agricultural sector, we particularly commend the decision to reduce barley import subsidies. However, there appears to be a need for further critical examination of the fiscal and natural resource implications of the apparent shift from a food security to food self-sufficiency objective. In sum, there remains a continuing need to resist the temptation to resort to restrictive and protective policies. In that connection, we encourage the authorities to take a positive decision on the question of full membership in the GATT.

As to fiscal developments in 1987, the staff suggestion that revenue shortfalls and expenditure overruns in 1988 could result in a much higher deficit than the 14 percent of GDP contained in the budget and medium-term fiscal projections suggests the need for a faster pace of fiscal adjustment and the desirability of reforming the tax system to generate additional non-oil revenue. The authorities are rightly concerned about continued annual fiscal deficits in the range of 15-20 percent of GDP through 1992, and attention needs to be given to reducing the deficit. In the meantime, it will be increasingly difficult to finance deficits through the drawdown of government deposits with SAMA. Therefore, we commend the decision to initiate a substantial development bond program to borrow from the private sector, as well as the offering of SAMA bonds to the Government's special funds. The sharp cut in subsidies planned for 1988, as shown in Table 40 of SM/88/118 is noteworthy as are

the staff suggestions for creating a personal income tax applicable both to nationals and foreigners, a broad based consumption tax, and a property tax. The staff report notes that an increase in the ratio of domestic revenue to GDP from a very low level of 9 percent in 1988 to a moderate level of 15 percent in 1992 would reduce the borrowing requirement by about 40 percent. It would apparently reduce the average deficit ratio for 1988-92 by one third, from about 17 1/2 percent to 12 1/4 percent of GDP. However, even this reduced ratio is very high by international standards. Therefore, the authorities should persevere in restraining expenditures, especially subsidies, and begin soon to consider fundamental tax reforms in the context of a more diversified economy.

The intended reduction in the role of the Government in the economy and economic diversification call for the development of private financial markets that are attuned to the needs of a growing and more complex private sector. A start has been made in the form of such innovations as the Bankers' Security Deposit Accounts and the success achieved in improving bank/debtor relations, as well as with the new bond issues. In addition, the further attempts to develop a stock market, although still at an early state, are of interest. While some caution is required, there is some urgency in building institutional structures for intermediating private financial resources on a larger and more sophisticated scale.

Saudi Arabia's ability to absorb large current account and overall balance of payments deficits through reserve drawdowns has been considerably reduced by cumulative current account deficits of \$54 billion in 1983-87. The sharp fall in the real effective exchange rate of the riyal since 1985 should help in fostering non-oil exports and in containing import demand. However, the staff's medium-term projections raise questions about the authorities' ability to finance external deficits on the scale projected, if a sufficient cushion of SAMA foreign assets is to be preserved and private capital inflows of an unprecedented size do not materialize. Of course, there are considerable uncertainties surrounding any such medium-term projections, but the numbers do provide an additional reason to move promptly to reduce public dissavings by deficit reduction, so Saudi Arabia would become less dependent on foreign savings.

The Saudi Arabian authorities have continued to demonstrate a prudent and generally effective approach in adjusting to a lower world price for oil and in fostering diversification of the economy. However, as time passes and the cushion of financial surpluses declines, there is growing evidence that the scope and pace of progress can be improved. We urge the authorities to consider carefully ways to bring this about.

Finally, we are happy to support the decision on the renewal of the borrowing arrangement between Saudi Arabia and the Fund in association with the General Arrangements to Borrow.

Mr. Sengupta made the following statement:

Saudi Arabia has in recent years followed a highly commendable path of adjustment to counter the effects of the sharp decline in oil export earnings. It has focused on fiscal retrenchment and monetary restraint. However, in view of the predominance of oil on the economy, the need to promote activities in the non-oil sector has become urgent.

The 1987 fiscal stance reflected the need to promote the non-oil sector. Government expenditures were increased so that the non-oil sector would get the requisite stimulus. As a result, the growth rate in the non-oil government sector was substantial, giving rise to a positive overall growth rate for the first time in four years, as pointed out by Mr. Nimatallah. The extent of contraction in the non-oil private sector itself was much less than in previous years. However, it is not clear whether the positive effects of the 1987 fiscal relaxation have been completely captured, and there may still be some lags in public expenditure impact, so that the growth stimulus may continue.

The 1988 budget appears to be reverting to the pre-1987 stance of expenditure cutting. It is not clear what will be the impact of that on private sector activity, which is expected to be increasingly responsive to public sector spending. It is possible however, with the recovery of oil prices in 1987, that the overall economic situation would improve, with the non-oil sector performing better. But some further policy initiatives may be needed to promote private sector non-oil activities, if there is no acceleration in public sector spending.

These questions gain importance particularly in light of the fact that economic activity in Saudi Arabia is likely to be somewhat subdued over the next four to five years. The staff's assessment of the medium-term outlook seems to indicate that on an average annualized basis, real non-oil GDP growth will probably decline. Given the uncertainty of oil market conditions, the generation of growth conditions in the non-oil sector on a sustained basis will be critical for the economy to capture the buoyancy that it had in the early 1980s. In this respect, a fiscal strategy may have to be devised in terms other than expenditure cutting.

The fiscal deficit could be financed by market borrowing, and not only borrowing from banks, since in the existing situation of dormant private sector activity, there would hardly be any crowding out. This is not to be interpreted as advocacy for creating larger fiscal deficits, meaning that revenue raising measures are not envisaged. In fact, there is merit in the staff's suggestions, which we support, regarding the introduction of new tax measures--such as personal income taxes, a general consumption tax, and a property tax--and the improvement in the efficiency of government expenditures through rationalization of incentives, and alteration of investment policies.

The fiscal strategy could be supplemented by a credit policy that helps the private sector to have increased access to institutional sources of financing its fixed as well as working capital purposes.

On the external front, the authorities should be commended for pursuing a flexible exchange rate policy and for continuing to maintain an excellent record of foreign aid disbursements. In this connection, we congratulate the authorities for agreeing to renew the arrangement associated with the General Arrangements to Borrow for a further five years. We are happy to note from Mr. Nimatallah's statement the authorities' continuing support to needy countries through development assistance. There is no doubt that Saudi Arabia's record on foreign aid--as Mr. Nimatallah mentioned--is commendable, and all countries have benefited from it. It is because of this commendable record that we are worried about staff forecast that foreign aid is expected to fall very sharply in nominal terms in the next few years. It is hoped that this forecast will not materialize, and Saudi Arabia will continue to play its important role in world development.

Mr. Ovi said that the authorities had, indeed, shown commendable flexibility in adjusting the economy to the drastic fall in oil revenue. Nevertheless, the present economic development and the problems which could be foreseen for the medium term, called for a continued firm policy stance. Therefore, it was heartening to note the commitment of the authorities to persevere in their efforts to gradually restore the external balance. As the staff had pointed out, the results of developments in the short run might be worse than had been predicted by the authorities, and the present level of the fiscal deficit would not be sustainable in the medium term. Consequently, he agreed with the staff that the authorities should continue their current adjustment policies while, at the same time, alerting them to the attendant risks if further measures were not to be sufficiently comprehensive.

With reserves already down to a level which gave rise to concern, there seemed to be no alternative to fiscal restraint to reduce the

deficit, Mr. Ovi observed. Particularly as the fiscal stance the previous year seemed to have been more lax than appropriate, it was important not only to show restraint on the expenditure side, but also--as the staff had advocated--to find ways to strengthen the revenue side of the budget. However, Mr. Nimatallah's opening statement had left the impression that the authorities did not fully agree with the staff's view on how that should be done. Also, there had recently been some news in the press about the possible introduction of an income tax for foreign workers. Mr. Nimatallah or the staff should comment on that special tax and, in particular on whether it was part of a more far-reaching plan to broaden the tax base. In any case, the raising of more non-oil revenues must also include more realistic pricing policies for public services.

The authorities' concern that practicing too much fiscal and demand restraint would jeopardize the goal of revitalizing the private sector was understandable, Mr. Ovi commented. However, that danger should not be overemphasized, since radical decreases, for instance in subsidies, would be needed to bring about the necessary strengthening of the non-oil sector.

As the staff had pointed out, a flexible exchange rate policy would have to be pursued to support the restrictive budget policy. However, trade policy was expected to continue to protect the domestic industry in different ways. That had contributed to a misallocation of resources within Saudi Arabia. On the other hand, the staff had rightly pointed out that more liberal access abroad for Saudi Arabian products would also benefit the importing countries.

Like other speakers, he commended Saudi Arabia for its generous official development assistance, Mr. Ovi concluded. The outstanding record was all the more impressive because it had been largely maintained during periods of adverse economic developments, and that the authorities firmly intended to continue that policy was commendable. He welcomed the decision on the renewal of the borrowing arrangement between Saudi Arabia and the Fund in association with the General Arrangements to Borrow.

Mr. Grosche said that it was commendable, as previous speakers had already observed, that Saudi Arabia had continued to adjust in a smooth, orderly, and timely manner. It was true that that adjustment had been facilitated by the availability of large official foreign assets, which had been drawn down in a prudent fashion. However, the existence of those assets alone demonstrated the prudence and medium-term orientation and that the Saudi Arabian authorities had displayed in the past, and which they would surely display in the future.

Despite the commendable progress that had been made over the past six years, major challenges remained, Mr. Grosche observed. The large fiscal deficit represented the most important of those challenges, and the authorities' intention to seek a substantial reduction in 1988/89 was

welcome. However, given that certain proposed revenue measures had been suspended, it was not clear whether the projected slight increase in revenues would actually materialize.

With respect to the medium-term fiscal projection, previous speakers had already pointed out the differences between the authorities and the staff on how best to reduce the deficit to a more sustainable level, Mr. Grosche noted. While the authorities had appeared to concentrate mainly on further reductions in government spending, the staff had proposed the introduction of new tax measures aimed at enhancing the buoyancy of the domestic tax system. He appreciated Mr. Nimatallah's argument that, at least for the time being, Saudi Arabian citizens preferred reduced public service over higher taxes. Also, a higher tax burden might reduce incentives for an expansion of the private sector. However, in the absence of a significant increase in revenue, annual budget deficits would likely remain very high and require substantial government borrowing. Therefore--and also because the domestic revenue to GNP ratio was very low in Saudi Arabia--he saw merit in the staff's recommendation to introduce new tax measures and to begin establishing the required institutional structures.

Still on fiscal policy, he had noted with interest Saudi Arabia's first major commercial borrowing in 25 years, Mr. Grosche continued. Such borrowing was an adequate response to the present fiscal constraints. Like the staff, he welcomed the authorities' determination to ensure that the budget deficit was not being financed by SAMA. As to the yield of those new bonds, recent press articles had reported that some bankers had received the impression that the terms of the first issue of bonds had been quite complicated, owing to Islamic bans on the payment of interest, and that it had been difficult to assess whether the bonds would have an attractive yield and, therefore, whether they would be a worthwhile investment. However, as Mr. Nimatallah had explained, the first issue had gone smoothly despite those features.

As to the medium-term prospects for the economy and development policies, he firmly agreed with the general thrust of the staff appraisal on expanding the role of the private sector, Mr. Grosche continued. Mr. Nimatallah's timely opening statement had made valid points on that subject. Indeed, in the long run, the dependence of domestic activity on fluctuations in the oil market could only be overcome by the development of a broad based and active domestic sector. To be sure, Saudi Arabia had or would eventually have a comparative advantage in the number of activities. Nevertheless, it appeared that the viability of certain sectors was still overly dependent on continued government support, be it through tariff protection, input in production subsidies, government procurement policies, or through the provision of interest-free, long-term loans. Thus, as the staff had stated, "the economy would greatly benefit from greater exposure to international competition," a prescription which held true not only for Saudi Arabia, but also for other mature industrial

economies. The continuation of a flexible exchange rate policy would have a positive impact on the diversification efforts undertaken, as should the efforts to enhance Saudi Arabia's domestic human resources.

Like other speakers, he commended the Saudi Arabian authorities for the generous level of assistance they had continued to provide to developing countries, despite losses in foreign exchange earnings, Mr. Grosche concluded. The authorities should certainly be commended for the constructive role they had continued to play in supporting the international adjustment process, above all through their support of the Fund. In that connection, he welcomed the Saudi Arabian authorities' willingness to renew the 1983 borrowing agreement with the Fund in association with the General Arrangements to Borrow, and he supported the proposed decision in EBS/88/109.

Mr. Zecchini made the following statement:

Since the early 1980s, Saudi Arabia has embarked on a substantial effort to adjust its economy toward a more durable growth pace. The thrust of this strategy, which has yielded significant results so far, was somewhat relaxed in 1987, as clearly described in the staff report. At this stage overall economic conditions and oil market prospects do not warrant a delay in the adjustment process, particularly in view of the size of the remaining domestic and external imbalances and the medium-term projections. Therefore, the authorities have to continue to pursue their twin objectives of reducing the fiscal deficit and supporting the development of the non-oil productive sector and private economic initiatives. In this respect, we are reassured by Mr. Nimatallah's statement that the authorities' commitment to adjustment is firm and unwavering.

Some disagreement, however, seems to remain between the authorities and the staff on the most appropriate tools to use to simultaneously achieve these two objectives. I will comment on some of these differences in assessment, and in particular, on fiscal and trade policies.

Containment of the fiscal deficit remains the key element in the adjustment strategy in order to reduce domestic absorption, to limit external imbalances, and to allow the crowding-in of the private sector.

To this end, the fiscal deficit projected for 1988 is broadly appropriate, although the likely outcome seems higher than the original budget target. Taking a long-term perspective, there is some ground for the staff's view that recourse to budget financing, even if provided by commercial banks, should be viewed only as a temporary solution. In fact, the accumulation of public debt over a number of years will raise future public expenditures for debt servicing, which in turn can be

financed either through additional oil revenues, new taxation, or additional debt issuing. If the authorities expect a rebound in oil revenues in the coming years to offset the cost of newly issued debt, then they are justified in using debt as a means of smoothing out fluctuations in oil revenues. But, if it is not likely that prospective trends in oil revenues are sufficient to cover a string of public deficits in the near future, then new taxes or accelerated debt expansion are the only remaining alternatives. If caution has to be used in using new debt in order to service maturing debt, additional taxation will ultimately be unavoidable to cover rising or continuing public deficits.

Some further reduction of the fiscal deficit in the coming years is therefore advisable, and should be brought about by cutting expenditures while making them more cost effective and by strengthening the revenue side of the budget. A broadening of the present small domestic revenue base is also warranted to reduce the dependence of the fiscal stance on volatile oil revenues, to increase the degrees of freedom of the authorities, and to widen the set of instruments available for the conduct of fiscal policies.

Moreover, the emphasis appropriately placed by the authorities on the quality of adjustment also justifies the need for a fiscal framework more adequate to achieve the ambitious objective of structural improvement of the economy. The strengthening of the revenue base will also improve the income redistribution function of fiscal policy, as well as its stabilization function. As a result of these considerations, the authorities should consider the implementation, within a medium-term framework, of the reforms pertaining to taxation of income, consumption, and property. At the same time, the set of fiscal measures suspended in early 1988 should be reconsidered for a timely introduction in a more balanced fashion.

Efforts should continue to be applied in order to modify the composition of expenditures so as to expand the share of social and economic infrastructures and foster private economic initiatives. The reduction in the share of defense and security expenditures envisaged in the 1988 budget should be commended, while the authorities should be encouraged to step up expenditures pertaining to manpower and social development as well as to infrastructures. Improvements in the quality of the present adjustment strategy could derive from reassessment of the current subsidy outlays and from a policy of administered prices and utility rates which is in line with fiscal retrenchment.

Pending the reduction of the fiscal deficit, the key objective of financial policies will remain to be providing adequate financing of the existing deficit on the best possible terms,

under conditions of price stability. To this end, the two-pronged approach based on structural improvements in the domestic capital market and cautious monetary policy seems appropriate. In particular, more efforts should be made to develop new financial instruments for government financing and a well-articulated capital market with a broader participation of commercial banks and individual investors.

On trade policy, in the past, the authorities were commended for their long-standing exchange and trade system, which was broadly free of restrictions. However, in 1987 and in the early part of 1988, protectionist measures were markedly increased. "Ad valorem" import duties have been raised, and the list of import items subject to duties has been enlarged. Moreover, these measures have been accompanied by a tightening of government procurement and contracting practices to support domestic producers. While some support to some infant industries might be justified, it should not be introduced at the expense of efficiency in the allocation of domestic resources and by affecting trade expansion in goods and services. I am sure that Mr. Nimatallah, who has often highlighted the benefits of free trade, will convey to his authorities our concern for these protectionist trends which are contrary to the established liberal tradition of Saudi Arabia.

We note the large efforts undertaken by the authorities to develop the agricultural sector, which appears to be a good objective in the context of the plan for the diversification of the country's productive base. In the same context, equal importance should be given to the diversification of other sectors more in line with Saudi Arabia's comparative advantages, like the manufacturing and chemical sectors. In this respect, it should be recalled that the successful development of the agricultural sector has, in fact, benefited from several indirect subsidies on primary inputs, such as electricity and water, and from guaranteed producer prices that are substantially higher than import prices. This approach to diversification, apart from the high costs for the public budget and the consumers, raises some questions about the long-term viability and the efficiency of investments in the agricultural sector.

We strongly endorse the renewal of the borrowing arrangement between Saudi Arabia and the Fund in association with the General Arrangements to Borrow.

Mr. Posthumus said that most of the energy exporting countries--both industrial and developing--that had experienced a large increase in export proceeds from petroleum or natural gas in the 1970s followed by a substantial decrease in those proceeds in the 1980s have maneuvered themselves into unsustainable economic, fiscal, monetary, or debt situations.

Saudi Arabia was the only major energy exporter that had managed to keep developments largely under control. He could support the staff appraisal.

The fiscal deficit for 1988, which had been planned to be substantially smaller than the deficit for 1987 would apparently be much larger than intended--SRls 56 billion, instead of SRls 36 billion, Mr. Posthumus noted. In its report, the staff had noted that that result would still be better than the 1987 figure of SRls 68 billion, which was a very diplomatic way of commenting on a much larger deficit than planned. However, he assumed that there were good reasons for the original figures, and those reasons should be clearly brought out.

He agreed with the staff's advice that tax measures were required to help reduce the size of the budget deficit, Mr. Posthumus commented. He also agreed with Mr. Nimatallah that the delicate balance between reducing the fiscal deficit and revitalizing the private sector should be kept in mind. However, a certain amount of taxation together with well-directed government expenditures could have a net positive effect in the private sector as well. The negative effects of taxes should not be considered in isolation, but only in conjunction with the effects of government expenditure--which could be positive for the economy.

He wondered whether the staff advised a continued depreciation of the riyal in real effective terms, Mr. Posthumus asked. If so, he wondered what that advice had been based on. A still large fiscal deficit remained, which meant a macroeconomic imbalance existed, which should be reflected in the balance of payments. However, that did not necessarily indicate a lack of competitiveness. The real effective exchange rate had substantially depreciated over the past two to three years, and that alone had already improved competitiveness, and it might be sufficient seen in the medium term. It should be noted that the most recent data in International Financial Statistics for 1987 were so far limited, Mr. Posthumus remarked, and the explanation given for that in the staff report was not particularly clear.

While he urged the authorities to take stronger measures to bring the budget deficit to much lower levels, he also commended them for the prudent adjustment measures taken so far, Mr. Posthumus concluded. He wholeheartedly supported the proposal to renew the borrowing agreement between the Fund and Saudi Arabia.

Mr. Abdallah made the following statement:

Let me begin by commending the staff for its relatively short, lucid, and well-balanced report on the Saudi economy. Secondly, let me commend Mr. Nimatallah for his informative and eloquent exposition of the attitudes and preoccupations of the authorities.

It is clear that the adjustment process in Saudi Arabia is continuing in a steady and resolute fashion. There is no basic

disagreement between the staff and the authorities on the basic objectives, and the divergence that has occurred only concerns the pace and quality of adjustment. In 1987 the authorities were slightly more expansionary than the staff felt was justified, but that is no reason for serious concern, because the year's fiscal stance was not meant to be permanent. It should not be forgotten that structural adjustment takes time and occasional deviations may be tolerable where definite progress is clearly being made. Mr. Nimatallah pointed out that during the past year, there were no inflationary pressures in the economy. The low-income groups were protected from any hardship arising from the adjustment, some modest growth was attained, and the country continues to maintain an open trading and payments system.

Special note may be taken of two aspects of the economy which help to put the adjustment process in perspective. First, there is the fact that, despite its persistent efforts to promote diversification, Saudi Arabia is still largely an oil-based economy, which makes it vulnerable to the vagaries of the international oil market. Second, notwithstanding the growing importance of the private sector, the public sector remains the prime mover of the economy. This results in a larger role for fiscal policy encompassing not only short-term stabilization but also its impact on the longer-term process of economic growth. In such a situation, shock treatment through a rapid withdrawal of government participation in the economy could itself become destabilizing and compromise the basis for future economic growth.

It is also worth recognizing, as Mr. Nimatallah said in his opening statement, that the Saudi Arabian economy had been transformed into a complex and increasingly sophisticated one. In fact, the physical changes that have been made to the urban and rural landscape have been sufficiently massive and widespread as to be almost staggering. It is a great tribute to the leadership and traditions of Saudi Arabian society that it has held together during the transformation, that it has maintained its social norms and values, and that it has not lost its zest for life or sense of humor.

Therefore, it is necessary when discussing the performance of an economy not to lose sight of the society which stands behind the statistics and the values which make up that society. Mr. Nimatallah, in a fairly humble way, drew attention to one such value when he said that, within a given level of economic activity, it is not expected that the Government will impose much taxation.

The work program presented to the Board on May 13, 1988 (EBM/88/75 and EBM/88/76) indicated that the staff would be

undertaking some studies on Islamic fiscal policies. That study assumes special significance when viewed against Mr. Nimatallah's apparently simple statement, because Islam not only has something to say about what kind of taxes may be imposed, but also about the role and size of government. It is thus not surprising that the Saudi Arabian authorities are more inclined toward fiscal retrenchment than securing a substantial enhancement of revenue.

Saudi Arabia has good economic prospects. In addition to oil, it has many other natural resources that are still unexploited. It has made good advances in promoting manufacturing and agriculture, the latter having grown from about 4 percent of GDP in 1982 to about 8 percent in 1987. Government revenue from non-oil sources has increased steadily; and the role of the private sector is expanding. These together with its substantial official reserves and its strategic position in the Middle East give it some capacity to withstand exogenous shocks, thus enabling it to adjust in a more orderly fashion.

During the previous Article IV consultation with Saudi Arabia, I commended the authorities for their flexible management of the riyal, which has continued to depreciate, although I note that the impact of the depreciation has been rather limited compared with the many objectives it was intended to achieve. One clear factor which limits the impact of the depreciation is the protectionism which confronts Saudi Arabian exports in industrial countries, especially exports of petrochemical products in which Saudi Arabia has definite comparative advantage. It is most essential that industrial countries open markets to the nontraditional exports of developing countries. Otherwise, the best adjustment policies these countries may pursue will fail to yield optimal results.

I have noted with great admiration that, despite persisting budgetary constraints, the authorities commendably continue to extend assistance to a number of needy countries, including countries in my own constituency, and have expressed a strong intention of continuing to do so. I support the proposed decision presented in EBS/88/109, authorizing the renewal of the borrowing agreement with Saudi Arabia for another five years.

Mr. Dai made the following statement:

Saudi Arabia has continued to make good progress with its successful adjustment process, which was initiated six years ago in response to the sharp decline in oil revenues. The economy resumed growth for the first time in four years, in spite of only a marginal increase in oil receipts in 1987 resulting from a repeated decline in oil output. Especially noticeable is that

real non-oil GDP registered an increase of 0.7 percent, which--although modest--was a shift from negative GDP to positive GDP for the first time since 1983. Remarkable success has been achieved in the diversification of the economy. The authorities should be commended for their prudent and effective policies and for the courageous and orderly manner in which they have adjusted to the drastic changes in the oil markets in recent years.

As a comprehensive analysis of the Saudi Arabian economy has already been given in the staff report, and in Mr. Nimatallah's succinct and informative opening statement, I shall limit my comments mainly to fiscal policy and oil policy.

The authorities are well aware of the fact that the present large fiscal deficit is not sustainable over the medium term, and that the continued drawdown of reserves may also endanger economic stability and adjustment efforts. The authorities have re-emphasized their firm commitment to reduce this fiscal deficit and, at the same time, to continue adjustment efforts. As noted by the staff, the authorities need to achieve two objectives simultaneously. One is to intensify fiscal restraint so as to check a further decline in usable reserves and the other is to continue to revitalize private sector activity, which, until now, has depended heavily on fiscal impulses. Keeping a delicate balance between these two conflicting objectives requires great skill in policy manipulation. It is, therefore, logical at this crucial juncture for the authorities, in selecting an appropriate policy mix, to implement certain policy-oriented experiments and to try to achieve both objectives at the lowest possible cost.

Owing to the lack of necessary institutional structures introducing new tax measures, such as a comprehensive income tax system, fiscal problems in many developing countries often have to be dealt with by expenditure restraint or borrowing, even though this is generally recognized to be less sustainable in the longer run. Notwithstanding the fact that the Saudi Arabian authorities are trying to speed up the pace of raising more non-oil revenues, it is understandable that the budget deficit problem will be addressed through more emphasis on expenditure reduction rather than through revenue increases at the present stage.

Regarding oil policy, the Saudi Arabian authorities' position on maintaining stable oil markets and prices is commendable. In his statement, Mr. Nimatallah rightly pointed out that oil price stability is in the best interest of both consumers and producers. In this context, we agree with the Saudi Arabian authorities that all parties concerned should join forces and cooperate in stabilizing the oil markets.

Finally, I appreciate greatly the foreign aid policy of Saudi Arabia, which is well known for its generosity and consistency. Despite the sharp decline in foreign exchange earnings and the continuing drawdown of unstable reserves, the authorities have continued to commit and provide financial support to the developing countries and to the international financial institutions. As regards the renewal of the borrowing agreement between Saudi Arabia and the Fund, this chair supports the proposed decision in EBS/88/109.

Mr. Ismael made the following statement:

I would like to join other speakers in commending the authorities for the management of their economy and for the maintenance of their adjustment efforts. Given the magnitude of the decline in export earnings and in budgetary revenue, the authorities have indeed shown excellent skill, as Mr. Nimatallah described in his opening statement, in implementing an adjustment program that has prevented major disruption to the domestic economy. To a large extent, this has been made possible because of the prudent policies, which were followed during the surplus years and which have allowed for the building of a comfortable foreign exchange reserve. However, since no immediate recovery is expected in the oil market and since the level of reserves had been falling rather sharply, the adjustment efforts will need to be maintained or even strengthened.

On the whole I am in agreement with the staff's analysis and appraisal, and I shall limit my comments to the fiscal and external sectors.

In the fiscal sector, I note the authorities' efforts to halve the deficit in 1988 through a 24 percent reduction in expenditures. Particularly noteworthy are the projected cuts in subsidies and project expenditures. While this approach of concentrating fiscal adjustment efforts on the reduction of expenditures has proven successful in the past, it may not be sustainable. In view of the low level of usable government deposits, other sources of financing the deficit are required. In that context, the intention of the authorities to finance part of the 1988 deficit through the sale of bonds is appropriate. However, this can be very costly and can be a temporary means of financing the deficit, if present conditions continue. Other ways of permanently raising the level of government revenue, which now stands at about 8.5 percent of GDP, are obviously needed, and the authorities should consider the suggestions made by the staff in this respect.

With respect to the external sector, the authorities appropriately have been following a flexible exchange rate

policy, which has contributed to adjustment in that sector. This policy, together with that of export diversification and import substitution are in the right direction. However, like some previous speakers, I note the protectionist measures that some industrial countries have taken against the entry of some of these products into their markets. This attitude is in sharp contrast to that of Saudi Arabia, which has a long-standing policy of openness of its economy, and which has remained open despite the enormous shortfall in export earnings. The diversification of Saudi Arabia's economy can only succeed if industrial markets remain open to Saudi Arabia's non-oil exports.

Finally, I commend the Saudi Arabian authorities for maintaining their generous financial assistance program to developing countries and for their support of international organizations. I support the proposed decision regarding the renewal of the borrowing agreement between Saudi Arabia and the Fund in association with the General Arrangements to Borrow.

Mr. Zeas made the following statement:

Compared with 1986, real GDP declined by more than 3 percent in 1987, despite a minor increase in non-oil GDP. The decline was related to the cutback of 12 percent in oil output. The 1987 decline in GDP, however, was not as severe as the one in 1982-85. In addition, with the rapid annual growth of the population at 4.2 percent, per capita GNP dropped substantially during 1987-88, but it is, of course, still very high at \$8,850 a year.

Aided by the improvement in oil prices in 1986, the overall balance of payments deficit improved moderately. Saudi Arabia's loss of net international reserves in 1987 amounted to \$8 billion; and, for the 1981-87 period, the cumulative loss of SAMA's net international reserves surpassed \$80 billion. Nevertheless, at the end of 1987, those reserves stood at \$54 billion, equivalent to three years of imports.

Although the present trend of deterioration of SAMA's net international reserves is not a cause for alarm, we share both the authorities' and staff's concerns, and we welcome the authorities' decision to halt the deteriorating trend by addressing the most important problem of the public sector deficit, which in 1987 reached 25.7 percent of GDP. In the absence of policy changes, the staff projects an average annual deficit of SRls 50 billion, or 17.5 percent of GDP, for the next five years.

We agree with the authorities' preference to reduce the fiscal deficit mainly through a reduction of expenditures. Two

areas with possible room for expenditure reduction, identified by the staff, are subsidies and fiscal incentives. However, if the authorities' aim is the total elimination of the deficit in the not too distant future, as explained by Mr. Nimatallah, then some action on the revenue side may also be required, as suggested by the staff, particularly in the area of income and property taxes and the sale of state enterprises, which could be run more efficiently by the private sector. From Mr. Nimatallah's opening statement, the authorities have apparently already begun the process of selling the equity of the Saudi Arabian Basic Industries Corporation.

The authorities commendably succeeded in controlling inflationary pressures during the past few years through a disciplined monetary policy, and an open trade and payments regime. Mr. Nimatallah emphasized this latter point in his statement. The staff has identified an increase in the number of industrial activities subject to protective tariffs during 1987. At the same time, however, we note, as we did in 1987, that, due to Saudi Arabia's limited market, the full cooperation of all industrialized countries is needed to ensure access to their markets of products in which Saudi Arabia has a comparative advantage, especially petrochemicals.

Although the nominal exchange rate of the riyal depreciated only moderately vis-à-vis the dollar between 1981 and 1987--from SRls 3.42 to the dollar to SRls 3.75 to the dollar--the real effective exchange rate of the riyal depreciated substantially, owing to the low inflation rate in Saudi Arabia. We support the authorities' flexible exchange rate policy. Exports of non-oil products increased at an average annual rate of 20 percent between 1982 and 1987, from \$1 billion in 1982 to \$2.5 billion in 1987, representing over 9 percent of total exports in the latter year. Saudi Arabia's flexible exchange rate policy stance has helped to achieve this very satisfactory rate of growth of non-oil exports.

Finally, we commend the authorities' generous stance on official foreign aid.

Mr. Morales made the following statement:

The Saudi Arabian authorities have recently been implementing, with great success, past, an economic program aimed at adjusting their economy to the reduction in its oil export earnings. During past years they have managed to make important reductions in public expenditures, to decrease balance of payments disequilibria, and to keep the rate of inflation

totally under control; and in doing so, they have moderated the disruptive impacts on the domestic economy of the changes in oil prices.

It is clear that these achievements are the result not only of the recent adjustment policies promptly implemented, but also of long-term sustained economic strategies executed since the period of significant export earnings, when prudent policies aimed at accumulating financial resources were present.

In addition, policies were fostered to diversify the economy, to increase agricultural production, and to develop private enterprises. As mentioned by Mr. Nimatallah in his opening statement, the private sector has increased its share of economic activity in Saudi Arabia to about 40 percent and non-oil exports have nearly tripled in the past five years.

Economic growth in the non-oil sector was obtained in 1987, following many years of decline. Despite this result, it implied a relaxation of fiscal restraint, which would only be temporary. In this sense, we welcome the intentions of the Government to reduce the fiscal deficit for 1988 to a level lower than in 1987. We recognize the importance the authorities attach to quality economic policies and we feel assured that adjustment in the fiscal sector will continue along that track, avoiding excessive borrowing that could affect the development of the private sector or could tamper with an adequate allocation of resources.

The medium-term outlook highlights the difficulties of the task lying ahead and the necessity of persisting both in reducing the size of the Government and in increasing the fiscal revenues as the main way to effectively reduce economic imbalances. In this connection, we concur with Mr. Nimatallah that the more reasonable approach is to emphasize expenditure reduction, and we agree that such a process should be done gradually. We welcome his comments that the authorities are speeding up the pace of raising more non-oil revenues, as broadening the revenue base is likely to be a necessary step to reduce the fiscal deficit on a sustained basis.

The flexible approach in exchange rate policy has certainly been a consistent complement to the efforts on other fronts to correct the imbalances of the external sector. In this sense, we welcome the adjustment of the riyal and the commitment of the authorities to continue with such a strategy.

The Saudi Arabian authorities have been highly successful in their firm commitment to economic adjustment. We continue to fully support these adjustment and development policies applied

in Saudi Arabia, directed to export diversification, a strengthened private sector, and sustained economic growth.

Finally, we wish to join the other Directors in commending the Saudi Arabian authorities for their foreign aid policy. We support the proposed decision on the renewal of the borrowing arrangement in association with the General Arrangements to Borrow.

Mr. Haynes made the following statement:

The continuing weakness of the international oil market and its depressing effect on the Saudi Arabian economy during 1987 emphasizes the need for the authorities to further maintain the process of diversification and adjustment. Past efforts to cut public expenditures and promote private sector activity in the non-oil sector have been commendable, but fiscal and external imbalances remain large as a result of declining output and lower export and fiscal revenues.

Since the early 1980s, Saudi Arabia has experienced a sharp decline in its share of OPEC and world oil production, reflecting the high relative costs which it has been prepared to pay over the years to ensure market stability. The collapse of oil prices in 1986 and the attendant decline in oil revenues reinforces the need for this stabilizing role. The low inflation growth of the industrial countries in recent years is in part due to the decline in oil prices from the levels prevailing in the early 1980s. Further stability at current prices will continue to benefit the international economic system, and both OPEC and non-OPEC producers have an important role in ensuring price stability.

Under the current circumstances, a cautious fiscal policy must be pursued, because the fiscal imbalance reached almost 26 percent of GDP in 1987. Mr. Nimatallah gave assurances in his opening statement that this apparent deviation by the authorities to provide added stimulus to the private sector was only a temporary measure that represented the effort to combine adjustment with growth. While we appreciate the authorities' concern about the continuing contraction of the economy, we encourage them to renew their efforts to bring about a somewhat faster pace of fiscal adjustment. In this context, the difference between the budget estimates for 1988 and the staff's assessment of the likely outcome of the fiscal balance for 1988 is worrying, especially since the medium-term fiscal deficit to GDP ratio in excess of 15 percent will become increasingly unsustainable.

The emphasis so far has been on expenditure adjustment, reflecting the structural dependence of the fiscal accounts on oil revenues. However, we agree with the staff that the authorities need to pay more attention to domestic revenue raising measures, including the possibility of a comprehensive income tax. The need for such an approach seems warranted, given the unfavorable medium-term outlook for oil revenues and the possible difficulties in achieving further substantial expenditure adjustment over the short term.

The need for the authorities to control the fiscal imbalance is all the more imperative in light of the potential impact that imbalance could have on monetary policy. The rundown of deposits with the SAMA has forced the authorities to undertake its first borrowing in over 25 years. Details of the arrangement remain sketchy, but Appendix I of the background paper on recent economic developments in Saudi Arabia clearly demonstrates that the authorities must proceed cautiously to avoid crowding out the private sector. While the initial bond offer seems to have been directed toward commercial banks, it will, however, be useful to gradually bring the nonbank private sector into future bond issues. In addition, while banks should be permitted to trade these bonds, it is important that SAMA should not be involved in financing the budget deficit.

Over the long term, the balance of payments outlook will hinge critically on the take-off of non-oil export sectors. The authorities' focus in this area will benefit from the large depreciation of the real effective exchange rate, which has already enhanced Saudi Arabia's competitiveness. Like other Directors, I believe that market access is equally crucial for Saudi Arabia's export efforts.

Finally, Saudi Arabia has maintained an impressive aid program for developing countries, providing bilateral and multilateral support. A decline in its assistance at this critical juncture would be unfortunate. In addition, Saudi Arabia's decision to renew the borrowing agreement with the Fund under the General Arrangements to Borrow is welcome.

The Director of the Middle Eastern Department said that the impact of the declining price levels on monetary policy had been minor, because the decline in the velocity of money reflected the decline in economic activity that had occurred in the economy over recent years and the increased monetization. Interest rates in Saudi Arabia were closely linked with international rates on the dollar, and thus were determined by international market conditions. The international linkage of the interest rate had reduced the role of the interest rate in monetary policymaking in Saudi Arabia. It had been suggested that the fact that high real interest rates existed in Saudi Arabia had had a depressive impact on private

sector investments, and generally, such a suggestion might be theoretically correct. However, in Saudi Arabia there was a large supply of low interest or zero interest credit available for investments from official sources.

A question had been raised about the slowdown of economic activity, the resulting possibility of increased unemployment, and the social costs, including to the expatriate population, the Director continued. The decline in economic activity had had an impact on the level of employment for both Saudi Arabia and expatriate laborers as well as on the level of wages. However, most of that unemployment with respect to Saudi Arabian nationals was functional since the economy was undergoing structural changes. The authorities were taking initiatives, including to retrain the population, in order to accommodate those changes. The authorities were to be commended for the minimal amount of social costs that had been associated with such a major adjustment. In assessing the authorities' performance, it should be kept in mind that as recently as 1981 oil revenues had amounted to \$111 billion; they were currently under \$20 billion. In light of the sharp decline in oil revenues, the social costs of adjustment had been kept remarkably low.

For the most part, the increase in nontraditional exports shown on Table 2 of SM/88/107 had come from competitive industries, the Director explained. If the agricultural sector, which was not competitive, were excluded from the statistics, most of the increased exports were from the petrochemical sector, which in the staff's judgment was highly competitive and was producing at more than full capacity.

During a recent meeting, the OPEC countries had decided to maintain production quotas at their current levels, the Director reported. That decision would have little, if any, impact on the staff's projections, because although oil prices were expected to decline somewhat, the volume of exports was expected to largely compensate for the price decline, given the revised growth rates anticipated for the industrial countries and the associated demand for petroleum products.

A question had been raised as to whether or not the fiscal target for 1988 would be achieved, the Director stated. The authorities had assured the staff that they were likely to reach that target. The staff's reservations about that assertion had been clearly stated in the staff report, but, of course, it was hoped that those discouraging projections would prove to be incorrect.

Another question had been raised about the reduction contained in the budget for expenditures in maintenance and operations, given the high level of infrastructure that needed to be maintained, the Director noted. It was true that maintenance costs were expected to be high, but the authorities were trying to find ways to make maintenance and operations more cost efficient. While the results of those efforts remained to be seen, the authorities had achieved a high degree of success in that area in the past.

Congratulations for the first five-year medium-term projection on the budget and the balance of payments should go to Saudi Arabia's Minister of Finance, who had encouraged the Fund staff to carry out that exercise, the Director remarked. In light of the previous uncertainties in the oil market, it was understandable that such a study had not been undertaken previously. However, there currently seemed to be a degree of consensus that, barring any unforeseen events, oil prices were going to remain more or less stable for the foreseeable future.

He disagreed with Mr. Enoch's statement that there had been an overrun in the 1987 budget deficit target, the Director commented. There had been an increase in expenditures over the budgeted level, because the authorities had had to take legislative action to obtain additional allocations before any additional expenditures could be made. However, the authorities had quite a tight expenditure control mechanism.

The staff had discussed with the authorities the bond issue and the appropriateness of directing the sale of bonds to the private sector, the Director said. The authorities had not been closed to the idea, but they had preferred to move slowly, which was understandable. The institutional structure for a capital market was just not available in Saudi Arabia at present, and it would probably be overly ambitious to direct those sales to the private sector. Ultimately, the authorities had that plan in mind, but they wanted to proceed quite cautiously in that direction.

The Al-Rajhi Banking and Investment Corporation, which had been converted from a money exchanger to a bank in March 1988, was the largest bank in Saudi Arabia in terms of the number of branches, the Director explained. It was the second largest in terms of assets. The conversion of the Al-Rajhi Banking and Investment Corporation was a positive development, because it allowed for more competition among commercial banks.

A question had been raised as to how Saudi Arabia could encourage foreign investment, the Director noted. Saudi Arabia was already encouraging such investment through various measures, such as income tax holidays, which at present amounted to about 10 years, and more importantly through joint ventures. Those instruments had been utilized in a large part of Saudi Arabia's industrial activity. Foreign investments were granted the same subsidies and incentives--whether too large or too little--as Saudi Arabian investments. As the staff had reported previously, it was, of course, possible that certain public sector procurement policies tended to favor domestic producers, but the authorities had assured the staff that there had been no intensification of that practice in recent years. It was debatable whether or not removing that restriction on public sector procurement would enhance foreign investment further.

There had been some lag in the expenditure increase for 1987 would spill over in 1988, the Director continued. However, the spillover was not likely to be significant, and it had been reflected in the staff's projections for 1988.

The Saudi Arabian authorities had no illusions about recapturing the buoyancy that existed in the economy in the early 1980s, the Director observed. The authorities fully recognized that the unusual surge in non-oil economic activity that had occurred at that time was not sustainable, and they knew that the economy would have to operate at a lower and more sustainable level than had previously been the case.

He considered that Mr. Zecchini's statement about the increased protectionist measures introduced in Saudi Arabia had been too strong, the Director said. The Saudi Arabian authorities had increased the minimum customs duty rate from 7 percent to 12 percent and had unified the protective tariff duty at 20 percent from 10-20 percent previously. For a developing country, a protective rate of 20 percent was not unreasonable, given the institutional constraints involved.

As to whether the staff felt that the continuing depreciation of the riyal in effective terms had been desirable, in its report the staff had urged the authorities to continue the flexibility they had shown in managing the exchange system in the past, the Director of the Middle Eastern Department concluded. It would be difficult to judge that stance until the exchange rate policy could be seen in the context of other economic policy actions.

Mr. Nimatallah noted that the general focus of the discussion had been on whether the pace of adjustment was adequate, or whether it should be quickened, and the Directors' views had fallen between two extremes. He considered that the current pace was the right one. Another important issue had been that of adjustment with growth. Mr. Sengupta had rightly pointed out that there usually was a lag between the introduction of a stimulus and the final result. As he had said on previous occasions, it was time to look for the right moment to really combine adjustment with growth, because for a while adjustment in Saudi Arabia had been given priority, and it still received high priority. However, there had to be a point where adjustment and growth could no longer be combined. The authorities had considered 1987 to be that point, but nevertheless they had promised to maintain the current pace of adjustment.

Another issue that had been raised concerned whether the fiscal deficit should be reduced through expenditure cuts alone, or whether those cuts should be combined with additional revenues, Mr. Nimatallah continued. There had been no difference of opinion between the staff and the authorities on seeking additional non-oil revenues, but it would be some time before the authorities could succeed in introducing additional taxes, regardless of whether they were income taxes, consumption taxes, or property taxes.

As Mr. Zecchini had pointed out, if oil revenues increased in the near future, the authorities might not need to significantly increase taxes or borrowing, Mr. Nimatallah observed. In that connection, there was a chance that oil revenues might increase within the next few years. However, his authorities were taking a conservative view in that they wanted to combine revenues, taxes, and borrowing: hopefully oil revenues would increase eventually, but the Saudi Arabian people would have to start to get used to being taxed, and it would be helpful to introduce domestic borrowing at least to make it a means of investment for the private sector. For the time being, the authorities seemed to be hoping for a combination of those three factors to reduce the fiscal deficit. However, the fiscal deficit would have to be narrowed substantially, and the authorities were working on it.

A point had been raised by Mr. Finaish on the benefits of oil producing countries' direct investments overseas in oil facilities, such as refineries, distribution stations, and gas stations, Mr. Nimatallah remarked. That point deserved consideration, because such investments would make the world more integrated and countries more interdependent. That would eventually be helpful for the coordination of policies and efforts to stabilize economies, prices, and exchange rates. Such foreign investment should be encouraged by the host countries, particularly the oil consuming countries. The objective was to open more markets for investment, and to welcome that kind of investment. If nothing else, it created more interdependence among countries, which was good in that countries would be more concerned about what went on in the world economy.

As to future oil prices, his authorities considered \$18 a barrel to be a focal point, Mr. Nimatallah said. Prices might fluctuate somewhat around that figure, but that base figure gave his authorities confidence to venture into studying medium-term scenarios. Prior to the price stabilization, the authorities had not seen much point to putting together medium-term scenarios that depended on highly fluctuating prices. He would convey to his authorities the views expressed by Directors, particularly on joining the GATT. The Saudi Arabian authorities wanted to join that organization, because they considered it to be an increasingly important organization that was beneficial to the adjustment process.

Mr. Zecchini said that he had been reassured by Mr. Nimatallah's remarks on external trade and the Saudi Arabian authorities' plans for managing that area of the economy. The information provided by Mr. Nimatallah was particularly welcome, because the measures taken over the past year were even more worrying than the staff had indicated. In particular, the increase in ad valorem import duties, even of the size mentioned by the staff, represented an increase of more than 50 percent in import duties. In addition, the enlargement of the list of imports subject to duties could not be seen as an opening of the market. One of the Fund's primary objectives was to create the conditions for much greater international trade; therefore, it should not overlook the external aspects of economic policy. He found it a bit surprising that at a

time of international negotiation for tariff reductions, some of the more prominent members of the Fund were taking measures that went in the opposite direction.

Another factor that had contributed to the concerns of his chair was that Saudi Arabia was running a public budget deficit which needed to be covered and, therefore, could serve as an incentive to use import duties as a source of revenue, although that practice was self-defeating over the longer run. Although Mr. Nimatallah had reassured the Board about the intentions of the authorities, there had been several factors which had justified the Italian chair's concerns about the extent, timing, and context of the measures taken in the external sector.

Mr. Sengupta said that Mr. Zecchini's comments had prompted him to welcome Saudi Arabia's proposal to join the GATT, because after Saudi Arabia joined it would become clear that developing countries did have a need for protection for balance of payments and other purposes.

Nevertheless, Saudi Arabia's continuing official development assistance was a primary cause for concern, Mr. Sengupta continued. The Directors has been unanimous in commending the authorities for their performance on foreign aid. However, Table 1 of the staff report, which gave projections for official development assistance in riyal terms, had indicated that Saudi Arabian assistance had been very large for the past three years, at about SRls 1.5 billion, but that it was expected to decrease to SRls 5.4 billion in nominal terms. He wondered whether Mr. Nimatallah could give any reassurance of his authorities' commitment to maintain the current level of foreign aid.

Mr. Nimatallah said that Mr. Zecchini was exaggerating a minor point, because there were very few, if any, economies in the world as open as the Saudi Arabian economy. Saudi Arabia had increased tariffs on some imports as a means of raising revenue, but the increases were minor compared with the level of tariffs that had existed prior to the oil price increases. When oil revenues increased, tariffs had been drastically reduced to 7 percent from over 30 percent. Even a 20 percent tariff was minor compared with those prevailing in many European countries, including Italy.

It was nontariff barriers that were not acceptable, Mr. Nimatallah pointed out. According to GATT rules, tariff barriers usually were nondiscriminatory. It should be kept in mind that, while Saudi Arabia was not discriminating against other countries, Saudi Arabia was discriminated against in certain countries, including Italy. Therefore, if Saudi Arabia resorted to raising some revenue through tariffs, it should not be exaggerated as protectionism. The principle of maintaining a free economy was extremely important to the Saudi Arabian authorities, who had for many years resisted the temptation of protectionism, even to help infant industries.

As to Mr. Sengupta's question about Saudi Arabian official development assistance, it would be reasonable to assume that as public expenditure cuts were intensified, foreign aid would also decline, Mr. Nimatallah continued. Of course, the staff's scenarios were only projections, and therefore they did not necessarily indicate what was going to happen. In any case, the authorities' commitment to helping other countries was unwavering, and as the economy improved, foreign aid would also return to its previous level.

The Chairman then made the following summing up:

Executive Directors warmly commended the Saudi Arabian authorities on their policy of adjustment to the sharply reduced oil receipts over the past several years through expenditure restraint and a flexible exchange rate policy. While price stability continued to prevail and the outlook for the current account of the balance of payments appeared manageable over the medium term, Directors observed that the continuation of relatively low oil revenues called for a strengthening and broadening of the adjustment effort to achieve the authorities' twin objectives of stemming a further substantial drawdown of SAMA's foreign assets and encouraging the growth and diversification of private sector activity.

Directors, therefore, welcomed the resolve of the authorities to adjust the economy further to a more sustainable level. In that context, most Directors expressed concern about the recent and prospective magnitude of the public sector deficits.

Directors commended the authorities for initiating budgetary planning in the medium-term framework. They supported the underlying objective of the 1988 budget, which calls for a substantial reduction in the fiscal deficit, and welcomed the Government's intention to address the underlying problems so as to eliminate budget deficits and external payments imbalances in the medium term. They stressed that financing the budget deficit through bond sales should be viewed only as a temporary relief, since it would not address the need to adjust, and risked crowding out the private sector and burdening future budgets.

In this context, the authorities were encouraged to speedily implement the new revenue measures proposed along with the 1988 budget and to consider further substantial steps in order to expand the domestic revenue base. While it was noted that it was not now to be expected that the Government would impose much taxation, many Directors supported the need to introduce new taxes such as an income tax encompassing all personal incomes and a general consumption tax. At the same time, the authorities were encouraged to continue enhancing efficiency in government operations so as to further reduce current expenditures and

limit capital outlays to productive projects. Directors welcomed the authorities' intention to supplement the restrictive fiscal stance by a continued pursuit of a prudent monetary policy so that bond financing of the budget deficit is not finally accommodated by SAMA. It was also noted that the authorities were aware of the need for steps to encourage a sustained inflow of private capital currently held abroad in order to facilitate budget financing, promote private investment, and strengthen the balance of payments.

Directors commended the authorities' determination to reduce and rationalize subsidies further and felt that such steps would be helpful not only in improving resource allocation and economic efficiency, but also in reducing budget deficits. Regarding the authorities' plans to facilitate growth of the private sector through the continued provision of nonfinancial support, they observed that caution should be applied in extending such support, so that it was held to moderate levels and only those economic activities were promoted in which Saudi Arabia had comparative advantage. Directors stressed that increased efficiency in resource allocation and progress toward self-sustaining growth of the private sector would benefit from greater exposure to international competition and continued avoidance of protectionist measures. At the same time, Directors emphasized that free access abroad for Saudi Arabian non-oil exports, especially petrochemicals, would be beneficial for the world economy.

Directors endorsed the authorities' flexible exchange rate policy which had led to a substantial real effective depreciation of the riyal over the past three years. They stressed that the continuation of such a policy would not only be supportive of the restrained fiscal stance but would be helpful in promoting a better allocation of resources, diversifying the economy, and encouraging growth of the private sector.

Directors were highly appreciative of Saudi Arabia's exceptionally generous program of economic assistance to developing countries. They commended highly the authorities' determination, as reiterated by Mr. Nimatallah, to continue to provide as much assistance to developing countries as Saudi Arabia's budgetary and balance of payments conditions permitted. Saudi Arabia's policy to continue supporting stability of oil markets and prices was welcomed. Saudi Arabia's continued close collaboration with the Fund was also appreciated, as was the renewal of the borrowing arrangement between Saudi Arabia and the Fund in association with the GAB.

The next Article IV consultation with Saudi Arabia is expected to be held on the standard 12-month cycle.

The Executive Board then took the following decision:

Pursuant to Article VII, Section 1 of the Articles of Agreement, the Managing Director is authorized to send to the Minister of Finance of Saudi Arabia a letter as set forth in the attachment to EBS/88/109, proposing a renewal, for a period of five years from December 26, 1988, of the 1983 borrowing agreement with Saudi Arabia in association with the General Arrangements to Borrow. When a reply is received from the Minister accepting the proposal, the Managing Director's letter and the reply shall constitute an agreement on the renewal of the 1983 borrowing agreement between Saudi Arabia and the Fund, which shall enter into force on December 26, 1988.

Decision No. 8897-(88/93), adopted  
June 15, 1988

2. DESIGNATION PLAN AND OPERATIONAL BUDGET FOR JUNE-AUGUST 1988

The Executive Directors considered staff papers on the designation plan for June-August 1988 (EBS/88/102, 5/27/88) and the operational budget for June-August 1988 (EBS/88/103, 5/27/88).

Mrs. Walker said that her authorities welcomed the review of mitigation for the United States in the context of burden sharing, which had been contained in the staff paper. That mitigation was an integral part of the burden sharing arrangement, and during the Board's meeting on burden sharing (EBM/88/66 and EBM/88/67, 4/27/88), she had clearly indicated that U.S. support for the continuation of burden sharing was contingent on the continuation of mitigation for the United States. That remained to be the case. She could support the continuation of the current procedures as long as the burden sharing agreement remained in effect.

Mr. Grosche said that his authorities welcomed the abolition of the mitigation adjustments in favor of the United States. However, given the balance of payments position of the United States and the special role of the dollar in the operational budgets, he could go along with the proposed decisions. He did so with the understanding, which had been expressed on page 6 of EBS/88/103, that the staff would again review that matter in the budget for the quarterly period June-August 1989 or earlier, if necessary, in light of the review of the burden sharing decision.

The Executive Board then took the following decisions:

SDR Department - Designation Plan for June-August 1988

The Executive Board approves the designation plan for the quarterly period beginning June 15, 1988 as set out in EBS/88/102.

Decision No. 8903-(88/93) S, adopted  
June 15, 1988

Operational Budget for June-August 1988

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/88/103, page 3, footnote 1, and the operational budget for the quarterly period beginning June 15, 1988 as set out in EBS/88/103.

Decision No. 8904-(88/93), adopted  
June 15, 1988

3. GUYANA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING  
DECLARATION OF INELIGIBILITY - POSTPONEMENT

Paragraph 4 of Executive Board Decision No. 8756-(87/176), adopted December 18, 1987, shall be amended by substituting the words "no later than June 20, 1988" for "within six months of the date of this decision."

Decision No. 8905-(88/93), adopted  
June 15, 1988

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/88/92 (6/15/88) and EBM/88/93 (6/15/88).

4. SRI LANKA - TECHNICAL ASSISTANCE

In response to a request from the Sri Lankan authorities for technical assistance in the banking area, the Executive Board approves the proposal set forth in EBD/88/158 (6/9/88).

Adopted June 15, 1988

APPROVED: January 18, 1989

LEO VAN HOUTVEN  
Secretary

