

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/2

10:00 a.m., January 6, 1988

M. Candessus, Chairman

Executive Directors

A. Abdallah  
Dai Q.  
C. H. Dallara

M. Finaish  
G. Grosche

A. Kafka

T. P. Lankester

Mawakani Samba  
Y. A. Nimatallah

G. A. Posthumus

G. Salehkhoul

Alternate Executive Directors

E. T. El Kogali

J. Prader  
R. Morales, Temporary  
A. M. Othman

A. Iljas, Temporary  
J. Hospedales  
J. E. Zeas, Temporary

D. McCormack

L. Filardo  
M. Fogelholm  
D. Marcel

C.-Y. Lim, Temporary  
O. Kabbaj  
V. K. Malhotra, Temporary  
S. Yoshikuni  
F. Di Mauro, Temporary

L. Van Houtven, Secretary and Counsellor  
S. Wooll, Assistant

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Also Present

IBRD: F. Lysy, Latin America and the Caribbean Regional Office; J. Salop, Africa Regional Office. African Department: E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; M. Allen, B. W. Ames, G. C. Dahl, P. Dhonte, M. E. Edo, R. R. Schneider. Exchange and Trade Relations Department: S. J. Anjaria, G. Belanger, E. Brau, J. Fajgenbaum, H. B. Junz, M. H. Rodlauer. Fiscal Affairs Department: A. Cheasty, J. Diamond, G. A. Mackenzie, L. J. Vazquez-Caro. Legal Department: H. Elizalde, A. O. Liuksila, J. K. Oh. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; J. Ferrán, Deputy Director; L. A. Cardemil, J. Clark, R. A. Elson, M. E. Hardy, J. R. Karlik, L. Schmitz, S. C. de Sosa. Personal Assistant to the Managing Director: H. J. O. Simpson. Advisors to Executive Directors: P. E. Archibong, E. Ayales, K.-H. Kleine, P. D. Péroz. Assistants to Executive Directors: E. C. Demaestri, W. N. Engert, V. J. Fernández, P. Gorjestani, S. Guribye, C. L. Haynes, S. King, K. Kpetigo, T. Morita, C. Noriega, L. M. Piantini, S. Rebecchini, A. Rieffel, S. Rouai, V. Rousset, C. C. A. van den Berg, E. L. Walker, D. A. Woodward, I. Zaidi.

1. REPORT BY MANAGING DIRECTOR

The Chairman said that during his recent visit to Europe, he had taken the opportunity to meet with heads of government and senior financial officials in France, Italy, Spain, and Switzerland. He had provided detailed information on the enhanced structural adjustment facility, and had expressed thanks to them for their contributions to that facility. In addition, there had been exchanges of view on the Fund's efforts to stabilize exchange rate markets and on its role in the debt strategy. Leaders in all four countries had encouraged the Fund to continue to pursue the efforts it was currently undertaking in various directions.

While in Italy, he had been received by Pope John Paul II, the Chairman remarked. He had been invited to meet the Pope because he had previously made a written response to a Vatican document on debt issues in which a strong line had been taken on the role of the Fund in the debt strategy. The Pope was clearly aware of the Fund's efforts to help the poorest countries through the enhanced structural adjustment facility, as well as of the situation in Latin America, including the debt problem. The Pope had also expressed interest in the Fund's relations with Eastern Europe.

In December 1987, the Chairman recalled, he had reported a delay in carrying out the discussions for the review under the stand-by arrangement for Argentina. At that time, the authorities were still seeking congressional approval of a package of new revenue measures. As that package was soon likely to receive legislative approval, a staff mission had just left for Buenos Aires to begin discussions on the review.

2. VENEZUELA - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Venezuela (SM/87/243, 10/19/87). They also had before them a background paper on recent economic developments in Venezuela (SM/87/254, 11/5/87).

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

Recent information received by the Fund staff suggests that the outturn for 1987 was broadly in line with the macroeconomic projections for Venezuela set out in SM/87/243.

During the last few months the rate of inflation has accelerated, and in November 1987, the 12-month rate of increase in consumer prices was 36 percent. Real GDP is estimated to have expanded by about 3 percent in 1987. Through end-November 1987, the growth in money and quasi-money (M2) was about 20 percent on an annual basis, while commercial bank credit to the private sector increased by approximately 36 percent in the same period;

these growth rates are similar to those projected in the staff report. Preliminary information suggests that the public sector deficit in 1987 was on the order of 6 percent of GDP, as envisaged in the staff report.

In the external sector, an overall balance of payments deficit of \$0.8 billion is now estimated for 1987, compared with one of \$1.6 billion projected in the staff report. This improved outcome with respect to the projections in the staff report appears to be the result of a lower deficit in both the current and capital accounts. The stronger than projected current account outturn reflects a higher level of nontraditional exports; the value of petroleum exports is estimated to be similar to the staff's projection of \$9 billion. In the capital account, trade financing is estimated to have been higher than projected. These two factors were sufficient to cover the financing gap that was projected in the staff report.

The free-market exchange rate moved from Bs 32-33 to the U.S. dollar in September 1987 to about Bs 30 to the U.S. dollar by late December 1987; these rates may be compared with an exchange rate of Bs 14.50 in the main controlled exchange market. On November 13, 1987, Venezuela's revised multiyear rescheduling agreement (MYRA) was ratified by the foreign commercial banks.

In recent months, average prices for Venezuela's crude petroleum exports have fallen by about \$3 a barrel below their peak levels at midyear to less than \$15 a barrel. The average realized price for Venezuela's petroleum exports--crude and derivatives--is estimated to have been about \$16.50 a barrel for 1987 as a whole, which is similar to the projection in the staff report. If, for example, an average realized price of \$16 a barrel is assumed for oil exports during 1988 instead of \$17 a barrel projected in the staff report, the value of Venezuela's petroleum exports would amount to \$8.9 billion in 1988, or \$0.5 billion less than shown in Table 6 of the staff report. Similarly, public sector oil revenues would be about Bs 8 billion less than shown in Table 2 of the staff report, which is approximately 1.3 percent of projected GDP in 1988.

The next staff visit to Venezuela under the enhanced surveillance procedure is expected to take place in the second half of February 1988.

Mrs. Filardo made the following statement:

On behalf of my authorities I would like to express appreciation for the way economic policy discussions between the authorities and the Fund staff were held in Venezuela at the time of the 1987 Article IV consultation. After the 1986 midyear Article IV

consultation in March 1986 two missions visited the country, both of which were very helpful in guiding the Government in reassessing the economic program that has been implemented. In general, the authorities agree with the staff that some adjustments had to be made in certain areas, especially in fiscal, monetary, and commercial policies, although they also stressed the importance of maintaining a minimum growth rate in view of the long stagnation period the country experienced for seven years prior to 1986.

During the first half of the 1980s, and notwithstanding the impact of the oil and external debt shocks, the Government intensified the austerity measures adopted in 1983 with the aim of correcting the external disequilibrium, and thereby setting the country in a position to continue complying with its external debt obligations and re-establishing normal access to international capital markets. To encourage these developments, my authorities agreed to enter into an enhanced surveillance economic program with the Fund, whose reports were to be distributed to the banks. Despite the fact that this process has been faithfully fulfilled, after a long period of negotiation Venezuela was able to reach only in February 1986 a multiyear rescheduling arrangement (MYRA) that was further amended in October 1987.

The lack of access to financial markets combined with larger amounts of debt service since 1982 contributed to undermining the Government's economic policy during 1986 and 1987 and to increasing the overall climate of uncertainty in the aftermath of the oil crisis.

Against this background, I will focus my comments on the external sector and adjustment policies, on the performance of the economy during 1986-87, and on the program for 1988 in the context of the medium-term strategy.

Due to the country's overdependence on oil exports, which accounted for about 93 percent of its exchange earnings for four years up to 1985, Venezuela's economy is heavily influenced by developments in the petroleum sector. After the peak of 1981, when oil revenues reached \$19.2 billion, the country's exchange earnings fell subsequently by 18 percent in 1982, 12 percent in 1983, 13.5 percent in 1985, and 44 percent in 1986 as a result of a staggering reduction in price and volume.

The oil shock furthermore coincided with the debt crisis of 1982, when Venezuela's access to external financial markets was curtailed. While all of these events resulted in a considerable loss of confidence in the future of the economy, the authorities remained committed to the international financial community and were prepared to adjust to the new economic circumstances. In spite of the sharp decline in oil exports, the public sector debt

has been serviced on a timely basis. <sup>1/</sup> Since 1982, Venezuela has made payments for \$26.1 billion from which \$10.4 billion correspond to amortization, and the balance to interests. While developing countries were having positive financial flows from commercial banks and from the international financial community in general, our nation repaid debt in net terms reducing its balance from \$37 billion in 1982 to \$29 billion in 1987. This was possible as a result of demand-management policies implemented by the Government.

Economic adjustment was of such magnitude that imports were reduced by \$.5.5 billion in 1983 and have remained at a level close to \$7.3 billion during the past four years. As a consequence, the current account has improved substantially, recording a surplus of \$5 billion in 1984 and \$3 billion in 1985. Regardless of the fulfillment of external debt obligations, international monetary reserves recovered in those years. After having corrected the current account disequilibrium at the expense of sharp losses in investment and output in 1986, the authorities were prepared to adopt economic measures aimed at reactivating production and employment, but that year Venezuela experienced an overwhelming oil shock. Income was reduced by \$6 billion, equivalent to 14 percent of GDP, originating again a deficit in the current account of \$2 billion, although imports increased by only \$0.2 billion in nominal terms, but diminishing in real terms the debt service which amounted to \$5 billion for 1986 resulted in a dramatic decline in international reserves of \$4 billion.

The reduction in oil prices also contributed to a substantial deterioration of the overall public sector finances, which, after recording a surplus of 4.5 percent and 5.7 percent of GDP in 1984 and 1985, respectively, turned into a deficit of 6.7 percent of GDP in 1986. Whereas GDP declined sharply in 1983 and 1984, it recovered slightly in 1986. Unemployment increased from 7 percent of the labor force in 1982 to 13.1 percent in 1985, while the population was growing at an annual average rate of 3 percent, the labor force was growing at a rate of 3.5 percent. Besides the serious production and employment losses, real salaries fell by a staggering magnitude both in bolívar and dollar terms.

In the face of this situation, which could have rapidly unraveled into a major crisis, the authorities in 1986 adopted a growth-oriented strategy. For this purpose they considered it essential to implement comprehensive economic policies and to start a program of structural reforms; it was also necessary to reformulate the terms and conditions of external financing; the quantified economic program was designed and implemented in order to accomplish these goals.

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<sup>1/</sup> See Appendix Table.

During 1986 the growth objective was attained with a similar level of imports as in 1985, and debt amortization was fulfilled as programmed, but Venezuela did not receive the expected support from the international community; therefore, reserve assets declined sharply. In view of this outcome, the Government was prompted to devalue the controlled rate by nearly 100 percent, reducing the value of the bolívar in real effective terms to the level prevailing in the mid-1970s, and to leave the free market for tourism and private capital transactions.

The quantified economic program for 1987 was formulated with the immediate objective of continuing with the strategy of medium-term economic growth that was initiated in 1986 and of protecting international monetary reserves so as not to let them fall below a level of about \$9 billion. Given the limited diversification of Venezuela's economy and the overwhelming importance of the public sector, the Government decided to concentrate its efforts on fiscal policy and structural reform. It was also considered that for the success of the program, external support from different sources would be needed in an amount of approximately \$2.3 billion. Accordingly, in the quantified economic program three targets were established: the international assets of the Central Bank of Venezuela should remain about \$9 billion, which meant a reduction of \$0.8 billion; the consolidated public sector deficit as a proportion of GDP would be similar to that of 1986; and monetary expansion would reach 18 percent in nominal terms. This program together with the devaluation of the currency at the end of 1986 constituted the basis for discussions with the Fund staff.

The authorities considered that, in order for the exchange scheme to succeed, certain requisites were needed, namely, the simplification of exchange control regulations and adequate macro-economic policies. In the first quarter of 1987, as a result of the devaluation, prices started to accelerate, and given the continued weakening of real wages, strong political and trade union pressures emerged, demanding a general salary increase. In view of this pressure, the Government decided to raise wages by 23 percent in nominal terms, which still represents a deterioration of a significant magnitude, and to increase some subsidies.

In July 1987, the Fund mission, in assessing the situation, observed that interest rates had become negative: that the public sector budget, if implemented as envisaged, would originate a deficit of over Bs 70 billion or 14 percent of GDP; that the spread between the controlled and free markets had widened; and that given the adverse state of financial markets, it would be difficult for Venezuela to obtain new lending. Thus, they urged the authorities to reformulate the economic program, reducing the fiscal deficit to about Bs 30-35 billion, to increase interest rates, and to unify the exchange rates.



Regarding the staff comments and recommendations, the authorities reiterated their willingness to continue cooperating with the Fund and indicated that they were in a process of reviewing interest rates. Moreover, they invited the Fund mission to return to Venezuela in the following weeks to hold further talks with them regarding the revision of public sector current and investment expenditures. When this second mission took place, the authorities proposed to reduce the deficit for 1987 to about 6 percent of GDP. In order to accomplish this target, the authorities emphasized that current expenditure would be maintained under control, investment projects would be trimmed, priorities would be established, and the less important projects would be delayed or eliminated. They also stated their intention to enter a program with the World Bank that focuses mainly on trade policy reform and contemplates a further reduction of the overall public sector deficit for 1988, a review of interest rates, and a progressive unification of the exchange rate.

On the external front, after reopening the negotiations with commercial banks to amend the multiyear rescheduling agreement, the authorities were able to achieve the following results: extension of the repayment period through 1999, reduction of the spread over the London interbank offered rate to 7/8 percent, and enlargement of the relending clause. Thus, the multiyear rescheduling arrangement was finally signed and completed in October 1987; trade finance increased by \$1.7 billion, and a balance of payments loan of 1.2 billion was obtained from Fondo Andino de Reservas at the end of 1987.

The following chart gives a comparison between preliminary figures for 1987 and the targets contemplated in the quantitative economic program:

	Projected in QEP	Actual	IMF Recomm. & Proj.
(1) Consolidated public sector (deficit as percentage of GDP) (IMF methodology)	6-7	5.4	5
(2) External current account deficit (in billions of U.S. dollars)	0.03	-0.07	-0.4
(3) Net international reserves			
Central Bank of Venezuela	9.0	9.4	
Central Bank of Venezuela & Fondo de Inversiones de Venezuela		11.9	10.2
(4) M2 (annual percentage change)	18	21.3	23-25

In 1986, one of the most remarkable achievements on the external sector was the balance of payments and current account deficit reductions of \$2.9 billion and \$1.9 billion, respectively. This result is explained mostly by the increase in oil exports, the preservation of imports in dollar value similar to the level of 1986, and the interest rate debt payments which were lower than initially estimated.

The capital account deficit was also reduced by \$0.6 billion in spite of public and private debt amortization by \$2.2 billion. With respect to private debt, it is worth mentioning that 398 contracts have been signed, amounting to \$4.5 billion, or 78 percent of the total expected value to be registered.

GDP grew at a rate of 1.8 percent; this figure reflects mainly the decline in oil production since nonpetroleum GDP grew by 3.2 percent. The most dynamic sectors were agriculture (4.1 percent) and manufacturing (3.7 percent), followed by construction and nontradables production. Unemployment decreased from 10.3 percent in 1986 to 8.5 percent in 1987.

Notwithstanding the fact that these figures are only preliminary, the authorities consider that some of the achievements deserve to be noted: the reduction of the fiscal deficit, the correction of the external sector disequilibrium, the maintenance of economic growth in the nonpetroleum sector, and the fall in unemployment. They also want to stress the accomplishment of the multiyear rescheduling arrangement and the normalization of the private sector's debt service.

On the negative side, the authorities are aware that inflation has accelerated to a historically high record for Venezuela: the accumulated consumer price index growth reached 34.7 percent in November 1987, in comparison with 12.7 percent the year before. The wholesale price index rose by 44 percent. From the authorities' viewpoint these results were derived mostly from the effects of the devaluation of the bolivar.

Although in 1987 net capital outflows were not registered, the free foreign exchange market reflected some speculative transactions. Furthermore, import demand was channeled through this market when RECADI--the office in charge of supplying foreign exchange for imports--did not attend to the demand on a timely basis. Due to these factors, the free exchange rate has depreciated significantly and has been fluctuating at about Bs 30 to the dollar in the past two months.

The authorities recognize that although some of the main targets have been achieved, the economic program for 1988 will continue to be framed in a medium-term perspective, where the main goals envisaged are price stabilization and the continuation of

output growth. Nevertheless, they have expressed their concern in relation to the uncertainty surrounding the oil market, and the limited availability of external finance. Given these constraints, the Government deems as a prerequisite an adjustment of the program depending on the behavior of those variables.

In view of the relatively small amount of nontraditional exports, the authorities acknowledge that diversification and growth of this sector will take time, especially due to the period needed to reach agreement on the required legal and institutional reforms, and to the evolution of the external environment, which remains extremely uncertain. They are of the opinion that if oil prices fall by a substantial amount, the economic prospects for Venezuela will be seriously affected, given that nonpetroleum exports constitute only 8 percent of the total and private exports only 5 percent.

Regarding the outline for 1988, my authorities are considering different oil price scenarios, but they are at a preliminary stage. Therefore, the main features of the program are along the following lines: (a) a reduction of the fiscal deficit; (b) strengthening of the external sector, aimed at diversifying and increasing nontraditional exports and maintaining international reserves at a reasonable level; (c) simplification of the exchange rate regulations; (d) continuation of structural reforms in relation to trade, industry, and privatization; and (e) a prudent monetary policy.

Finally, to support policy implementation and to strengthen their relations with the international community, the authorities will continue to hold conversations with the World Bank. Furthermore, they remain committed to fulfilling Venezuela's external obligations.

Mr. Zeas made the following statement:

After a prolonged period of recession from 1979 to 1985, which was accompanied by an important adjustment effort in 1986-87, the Venezuelan authorities have eased credit, increased public investment, and raised wages, thus partially restoring the real wage loss experienced during the recessionary years. Unfortunately, these policies have coincided with a continued decline in the terms of trade, led by a further drop in oil prices in 1986, which resulted in the deterioration of key financial variables.

Some progress was achieved in the fiscal and external sectors in 1987, compared with the previous year. Even more important, according to Mrs. Filardo's opening statement, during the current year, the authorities intend to pursue a tighter fiscal policy, a

moderate credit policy, a more flexible interest rate policy, and a desirable rate of economic growth consistent with external equilibrium. Moreover, some structural reforms will be implemented.

During the recession of 1979-85, there was an average annual rate of decline in real GDP of nearly 1 percent compared with the annual rate of population increase of nearly 3 percent. Imports dropped from \$12.6 billion in 1982 to \$7.5 billion in 1985, and the unemployment rate more than doubled to 13 percent.

During 1979-81, Venezuela, along with other debtor countries, faced interest rates that reached 20 percent. After 1981, interest rates declined, but the sharp drop in oil prices more than offset the savings gained from the lower interest rates, and further restraint on access to financial markets led to balance of payments deficits in 1982-83. In the following two years, these deficits were turned into small surpluses, mainly through expenditure control.

The stock of outstanding foreign debt was reduced by \$3 billion between 1982 and 1985; at the same time, the stock of gross international reserves increased by \$3.7 billion. These accomplishments occurred during a period in which oil prices dropped from about \$35 a barrel in 1981, to \$26 a barrel in 1985, causing sizable oil export revenue losses. These commendable accomplishments were particularly important because oil exports represented such a large portion--about 90 percent--of total exports.

Therefore, it is clear that, under difficult circumstances, Venezuela adjusted in an important and decisive way in the period up to 1985. Perhaps adjustment was too quick.

During 1986, oil prices again dropped sharply--by approximately one half, to \$13 a barrel--resulting in a loss of oil export revenue of approximately \$5.5 billion, equivalent to 12 percent of GDP. To restore the deterioration in real wages, the first wage increase since 1980--averaging 12.5 percent--was granted to workers not covered by collective bargaining. In addition, public investment was stimulated. As a result, the fiscal deficit widened to 6.7 percent of GDP, but this deficit was still much smaller than the oil revenue loss. Furthermore, in 1987, the deficit was reduced to 5.4 percent of GDP.

During 1986-87, growth in real GDP resumed and the unemployment rate was lowered to 8.5 percent. The balance of payments swung into a cumulative deficit of \$4.4 billion, including an additional net repayment of \$4 billion of foreign debt. The balance of payments deficits were financed by a loss of international reserves, which by the end of 1987 dropped to \$9.3 billion, equivalent to more than one year's imports; this was still a comfortable level.

The inflation rate, which had been contained at 10-11 percent a year during 1982-85, accelerated to 13 percent in 1986 and to 34 percent in 1987. The acceleration in the rate of inflation was the result of, among other factors, the devaluation of the bolívar. In order to prevent excessive speculation, price surveillance was carried out by the authorities with a degree of flexibility.

Interest rates, after reaching a plateau in 1984, continued to decline throughout 1987, becoming highly negative in real terms. According to the latest available statistics in International Financial Statistics (IFS), it appears that this fact did not thwart a healthy accumulation of financial savings in the banking system during 1987. For instance, quasi-money increased by 38 percent for the 12 months ended in September 1987. According to the most recent estimates of the balance of payments, given on page 8 of SM/87/243, there is no evidence of significant capital flight. Nevertheless, it seems that more interest rate flexibility could become necessary during 1988.

The somewhat less orthodox demand-management policies of 1986-87, the acceleration of inflation, the loss of net international reserves, and the fact that Venezuela had to wait more than two years, until February 1986, to reach agreement with commercial banks on its foreign debt refinancing request, appear to have excessively influenced expectations with respect to the exchange rate. The authorities adjusted the nominal exchange rate by approximately 237 percent during 1984-87; the rate was Bs 14.50 to the dollar in 1987. Thus, the real effective exchange rate was adjusted to the level prevailing in the mid-1970s, as Mrs. Filardo explained in her opening statement. The free market exchange rate, however, which applies to tourism, some imports, and capital transactions, reached Bs 30 to the dollar by end-1987, representing a sixfold adjustment, compared with the exchange rate existing in 1983 and a rate of inflation of only 88 percent during the same period. While the 1982-83 exchange rate might have been overvalued, it seems that the exchange rate adjustments which took place in the free market during 1984-87 were excessive. Perhaps the authorities could move toward a unification of the exchange rate and an elimination of export subsidies in the not too distant future, provided external conditions stabilize more than they are likely to in the immediate future.

Under the present circumstances, I support the authorities' intention to maintain moderate internal policies in 1988 aimed at growth with external equilibrium. I also support their intention to reform their trade, industrial, and privatization policies.

Mr. Yoshikuni made the following statement:

As the staff report clearly points out, the authorities made significant policy changes in 1986 in launching an expansionary economic program. Although a relatively high rate of GDP growth resulted, it was unfortunately accompanied by a re-emergence of economic distortions and a loss of international reserves, thwarting a consolidation of the adjustment momentum gained during 1983-85. One of the most worrisome features of distortion is the recent upsurge in the inflation rate, which has adversely affected the exchange rate and price structures, including interest rates. The authorities have responded mainly by strengthening regulations and controls on imports and prices, while continuing stimulative fiscal and monetary policies. Although a high growth rate understandably remains an important priority in Venezuela, the excessively expansionary policies cannot lead to sustainable growth in the medium term. In fact, there may be a risk that they will result in a loss of confidence among foreign creditors and investors. When an economy like Venezuela's is faced with a weak balance of payments position, growth should be achieved through market-oriented structural measures, supported by prudent demand-management policies.

In this regard, I fully support the staff view that such structural measures as the unification of exchange rates, and a simplification of the tariff regime should be given high priority. The authorities are now in the process of transferring import items to the exchange rate of Bs 14.50 to the dollar. Although this adjustment is welcome, the current exchange rate system still seems to be causing distortions; therefore, the establishment of a unified floating exchange rate system should be considered immediately. I welcome the fact that a comprehensive review of the tariff structure is now under way, and I hope that visible results can be attained in this area.

Price controls have become part of the economy, and their distorting effects should not be overlooked. The authorities intend to apply discretionary controls on most prices flexibly. However, it is essential that stronger efforts be made to reduce price controls in order to encourage private sector activity.

On demand management policies, I have little to add to the staff appraisal, which is, on the whole, appropriate.

Fiscal policy must play a key role in bringing the economy back on an adequate adjustment path. I welcome the authorities' intention to reduce the deficit in 1988 by cutting subsidies. However, as suggested by the staff, further efforts should be made in this area. In particular, capital expenditures of 16.3 percent of GDP for 1988 still seem high in light of the present uncertainty about future oil prices. Investment projects need to be implemented on a priority basis.

Monetary policy must be kept tight and negative real interest rates must be corrected as a matter of urgency. The success of the tight monetary policy largely depends on the size of the public sector's borrowing needs; hence, an austere fiscal policy is required. In this context, I hope that the authorities will strengthen their efforts in the fiscal area along the lines suggested in the staff report.

I would like to stress the importance of the Venezuelan consultation in the context of enhanced surveillance. Although the country does not resort to using Fund resources, the staff report will be distributed to private creditors and will serve as a basis for debt negotiations between them and the Venezuelan authorities. In this connection, it is regrettable that there is a difference of views between the authorities and the Fund staff on the fiscal policy target. Accordingly, I appreciate the efforts of the Venezuelan authorities to narrow the fiscal gap, as explained by Mrs. Filardo.

Mr. Lankester said that he fully shared the views expressed in the staff appraisal. As Mr. Zeas had pointed out, the authorities had conducted a successful adjustment program during 1983-85, but in 1986, they had shifted to an excessively expansionary policy stance. After six years of declining or static GDP, the authorities' desire to reduce the burden on the economy was certainly understandable, but the timing and extent of the expansion of domestic demand in 1986 had been unfortunate. He wondered whether the authorities could not have restrained their enthusiasm for resumed growth in 1986, when it became clear that oil revenues were not going to be sufficient. Although the growth outcome for 1986 had been rather favorable, it had been clearly unsustainable in terms of the large imbalances that emerged. The authorities seemed to have begun moving in the right direction in restoring growth, but it was not clear whether the pace of the resumed adjustment was adequate to allow a return to sustainable growth, particularly in view of the oil price weaknesses. Venezuela was a resource-rich country, with considerable economic potential. However, to realize that potential, a major effort would be required to improve the macroeconomic policy stance and to achieve greater liberalization.

The strong fiscal position in 1984-85 had been followed by a rather large slippage that resulted from the low oil prices, which led to a considerable deficit in 1986, and that was coupled with a major expansion of capital expenditure. While oil revenues rose in 1987, the deficit had not been significantly reduced, owing to the substantial rise in current expenditures. Some reduction in the fiscal deficit was projected for 1988, but it did not appear to be adequate. Furthermore, the expected reduction was based on what appeared to be an unduly optimistic estimate of oil prices. Unless the oil price rose significantly from its current level, a further increase in the deficit seemed inevitable in the absence of further adjustment measures.

The fiscal deficit for 1987 was already substantially higher than what the staff had considered to be compatible with the authorities' targets for inflation and international reserves. Any deficit reduction expected from the underexecution of public investment plans in 1987 was likely to have been offset by falling oil prices. He agreed with the staff that stronger efforts needed to be made on the fiscal front in 1988. The staff had made a number of very helpful suggestions as to how that problem might be approached, and the authorities should give those suggestions serious consideration.

The domestic financing needs of the public sector were a major determinant of the rate of monetary expansion, and the failure to control the deficit was a major factor in the rapid rise in the inflation rate during 1987. Strongly negative real interest rates seemed to be a problem. The authorities' recognition of the need for changes in monetary policy was welcome, as was the proposed 4-5 percent increase in controlled interest rates. However, the authorities' apparent intention to rely on a decline in the rate of inflation for further adjustments in real interest rates seemed less than convincing, and they should ultimately be aiming toward market-determined interest rates.

Exchange rate policy had been weak since the end-1986 devaluation. The shift of transactions from the preferential exchange rate to the controlled rate would help to some extent. However, the wide spread between the controlled rate and the free market rate--although partly reflecting seasonal factors--suggested a need for further major adjustment. The authorities should unify the exchange rate system as quickly as possible to remove the serious distortions arising from the coexistence of four such divergent rates.

Distortions in the tradable goods sector were compounded by what appeared to be a very haphazard tariff system, with rates ranging from zero to 100 percent and widespread exemptions. As the staff had noted, increasing the uniformity of the system and replacing import controls with tariffs could contribute significantly to fiscal adjustment as well as to reducing distortions. Therefore, the proposed World Bank trade policy loan seemed entirely appropriate. He hoped that a rapid pace of liberalization could be achieved under that program, and the staff should provide some indication of the likely timetable for reform. The recent easing of restrictions on foreign direct investment and the introduction of a debt-equity conversion scheme were also welcome, although substantial improvements in exchange rate policy would be necessary before the benefits of those policies could be fully realized.

Mr. Prader made the following statement:

The adjustment burden imposed on the economy by the combined effects of the international debt crisis and the weakness of the international oil market has been an especially heavy one, and the authorities are to be commended for their continuous commitment to the international financial community, despite severe financing



conditions. Mrs. Filardo has illustrated the magnitude of the financial effort with solid evidence, which requires no further comment. However, the extreme fragility of Venezuela's gains, after five years of effort to correct the external and domestic imbalances, suggests that insufficient attention has been paid to the fundamental obstacles blocking Venezuela's entry to a sustainable growth and adjustment path. In particular, a more vigorous and systematic correction in the coming years is called for with respect to the overreliance on administrative controls and ad hoc measures to reduce financial imbalances and the excessive dependence of the export and domestic revenue base on oil receipts.

With the benefit of hindsight, it is clear that the adjustment program launched in 1983 relied too heavily on domestic demand restraint and the introduction of price and exchange controls. Perhaps the Fund failed to caution the authorities strongly enough at the outset that any improvement in domestic and external finances would be short lived unless it was supported by a more fundamental restoration of sound output prospects. Indeed, the 1983 program may have weakened, rather than strengthened, the underlying framework of the economy. More recent developments have clearly shown that the radical relaxation of financial policies decided in late 1985--though seen at the time by Venezuelan policymakers as the only way of arresting the continued erosion of output--led almost automatically to a rebound of domestic imbalances to previous levels.

While the authorities' decision to take new actions to regain the adjustment path is welcome, I am concerned that these new measures may once more perpetuate the role of administrative intervention in the economy, instead of phasing it out. Specifically, I fear that the new program relies too heavily on widespread intervention in the allocation of external and domestic resources, which will once more overload the public finances and offset the positive allocative effects achieved by devaluing the bolívar.

In addition to these immediate concerns about the present adjustment actions, there is a continuing real risk that the domestic finances will not be permanently stabilized, that inflationary pressures will continue to dim the investment and savings outlook, and that the export base will not improve substantially. Therefore, during the next consultation under enhanced surveillance, the authorities should begin substantive discussions with the Fund on a credible plan for phasing out the present controls on the process of price and exchange rate formation that would have the lowest social and economic cost.

Another task for which a comprehensive plan seems urgently needed is the diversification of the export and domestic revenue bases, both of which are too closely dependent on developments in the international oil market. According to the background paper,

nonpetroleum products accounted for only 8 percent of total exports over the past five years, while revenues from the petroleum sector make up 55 percent of total government revenue. Although a number of measures aimed at correcting these figures have recently been implemented or announced, Venezuela still seems to lack the kind of comprehensive diversification strategy from which a more durable export and public sector revenue structure can gradually emerge.

Liberalization of the investment laws is essential for promoting this needed diversification of the production structure, and the Government has recently taken decisive steps in that direction. It is not surprising that these first steps indicate that an effective reform of the investment regime will have to be supported by much bolder liberalization in all areas affecting the country's allocation and production structures. In the final analysis, the need for deregulation is inseparable from the need for diversification; the two needs must be addressed with a combined strategy if the economy is to be revived. Therefore, I hope the negotiations with the World Bank on a trade policy loan will soon be concluded, that they will result in the adoption of a more systematic policy, and those negotiations will be followed by a more intensive dialogue with the Fund on the deregulation of the economic structure.

Venezuela's multiyear rescheduling arrangement and process of enhanced surveillance provide an appropriate opportunity for embarking on a comprehensive medium-term strategy, but they are also beset with potential dangers. While the multiyear framework now governing Venezuela's arrangements with the commercial banks provides an ideal situation for launching adjustment policies with a longer-term perspective than annual rescheduling arrangements ordinarily permit, the quantified economic program imposed on the authorities as a condition of the multiyear rescheduling arrangement will continue to focus the attention of policymakers on the kinds of short-term performance criteria the banks are accustomed to using as a basis for their lending decisions. These competing requirements will be an enormous challenge for the authorities in coming years, since they will have to demonstrate that, even while wearing a financial straitjacket, they can implement the kinds of growth-oriented policies from which a stronger economy can emerge. The recovery of Venezuela's nontraditional exports shows that this is not an impossible task, and should encourage the authorities to move ahead in the preparation of needed reforms.

Mr. Marcel made the following statement:

At the end of 1985, the authorities implemented a program aimed at boosting the economy, which was effective in restoring a higher level of activity. As this chair noted during the

discussion of the midyear consultation with Venezuela in March 1987, the increased activity has been very favorable, considering the sluggishness of the economy since the late 1970s. Venezuela requires a significant rate of growth to support its expanding population and to raise the standard of living for its lowest-income inhabitants. Consequently, my authorities sympathize with the authorities' expansionary objectives.

However, reflation has not been without negative side effects: the excessive stimulation of demand had caused large internal and external imbalances, a sharp increase in inflation, and a deterioration of monetary conditions. It is clear that the measures taken by the authorities at the end of 1986 to tackle those problems were insufficient. The devaluation of the bolívar was certainly appropriate, but it should have been accompanied by further policies aimed at keeping domestic demand more effectively under control.

Implementing strong financial and structural measures is the best way to ensure sustained growth in the coming years. My authorities are convinced that steps must be taken to reduce the public sector deficit in line with the objectives of balance of payments equilibrium and reduced inflation. Both expenditure and revenue measures are needed. On expenditures, I agree with the staff that a postponement of low-priority investments should be envisaged. Although the strong public investment program has played an important role in the recovery of growth, private investment is also important, especially for the diversification of the economy and the promotion of medium-term growth. Therefore, it is necessary to lower the public sector deficit further in order to avoid crowding out the private sector.

Tightening monetary policy is crucial to more effectively control inflation and achieve the balance of payments objective; this further demonstrates the need to limit the public sector deficit, drastically reducing public sector recourse to domestic bank financing--or even better, eliminating it. In addition, interest rate policy must be modified, not only to control the increase in liquidity, but also to encourage financial savings. Another major reason for keeping demand under control would be to manage wage policies more effectively.

Prospects on the external side remain fragile. There was a substantial improvement in 1985, and the growth of nonpetroleum exports is particularly satisfying. The fact that Venezuela has practically completed the process of rescheduling its public and private external debt with commercial banks will ease its immediate debt service burden. However, it seems unavoidable that Venezuela will have to raise a significant amount of new funds abroad, and its success will depend on the soundness of its economic policies.

It is probably not feasible to introduce a unified floating exchange rate at this time. However, it is very important to improve the process of exchange rate unification, since the current exchange rate system is costly and distortional.

I stress the need to implement some important supply-side measures aimed at developing a more diversified economy, which would reduce Venezuela's sensitivity to changes in petroleum prices. As mentioned above, early results in certain sectors are already providing encouraging signs that this policy should be further developed. To this end, private investment should be stimulated.

The authorities' willingness to encourage foreign investments is welcome. They should continue in this vein, since these investments are not only a means to strengthen the balance of payments, but also to stimulate the competitiveness and the efficiency of the economy. To improve competitiveness, it is necessary to reduce structural rigidities and further liberalize the economy, especially with respect to trade. My authorities understand that this task will require more demanding policies, but Venezuela has great economic potential; therefore, it is capable of achieving such goals. Furthermore, the pursuit of these goals is the best way for Venezuela to realize its great potential.

Mr. Grosche made the following statement:

Compared with the report for the 1986 midyear Article IV consultation, the staff report before us seems to indicate that the authorities have made little progress in the policy areas identified by the staff and the Board as requiring decisive corrective action.

It is regrettable and clearly not in the long-term interest of the economy that the significant adjustment of the controlled exchange rate in December 1986 has thus far not been supported by the necessary strengthening of fiscal, monetary, incomes, and structural policies. This state of affairs is certainly less than satisfactory.

Views held by the authorities and the Fund on the appropriate course and pace of economic policy actions continue to differ, particularly on fiscal deficit targets. Such differences have already given rise to some concern in previous consultations, when it was felt that a further convergence of views between the authorities and the Fund staff on economic policies would be beneficial to the enhanced surveillance procedure approved for Venezuela. The execution of the Fund's enhanced surveillance task seems to be further complicated by the fact that the quantified economic program for 1988 could not be prepared in time for the staff

missions. The absence of specific data for financial policies and clear commitments and timetables with respect to structural adjustment measures make it difficult to assess economic policies for the future.

The staff report was subdued and perhaps not candid enough; however, it makes it clear that more needs to be done to bring this debt-burdened economy back on a path of sustainable economic growth. In particular, the need for a further tightening of financial policies is one of the most important prerequisites for restoring external equilibrium. To this end, Venezuela would be well advised to restrain fiscal and wage policies, conduct an interest rate policy more conducive to the generation of domestic savings, and establish a unified exchange rate system as soon as possible. Venezuela's ability to raise new money abroad clearly depends on its ability to formulate and implement a credible economic program along the lines outlined in the staff report.

With respect to structural policies, the continued pervasive system of government trade controls and regulations remains a matter for concern, given their distorting impact on private investment activity and the burden they place on the budget. Despite expansionary fiscal policies, private sector investment has remained at low levels, indicating that further efforts are needed to reduce price controls and to reform the trade system. With regard to trade, it is encouraging to know that the authorities are discussing a comprehensive tariff reform with the World Bank. It would be interesting to hear from Mrs. Filardo or the World Bank representative on Venezuela's chances of qualifying for a program loan from the World Bank.

Mr. McCormack made the following statement:

The economic situation in Venezuela is a cause for concern: inflation has escalated considerably and reserves have fallen sharply, despite various exchange and trade restrictions. Although the economy has grown, and as Mrs. Filardo pointed out, there are some other noteworthy and welcome developments, it appears that the recent growth performance is not sustainable, given the prevailing mix of policies. While Venezuela has faced very difficult circumstances in the past several years, recent demand-management policies have been too loose, with the authorities preferring to rely on the maintenance and expansion of controls in a number of areas. The staff report emphasizes that if present policies continue, the authorities' goals for 1988 are not likely to be achieved.

The degree of control and regulation in the economy has had an inhibiting effect on new investment and has resulted in distortions. It is clear that an easing of such controls will be required to sustain increased investment and output. I endorse the observations of Mr. Prader on this point.

Sound macroeconomic policy will be critical if the decline in international reserves is to be arrested decisively, and if the authorities are to achieve their goals of attracting substantial new funds from abroad and establishing sustainable, noninflationary growth.

The public sector deficit is of particular concern. The staff estimates that for 1987 the deficit will be about the same as it was in 1986. Although Venezuela has been facing difficult circumstances, it is unfortunate that large increases in revenue in 1987 have been largely offset by increases in expenditure, so that an opportunity to achieve important deficit reductions has been missed.

The authorities estimate that the overall public sector deficit will decline to about 4 percent of GDP in 1988, facilitated by reduced agricultural and exchange subsidies. While this improvement is welcome, the staff analysis suggests that an even larger reduction is required if the deficit is to be consistent with the authorities' balance of payments and inflation objectives. Therefore, if these goals are to be achieved, additional restraint in government expenditures is called for--perhaps by postponing or eliminating low-priority projects, and reducing current outlays for subsidies. In this connection, I welcome the authorities' intention to re-examine investment priorities and to improve the monitoring of capital outlays in the public sector. Expenditure restraint will probably need to be accompanied by new revenue measures, such as increases in the prices and tariffs of public enterprises, as suggested by the staff. My authorities would be particularly supportive of measures to broaden the tax base through, for example, the introduction of a general sales tax.

As to the increase in the rate of inflation during 1987, the authorities have tended to stress the role of exchange rate devaluation. However, expansion of bank credit appears to have played an important role as well. Tight control of financial policy will be necessary if the inflation goal is to be achieved and a further loss of international reserves prevented; such a policy stance would also facilitate the eventual removal of price controls, which is highly desirable in order to reduce allocative distortions in the economy.

The staff has identified two factors which have caused problems for the monetary authorities: the large public sector deficit and highly negative real interest rates. While I welcome the interest expressed by the authorities in raising nominal interest rates somewhat, the degree of their commitment with respect to this objective is unclear, and the timetable for these changes is as yet undefined. Perhaps the staff or Mrs. Filardo could clarify the authorities' current thinking on the matter. More generally, I agree with the need to establish a more market-determined

interest rate structure as soon as possible. In addition, I endorse the staff's recommendation to pursue a cautious wage policy in order to support monetary policy and to assist in fiscal deficit reduction.

An important objective of the authorities, balance of payments equilibrium in 1988, will be influenced greatly by the liberalization of complex and strict trade and exchange rate policies. The authorities should unify the exchange rate and pursue a more responsive and flexible exchange rate regime. These actions would assist the commendable efforts of the authorities to broaden the export base, and at the same time, decrease the need for capital and trade controls, thereby encouraging investment flows from abroad.

The authorities' intention to revise the presentation of the quantitative economic program to increase its transparency and usefulness is welcome, as is the new multiyear rescheduling arrangement. The staff should provide an update on progress achieved thus far in the normalization of private sector external debt service.

Mr. Nimatallah said that the present economic problems started in 1986, when the authorities decided to increase public expenditure on investment by more than 40 percent in real terms, to increase wages by 12 1/2 percent, and to ease monetary policy. All of those measures were implemented within a year that witnessed a sharp decline of approximately 50 percent in oil revenues. Two important issues were brought to mind: how could a developing country, like Venezuela, absorb this large increase in investment expenditure within such a short time? It was bound--as it did--to lead to inflation, simply because new expenditures caused bottlenecks, and therefore higher prices. Bottlenecks, in turn, led to lower productivity and lower returns on capital. Therefore, he wondered whether Venezuela could attract enough capital to finance its increasing fiscal deficit.

He agreed with the staff that after completing the process of rescheduling private and public external debt with commercial banks, Venezuela's ability to raise new funds from abroad would depend on the quality of the economic program to be implemented, Mr. Nimatallah went on, and he agreed with the staff that such a program should be based, among other things, on restrained fiscal and wage policies and on a gradual unification of exchange rates. The authorities needed to aim at the gradual restoration of fiscal balance if they intended to restore noninflationary, sustained growth over the coming years. The authorities could gradually reduce unnecessary current outlays by reducing waste and certain subsidies. But, more important for the immediate future, they could postpone or prolong the implementation of some investment projects, depending on their degree of priority. More structural reforms in the trade system and a phasing out

of price controls would be needed to encourage domestic and foreign investment. In addition, the authorities needed to follow appropriate monetary and wage policies to help control inflation.

Mr. Di Mauro made the following statement:

Recent developments show that the economy is overheated. Inflation is unusually high and is rising, fueled by the demand pressures caused by a very generous wage policy, a very accommodative credit policy, and an expansionary fiscal policy. At the same time the external accounts are worsening steadily showing that the economy is on a clearly unsustainable path, especially in view of recent developments in the oil market.

Under these circumstances, and in view of the continuous disagreement between the staff and the authorities on almost the entire range of desirable policies, I wonder about the wisdom of maintaining the enhanced surveillance arrangement with Venezuela. As this chair has said on previous occasions, the Fund, in officially monitoring a program, is also to some extent endorsing the members' policies. Therefore, whenever disagreements arise, the Fund should clearly point out the consequences of following the proposed course of action by presenting a clear and specific quantitative assessment; then, if the disagreement persists, the Fund should suspend the arrangement. Should the program fail, the credibility of the Fund would be at stake.

Turning to the economic policies being followed by the authorities, I generally concur with the thrust of the staff analysis, although I share Mr. Grosche's doubts about the quality of the staff assessment, and would have preferred a more explicit evaluation of alternative policies.

The staff's balance of payments projections, and therefore, the estimated external financing needs are subject to a large degree of uncertainty and are scarcely indicative of the necessary course of action. Recent developments in oil prices have already affected export earnings, substantively reducing them by at least \$1 billion, or by more than 10 percent. The balance of payments and inflation targets are clearly inconsistent with fiscal policy, and the requirement for new external financing appears to be at odds with the already restrictive attitude of the private capital markets and as well as with the past policy of debt service reduction. In view of such inconsistencies, it would have been helpful to have a more clear presentation of better alternatives. In particular, it would have been useful to have a comparison between the baseline scenario, based on current policies, but linking fiscal deficit and balance of payments developments, and an alternative scenario based on the policies suggested by the staff. In this respect, while the table presented by Mrs. Filardo in her opening statement is useful as a comparison, it also shows that important differences exist between



the staff and the authorities with respect to the underlying assumptions. I would appreciate further clarification on this matter.

Structural policies aimed at enhancing production diversification and promoting economic efficiency should represent one of the main aims of the adjustment process. Overdependence on oil earnings and overprotection of the manufacturing sector are a cause for the economy's extreme sensitivity to external developments and for the inflexibility of supply-side responses. The progress made thus far has not been sufficient. Although the oil sector's contribution to GDP has been declining during recent years, its contribution to total export earnings maintains a historically high level. In addition, the complex system of protection has been only partially removed. While certain positive signs have to be acknowledged, like the modification of the investment code, and the reduction in the scope of the preferential exchange rate system, major steps still have to be taken to reduce the widespread distortions in the pricing system, and therefore, in resource allocation. The authorities should make faster progress in the process of unifying the exchange markets, import liberalization, and tariff reform. Like Mr. Grosche, I find it regrettable that a more specific timetable for structural reforms has not yet been established.

Containment of the fiscal deficit is necessary to relieve the pressures on external accounts and on monetary aggregates. The indications contained in the staff report on this issue are not completely reassuring. A bolder attempt should be made to contain current fiscal expenditures. In this regard, the proposed delay in already scheduled investment projects should be carefully examined, as it tends to hold up the necessary process of production diversification. In addition, the containment of current expenditures would imply a containment of wage increases, which represent a major source of macroeconomic disequilibrium. A more specific contingency plan should be designed should the projection for oil prices and external financing turn out to be too optimistic.

Mr. Salehkhoulou made the following statement:

The economy of Venezuela, heavily dependent on oil and other primary commodities, has been suffering from the sharp downturn in those commodities' markets for the past few years. As noted by the staff, oil and its derivatives constitute a major component of the Venezuelan economy, accounting for 85 percent of export receipts, two thirds of public sector revenues, and about 20 percent of GNP. Exports of oil declined from \$19 billion in 1981 to \$7 billion in 1986. During the same period, the terms of trade deteriorated by 50 percent, corresponding to a loss of 14 percent of GDP.

These figures draw a fairly clear picture of the problems facing developing countries in general, and the oil producing countries in particular. In this connection, the authorities should be commended not only for their courage in having undertaken a series of harsh adjustment programs--without recourse to new financing--but also for having managed to actually reduce the country's external debt by more than \$5 billion between 1982 and 1987.

Therefore, I am surprised by the somewhat negative tone of the staff report, and by the insistence on the adoption of measures that are mostly of a demand-management variety. The recommendations made to the authorities are of the usual type, including, inter alia, a lower budget deficit, tighter money and credit policies, higher interest rates, and a further devaluation. The efforts by the authorities and their seriousness in addressing these grave problems merit a more comprehensive approach than the classical, narrow financial one. Of course, I am aware of the involvement of the World Bank, but I have the impression that this involvement is, at least so far, limited to trade liberalization, which would not, in the short term, be of help to the economy.

The recommended policies that were vigorously pursued between 1983 and 1985 did result in a shift from large deficits to large surpluses in the budgetary and current account balances--allowing the authorities to reduce debt and raise reserves substantially. However, these were achieved at extremely heavy economic and social costs. Real GDP in 1983-85 declined, unemployment rose sharply, and inflation did not abate much. Moreover, consumption declined by 9 percent, with per capita consumption falling by about 16 percent, and investment--which is supposed to assure future growth--was halved from 20 percent of GDP in 1982 to 9.5 percent in 1985 while, as the staff recognized, private investment stagnated following a sharp decline in 1982.

The Board should take the opportunity to examine this case in order to conduct a thorough review of the policies the Fund recommends to its members. For example, the axiom that sharp reductions in budgetary deficits necessarily lead to higher levels of private investment by releasing resources--does not seem to work even in relatively more advanced developing countries, which like Venezuela, have followed fairly conservative policies and have managed to maintain a rather high level of external reserves.

In view of the adverse economic and social consequences which followed the country's faithful implementation of policies recommended by the Fund under the much-heralded enhanced surveillance up to 1986, the authorities were justified in changing course to a more growth-oriented strategy--one that should be supported by the Fund and the international community. The goals envisaged, as

described in Mrs. Filardo's opening statement, seem reasonable and, at least as far as 1987 is concerned, do not appear to have been based on estimates much different from the staff's.

As for 1988, despite the unstable situation in the oil markets, and recognizing that the authorities' projections could warrant some fine tuning, I strongly support their approach to growth. As I mentioned earlier, given the more than reasonable debt position and the relatively comfortable level of reserves, the international financial community--especially commercial banks--should alleviate the adverse consequence of any unforeseen developments through the provision of contingency financing. In this regard, Venezuela's perfect record in fulfilling its external obligations, as reiterated by Mrs. Filardo, should be given full recognition.

Mr. Dallara made the following statement:

Since the last midyear Article IV consultation with Venezuela, the authorities have taken some additional positive steps to bring about further improvements in the fiscal position, to normalize relations with creditors, and in a number of other key policy areas. The overall thrust of economic policy in Venezuela, however, has not changed significantly, and therefore serious distortions and imbalances remain that hinder the economy and the authorities in achieving the desired level of sustainable economic growth and a sustainable payments position.

The medium-term forecast proposed by the staff indicates the need for additional financing from foreign creditors and other sources during the years ahead, and indeed the authorities' own economic plans contain built-in assumptions concerning additional net new financing. Obtaining such financing will be contingent on, among other things, building confidence in economic policies and developing an economic program that will encourage such confidence and provide a basis for increased foreign investment and capital flows. While there are certain specific elements of such a program emerging, and the authorities have taken a number of helpful steps within the past year to correct the imbalances, we agree with many other Directors that a more comprehensive liberalization and adjustment program is needed, one that includes, on the liberalization side, substantial changes in pricing, interest, and exchange rate policies, foreign investment, and exchange and trade regulation policies. This, combined with further fiscal restraint, subsidy reduction, and tighter monetary policy could provide a sounder basis for attaining the authorities' own economic objectives.

Progress, of course, has been made in improving the fiscal situation, but there is clearly a need for additional significant

fiscal restraint underscored in part by the recent oil price and domestic price developments in Venezuela. We noted with interest the potential size and scale of that fiscal adjustment suggested by the staff, depending on how various key economic variables may develop during 1988, which certainly suggests a need for a particularly cautious approach on the fiscal side. We urge the authorities to develop, and to be prepared to put into place, additional measures should the fiscal position not improve as expected or deteriorate further.

In the area of public sector enterprises, we question the fact that these enterprises are not included in the budget figures, and we would appreciate staff comment on their impact on the overall fiscal position of the Government. While we welcome steps that have been taken thus far to allow private sector participation in certain government enterprises, as well as the adoption of legislation allowing the Government to privatize enterprises, we believe these actions are much too limited in scope given the need for a more efficient allocation of resources and we hope that a more comprehensive reform effort in this sector, allowing private expansion into a number of other areas of economic activity, will be contemplated.

Further restraint in monetary policy is certainly needed, and in this connection we, while welcoming the authorities' intention to adjust controlled interest rates by four to five percentage points, urge that this action be taken very soon, and that the authorities engage in a more general liberalization and adjustment of interest rates toward real levels throughout the economy, something that does not appear to be contemplated according to current policies.

Even with recent changes, the regulated pricing policy remains a hindrance to improvements in private investment and resource allocation. Here, I simply associate myself with the specific comments of the staff and other Directors who have encouraged further liberalization in pricing policy.

On the external side, the projected level of nontraditional exports in 1987 shows some positive signs, and yet overall, the efforts to diversify the export base have not proven particularly successful. Here I noted with interest the concern the authorities apparently have about this lack of diversification, as suggested in Mrs. Filardo's brief statement, and yet it is not clear that the policy implications of the need to diversify have been fully drawn by the authorities. In that sense, it seems that the complex exchange system combined with the many pricing controls and many other controls in the economy seriously inhibit the kind of diversification that the authorities are looking for. Unification of the exchange system could assist in the efforts to diversify the economy. Unification of the exchange system should, in fact, go

in tandem with the liberalization of the trade system, which we understand is under discussion with the World Bank. We urge the authorities to work closely with the Bank to put into place major structural reforms in the trade area that could, along with other supporting policy changes, be an important contributor to economic growth and the reduction of imbalances. Liberalization is needed in the area of direct investment policy, and here again, while welcoming the steps that have been taken and those regarding debt equity swaps, we believe much more needs to be done.

Turning to the subject of enhanced surveillance, we have expressed reservations on a number of occasions in the past concerning the apparent effectiveness of the enhanced surveillance arrangement between Venezuela and the Fund. Regrettably, many of these concerns remain with us today. Mr. Grosche, Mr. Di Mauro, and many others have touched upon many of these concerns already, and therefore, I would first associate myself with their comments and the comments of others, and add perhaps the following specific thoughts:

It does not appear to us that the authorities have made a consistent effort to take into account Fund recommendations on economic policies in certain key policy areas. We recognize, of course, that the intent of every enhanced surveillance arrangement is not necessarily that the authorities reach full agreement with the Fund on all key policy areas. At the same time, it is our understanding that this enhanced surveillance arrangement is to build a close consultation process which should over time reduce divergences between the staff and the authorities on key policy objectives and assessments.

May I recall just a few sentences that were stated by the staff in a May 1985 Board discussion concerning the enhanced surveillance arrangement with Venezuela (EBM/85/115), the staff representative stated:

Enhanced consultation should serve as a means of bringing about modifications in the policies of the member country, where needed, and under normal circumstances, the staff representative went on, should there be a series of reports in which the staff and the authorities took differing positions, creditors receiving the report would notice the differences and at some point would arrive at certain conclusions about whether to continue the arrangement to reschedule or restructure a country's debt. Thus, there appeared to be a built-in bias in favor of bringing the two parties together and in favor of the staff's being able to influence the authorities in making the necessary policy modifications.

Regrettably, the evidence suggests on balance that that built-in bias has not developed as the staff member had hopefully anticipated. The bias has not been toward a considerable narrowing of views as far as we can tell, and we urge the authorities and the staff to intensify their efforts in the next mission to move in that direction. For example, it seems to us that the quantified economic program process is not characterized by close consultation, at least not as far as we can gather. Either the authorities should bring the Fund more closely into the formulation of their quantified economic program in a way that would more closely reflect some of the views of the staff, or, if that were considered inappropriate, we would certainly consider it important, as Mr. Di Mauro suggested already, that the staff provide us with alternative quantified projections as an indication of what reasonable policy objectives might be considered to be appropriate with the achievement of these policy objectives. The staff, if we understand its report properly, first does not believe that the quantified economic program is internally consistent in all respects and, second, does not believe that the current policy stance in some key policy areas is consistent with the achievement of the target of the quantified economic program. In addition, we tend to share some of the comments made earlier by Mr. Grosche, Mr. Di Mauro, and others concerning the need for a frank and candid analysis by the staff--and, I would say, throughout the report, not just in a staff appraisal section.

We urge the authorities to rethink some key aspects of their policies and to build on progress where important positive steps have been taken. We hope, with the next mission, that the staff will come back to the Board with a more constructive enhanced surveillance arrangement, more constructive for the authorities as well as the Fund.

Mr. Mawakani made the following statement:

It is encouraging to note that Venezuela continues to make progress in its adjustment effort, as Mrs. Filardo indicated in her opening statement. This is especially commendable in view of the fact that oil prices in 1987 were quite unstable. The measures that the authorities are implementing seem to be in the right direction, as they have boosted the growth in the non-oil sector, and particularly in the agricultural and manufacturing sectors. Furthermore, there was a significant drop in the unemployment rate, and the fiscal and current account deficits were reduced in relation to GDP.

In view of the substantial fall in the standard of living since 1982, it is appropriate that the authorities are focusing on the growth-oriented strategy introduced in 1986. In this context, I welcome the emphasis placed on fiscal and structural reforms.

In the fiscal sector, I suggest that more attention be given to a reduction in the different types of subsidies that presently exist. The measures taken recently by the authorities to reduce agricultural and exchange rate subsidies are welcome, and I encourage the authorities to give adequate consideration to the measures proposed by the staff.

Regarding exchange rate policy, the shift of most current transactions to the rate of Bs 14.50 to the dollar is a positive step, as it will remove many of the distortions that presently exist. The work under way to develop a comprehensive tariff reform along the lines recommended by the World Bank is also welcome, and its implementation could accelerate the process of exchange rate simplification.

The authorities should be commended for remaining current in their external debt obligations, despite the sharp fall in export earnings. I share the authorities' disappointment at the poor response of the international financial community to their adjustment efforts. Nevertheless, these efforts must be continued in order to restore economic growth and balance of payments viability. Venezuela has great economic potential because of untapped natural resources. Efforts should be concentrated on developing those resources to diversify the productive and export base of the economy. In that respect, the contribution of foreign investors should not be neglected, as this would also help in reducing the debt burden while ensuring inflows of capital. In this context, the recent reform of investment legislation is welcome.

While some progress has been made in reducing the economic imbalances, still more needs to be done to restructure the economy. Mrs. Filardo's opening statement indicates that the authorities are taking measures in that direction.

Mr. Othman made the following statement:

After significant improvements in its public finances and in its external position in 1983-85, Venezuela was exposed to a further sharp decline in the price of oil in 1986, which reduced export revenue by almost one half. It was unfortunate that this sharp decline in revenue occurred at the same time the authorities decided to shift their general policy stance to reactivate the economy. As a result, the overall fiscal balance moved from a surplus of 5 3/4 percent of GDP in 1985 to a deficit of 6 1/4 percent of GDP in 1986, bank credit increased, inflationary pressures intensified, the spread between the controlled and free market exchange rates widened significantly, the real interest rate turned negative, the current account shifted from a surplus of \$3 billion in 1985 to a deficit of more than \$2 billion in 1986,

and the international reserves declined by close to \$4 billion. To a large extent, all these developments reflect the severity with which the collapse in oil prices hit the economy in 1986.

Under these conditions, and to prevent further deterioration, it was essential that economic and financial policies be reconsidered and adapted to the new circumstances. Therefore, I welcome the new structural policies the authorities undertook at the end of 1986 and during 1987 in response to the changed circumstances, and I share the staff's view on the need to support these measures with appropriate fiscal, monetary, and incomes policies.

A sizable reduction in the overall public sector deficit is clearly needed if the balance of payments is to be restored to a viable position and economic growth is to be resumed. The fiscal measures that the authorities have already undertaken and their readiness to tighten control over public expenditure, as indicated in Mrs. Filardo's opening statement, is welcome. However, additional efforts on the revenue side would also be useful. A partial recovery in oil prices would provide an increase in revenue. However, any increase in revenue that results from treating the local currency counterpart of the revaluation of the Central Bank's foreign assets as part of the public sector's current revenue should be interpreted with caution, since such revenues are only accounting revenues, and if spent, their monetary impact would be similar to that of deficit spending.

While the authorities' concern about the adverse impact of a removal of ceilings, or a significant adjustment of interest rates, particularly on the mortgage market, is understandable, it appears that higher real rates of return are needed to encourage savings, restrain capital flight, and reduce pressure on the balance of payments. I welcome the authorities' intention to free interest rates for certain types of savings bonds, as hopefully this will help in reversing the recent downward trend in private savings.

The authorities' decision to continue shifting transactions from the preferential exchange rate to the more realistic rate of Bs 14.50 to the dollar is welcome; this action could be regarded as a positive step toward an eventual unification of the exchange rate at an appropriate level. The present multiple exchange rate system with its wide spread between the controlled and the free market rates is clearly distortive and makes the achievement of a sustainable external position and a more liberal trade system difficult. The authorities appear to recognize the detrimental impact of the exchange rate system on new foreign investment, and I welcome their decision to conduct all foreign exchange transactions for new foreign investment projects and joint ventures--with at least 80 percent production for exports--through the free exchange market.



The balance of payments is clearly sensitive to changes in the oil price, and calls for intensive measures on the supply side. It is also sensitive to changes in the value of the dollar, both because oil exports are denominated in dollars and because at least part of Venezuela's debt is denominated in dollars. The staff should comment on the net impact of recent movements in the U.S. exchange rate on Venezuela's balance of payments.

Mr. Morales made the following statement:

During recent years, Venezuela has been gradually adjusting to the changing circumstances of the world economy, mainly to fluctuations in oil prices.

The authorities have been pushing for economic growth, and the results attained in terms of GDP during 1986 and 1987 are clearly positive, especially considering the sluggish performance of previous years. Nevertheless, in 1986 growth was basically sustained by a high level of reserves that consequently declined by nearly \$3.8 billion. In 1987, the estimated overall trade balance was reduced to \$0.8 billion, which is 50 percent of the level previously projected by the staff. This is certainly a positive development. In addition, it is repeatedly mentioned in the staff report that this better than expected outcome is partially due to the improved performance of nontraditional exports, and I would appreciate further explanation from the staff on this welcome development.

The 1987 consolidated public sector deficit was 5.4 percent of GDP. It is encouraging that the authorities are conscious that further improvement is needed, and that, as Mrs. Filardo mentioned in her opening remarks, the authorities will consider the reduction of the fiscal deficit as one of the main features of their economic program for 1988. Nevertheless, the staff report suggests that to attain the targets for balance of payments and inflation, deficit reductions must go further than the present fiscal plans envisage. Therefore, the authorities should make every effort to curtail the fiscal deficit and to evaluate a set of measures that could reduce it even further.

As a necessary complement to the reduction of the fiscal deficit, a prudent monetary policy is required. I share the authorities' concerns about the existence of negative real interest rates. It is noteworthy that an increase in the ceilings on controlled interest rates is being studied by the authorities, and they expect to free interest rates for certain types of savings bonds and loans. This is an important move in the right direction, and the authorities should implement it as soon as possible.

In late 1986, the authorities simplified the exchange rate system somewhat and devalued the bolívar. Since then, some of the positive effects of that devaluation have been offset by the rate of inflation sustained in 1987. The authorities should keep the exchange rate system under review and continue to consider the unification of exchange rates.

The progress under way to comprehensively reform tariffs to provide a more uniform rate of effective production is welcome. This reform would allow the authorities to rely more on tariffs than on exchange and trade restrictions.

Mr. Malhotra said that he agreed with the broad thrust of the staff analysis and recommendations. His authorities agreed with the measures that Venezuela had undertaken to adjust to difficult circumstances, and appreciated their efforts. In her opening statement, Mrs. Filardo had pointed out the achievements attained thus far in the reduction of the fiscal deficit, the correction of disequilibrium in the external sector, the maintenance of growth in the nonpetroleum sector, and the reduction in the rate of unemployment.

However, further steps were clearly needed to remedy the current situation, Mr. Malhotra commented. He agreed with Mr. Prader and other speakers that the authorities should focus more on developing a comprehensive export diversification strategy and other measures to significantly reduce the fragility of the economy. In their report, the staff had made a number of suggestions as to how the present economic situation could be improved. In that connection, Mrs. Filardo's opening statement had contained adequate assurance that the authorities would continue to take appropriate structural and other measures in consultation with the Fund and the World Bank to keep their economy on track.

Mr. Fogelholm made the following statement:

The impact of fluctuating and, in particular, decreasing oil prices on the domestic economy and the accompanying need for economic adjustment are well known to at least one country in the Nordic constituency. It is therefore interesting to note that the policy challenges confronting the authorities in various countries seem to be similar, even if the underlying economic situation is not exactly the same. The challenge is how to insulate and shelter the economy from the adverse effects of reduced oil prices and bring about longer-term stability in the economy.

In Venezuela the answer seems to be fairly clear. There is a strong need to diversify the economy in general, and the production structure in particular. Obviously, this is easier said than done, plus, as Mrs. Filardo pointed out in her opening statement, diversification takes time. Nevertheless, I subscribe to what has

been said by Mr. Prader and other Directors that it is more important for the authorities to embark on a comprehensive program to reduce the present structural rigidities and excessive government controls. This appears to be the best way to vitalize the non-oil sector of the economy. In this context, the ongoing process to facilitate foreign investment and privatization is welcome. A gradual liberalization of foreign trade, and a restructuring of the present tax and duty system is also to be encouraged. Further elaborations in the staff report on the issue of economic diversification are warranted.

I am in broad agreement with the assessment and the recommendations contained in the staff report. With the benefit of hindsight, the measures taken by the authorities in 1986 to stimulate domestic demand to compensate for reduced oil revenues were unfortunate and ill timed, and it seems that the authorities were slow to react to changing circumstances. The consequences are well known: an emergence of deficits in both the external and public sector accounts and an excessive monetary expansion. This, in turn, has led to a high rate of inflation and to a widening of the spread in the exchange markets. I agree with the staff that to remedy these imbalances a tightening of fiscal and monetary policy, a unification of the exchange rate, and an increase in the overall flexibility in the exchange system are required.

Venezuela should be credited for its record of servicing its foreign debts, and the recent multiyear rescheduling agreement with commercial banks is welcome. However, the lengthy negotiations with the banks indicate that the enhanced surveillance procedure may not have been particularly effective, and he asked the staff to elaborate.

Mr. Posthumus said that he agreed with Mr. Lankester, Mr. Prader, and the staff appraisal. The way in which the authorities had reacted to adverse circumstances in 1983-85 was questionable in that they had introduced too many exchange, price, import, and interest rate controls. In macroeconomic terms, the authorities' actions were successful, because the public finances and external position had improved significantly. However, macroeconomic adjustment alone was clearly not a sufficient condition for sustainable growth. That was not to say that trying to start economic growth through a substantial loosening of fiscal policy was not growth oriented, but rather that such a policy should be more comprehensive. Implementing comprehensive growth strategies was extremely difficult for countries that were so dependent on a single commodity; however, Venezuela was in a better position in that regard than many other countries. The problems described in Mrs. Filardo's opening statement with respect to the level of unemployment called for comprehensive structural reform policies, not merely fiscal stimulation--which had apparently been the approach taken in Venezuela and which was clearly not sufficient.

The staff representative from the Western Hemisphere Department said that Venezuela's negotiations with the World Bank on tariff reform were continuing and were expected to be completed during the first quarter of 1988. However, the program underlying the negotiations for a planned sectoral loan had not been fully defined. In broad terms, it consisted of two major components: one aimed to phase down quantitative restrictions on imports and the other aimed to restructure the tariff system.

Quantitative restrictions currently covered approximately 50 percent of domestic manufacturing production, the staff representative remarked. Under the program to be supported by the program loan, the goal would be to reduce quantitative import restrictions to a coverage of about 10-15 percent of domestic manufacturing production only.

On the tariff side, the medium-term goal was to limit the tariff structure to about four or five basic tax rates, ranging from 10 percent to 30 percent, the staff representative from the Western Hemisphere Department concluded. The initial step would be to cap the current high nominal tariff rates to about 80 percent. Those planned measures were, of course, still under discussion and, therefore, subject to change.

The staff representative from the World Bank added that the Bank had been holding discussions with the authorities for the past year. The Executive Directors of the World Bank had been informed in 1986 that Venezuela's per capita income had reached a level that made it eligible to borrow from the World Bank. A mission from the World Bank had gone to Venezuela in January 1987, and had drafted a report which had been discussed with the Government in July 1987. Since then the World Bank staff had had technical discussions on the adjustment measures that would be required for a trade policy reform loan. Although those discussions were at a fairly advanced stage, they were not final. Furthermore, the required policy measures would have to be undertaken. However, once the Government had announced that such an adjustment program had been adopted, the World Bank could move quickly to support it.

The staff representative from the Western Hemisphere Department said that the timing for reforms of the interest rate had been a subject of considerable discussion within Venezuela. However, thus far, no action had been taken; perhaps Mrs. Filardo could comment on that matter. As to the normalization of private sector debt, Mrs. Filardo had noted in her opening statement that 398 contracts, covering about 80 percent of the total eligible debt, had been signed, and that the debt was being restructured on an eight-year schedule that had included provisions for access to exchange guarantees for which the debtors were to pay a premium.

A question had been raised about the staff report's coverage of statistics for the public sector finances and about the role of the public sector enterprises, the staff representative noted. For its report, the staff had used a very comprehensive definition of the public sector, which included the Central Government, the Venezuelan Investment Fund, the

petroleum company, extrabudgetary transactions, and 54 large government-owned enterprises. That coverage was broad enough, and very little would be gained from extending it further.

As the staff report had noted, allowing the exchange rate measures undertaken in December 1986, the bolívar had appreciated against the dollar in real effective terms by about 10 percent in the first half of 1987, the staff representative recalled. That appreciation was expected to have continued in the second half of 1987, owing to the relatively higher rate of inflation in Venezuela compared with that of the trading partner countries. Taking the most recent value of the dollar into account, the staff had estimated that the appreciation of the bolívar during 1987 as a whole would be in the range of 10-15 percent. That estimate had been based on consumer prices in Venezuela and export prices in trading partner countries, and if the staff had used wholesale price movements, the appreciation would have been even higher.

With respect to the Directors' comments on enhanced surveillance with Venezuela, the difference of view between the staff and the authorities may have been exaggerated, the staff representative commented. Discussions were held between the staff and the authorities approximately once every six months; therefore, the dialogue between the staff and the authorities was a dynamic one. For instance, the mission that had been to Venezuela in mid-1987 had been able to question the spending intentions of the various budgetary ministries and had concluded that if spending had continued along the lines intended at that time, the budget deficit for the year as a whole would have been very large. Partly as a result of that dialogue the authorities had taken substantial steps to rein in public expenditure to a more reasonable level. This was an example of the positive effects of the process of enhanced surveillance, and not so much a question of differences of view. Enhanced surveillance, as a process, involved constructive criticism, and it was not clear that a complete convergence of views was necessary or even feasible at any specific time. Nevertheless, greater convergence was part of the ongoing process.

The staff representative from the Exchange and Trade Relations Department said that the intention of enhanced surveillance had been to facilitate the member's relations with commercial bank creditors in the context of multiyear rescheduling arrangements. Enhanced surveillance was undertaken at the request of the member country, as it had been in the case under discussion. While a convergence of views--or rather, an acceptance by the authorities of policy views held by the staff and the Board--was very desirable and indeed hoped for, enhanced surveillance was not based on such a convergence. Rather, enhanced surveillance was intended to provide the authorities and the bank creditors, who would receive the staff reports, with a frank assessment of the current situation. It was the bank creditors' prerogative to draw their own conclusions from that assessment. Although differences of views on policy substance existed in the Venezuelan case, the process of enhanced surveillance had worked in that those differences were being examined and had been brought to the attention of the authorities and the creditors.

Mr. Dallara said that he was not entirely comfortable with the staff's characterization of enhanced surveillance. While he recognized that the purpose of that process was not to bring about a complete convergence of views, it entailed more than just a frank assessment.

In the summing up of the Board's discussion on the debt strategy that had taken place in March 1987 (EBM/87/48), the Chairman had described enhanced surveillance, stating, "The role of the Fund through implementation of enhanced surveillance in appropriate cases was one of influencing members' authorities to adopt and maintain appropriate policies through a close process of consultation and of helping the review and decision process of creditors through the provision of candid assessments," Mr. Dallara recalled. Therefore, enhanced surveillance was a twofold process: one of providing a candid, frank assessment, and one of constructive dialogue that hopefully involved a mutual influencing process.

The enhanced surveillance process with Venezuela was lacking in that a mutual influencing had not been taking place, Mr. Dallara commented. If the staff's assessment led to, or became part of, a process in which Venezuela's relations with its creditors deteriorated because its policies were deemed inadequate, on one level the Fund would have done its job, but on the other level, the job it had done would not be satisfactory.

Mr. Di Mauro said that there was a general need in the Fund's evaluation of programs to have a clear picture of what was happening in the member country. From the staff report for the current discussion, he had received the impression that there had been some sort of disagreement--or difference of opinion--between the staff and the authorities, specifically on fiscal policy. That implied, of course, that the medium-term scenario presented in SM/87/243 had been based on underlying adjustments that the staff did not believe were correct or realistic. It would have been helpful if the staff had provided some comparison between the medium-term scenario based on the authorities' plans, and an alternative scenario based on the staff's recommendations.

Mrs. Filardo thanked the staff for its clarification of the role of enhanced surveillance, because there were many different perspectives with respect to that process. Her authorities' view was that enhanced surveillance had been set up within the broader concept of surveillance to specifically address the needs of those countries that did not require use of Fund resources in their relations with commercial banks. The quantified economic program served as a guarantee to the banks that the country had adopted appropriate economic policies. In Venezuela's case, enhanced surveillance had been useful because it provided the authorities with a sort of technical assistance from the Fund by guiding them in their design of an economic program and its implementation.

During the mission in 1987, the staff had cautioned the authorities about the fiscal deficit, Mrs. Filardo reiterated, and some Directors had recommended that the authorities fix a quantitative target for that deficit. Those Directors should note that the Fund's recommended fiscal

target for 1987 had been met. The Fund and the commercial banks were primarily interested in the balance of payments result. In that regard, the current account deficit had been reduced from \$2 billion to \$71 million, and the capital account deficit had been reduced from \$6 billion to \$1 billion. Those outcomes showed that the authorities had made significant efforts to achieve external viability. In addition, Venezuela was one of the few countries that had kept current in its amortization of external debt.

The public sector debt amortization had largely been paid, Mrs. Filardo pointed out. Her opening statement, which had been circulated to the Directors, contained a table that showed the amount of debt amortization for 1987. The authorities had had a problem with the private sector, because it had claimed a preferential exchange rate, and the process of achieving that rate had been slow. However, that problem had been corrected, and \$1.2 billion of private sector debt had been amortized in 1987, and the future servicing of that debt was expected to be normal.

Re-establishing normal access to the capital market had been difficult, Mrs. Filardo commented. Such access had not been possible in 1986, and it was not until 1987 that Venezuela could increase its trade finance. Although some countries entered into stand-by arrangements with the Fund, the actual circumstances of the financial market made it difficult to gain normal access. In that connection, enhanced surveillance had been useful for Venezuela.

Traditionally, Venezuela had been very conservative in managing its fiscal policy, Mrs. Filardo continued. The deficits of 1986 and 1987, and in particular 1986, were brought about mainly by reductions in oil revenue, which had declined by 50 percent, and the deficit was currently about 6 percent of GDP. A revenue reduction of 50 percent was significant, and following seven years of stagnation, it was important for the authorities to implement a growth strategy.

Nontraditional exports had increased at an average annual rate of 10 percent over the past four years, Mrs. Filardo observed. However, it would be very difficult to substitute for oil revenues. She agreed with Directors on the need to implement a comprehensive economic and structural policy to reach the authorities' growth targets; as the representative from the World Bank had mentioned, the authorities were in the process of reviewing a growth-oriented program that she hoped would be implemented soon.

The interest rate had become one of the most difficult political issues in Venezuela. The Central Bank had been trying to find a way to increase the interest rate, and that effort had caused the recent removal of the President of the Central Bank and the Minister of Finance. The authorities had since appointed a new team, which expected to accomplish that task.

The authorities were concerned about the volatility of the oil market, and were making efforts to base their plans on a conservative projection of oil revenues, Mrs. Filardo noted. They were trying to adjust the program according to oil income and according to the external financial support expected for 1988. However, it would not be easy to carry out such a program because 1988 was an election year, which usually made gaining investor confidence more difficult, both domestically and internationally.

The Chairman then made the following summing up:

Executive Directors were in broad agreement with the thrust of the appraisal contained in the staff report for the 1987 Article IV consultation with Venezuela.

Directors commended the authorities for the major adjustment effort that had been implemented between 1982 and 1985 and observed that in 1986, in an effort to reverse several years of economic stagnation and rising unemployment, the authorities had adopted policies aimed at stimulating domestic demand just as the country experienced a major drop in its oil export earnings. While these policies helped to bring about a strong increase in real GDP and employment, the major decline in oil revenues and the policies followed led to the emergence in 1986 of large domestic and external imbalances, and were reflected in an acceleration of the rate of inflation and losses of international reserves.

Directors noted that the authorities had taken several measures at the end of 1986 to correct the economic situation, including a major devaluation of the bolívar. However, they observed that the public sector deficit in 1987 had been maintained, and that credit policy was expansionary. These policies had led to an acceleration in the rate of inflation during 1987 and a widening of the spread between the controlled and the free market exchange rates.

Most Directors stressed the need for Venezuela to adopt a comprehensive economic program that would bring about a lasting reduction of the rate of inflation, strengthen savings, and assure external competitiveness, and thus help to promote durable economic growth. Such a program would involve policies aimed at reducing the public sector deficit and the rate of bank credit expansion, and a unification of the exchange rate, and structural reforms geared to strengthening the balance of payments.

In the fiscal area, Directors supported the staff's conclusion that the overall fiscal deficit for 1988 needed to be reduced to a level that was consistent with the balance of payments and inflation targets. To this end, Directors saw the need for additional expenditure restraint, particularly through the reduction of subsidies and the postponement of low-priority investments.



Revenue measures also needed to be considered, including adjustments of tariffs and prices of public enterprises and strengthening of indirect taxes.

A tightening of monetary policy was required to help curb domestic inflation and reduce pressures on the balance of payments. Directors generally noted that the present structure of interest rates, which were significantly below current rates of inflation, discouraged the growth of savings and contributed to pressures on the free market exchange rate. Accordingly, they urged the authorities to establish a market-oriented interest rate structure.

Directors pointed out that the existing multiple exchange system gave rise to significant distortions, particularly because of the large differential between the controlled and the free market rates. A number of Directors, therefore, emphasized the need to move soon toward a unified exchange system, while some other speakers envisaged a more gradual approach in this area. Many speakers remarked that a more flexible exchange rate policy would help to promote nontraditional exports and import substitution.

Directors emphasized the importance of a cautious wage policy to complement other measures in controlling inflation and in achieving an adequate degree of external competitiveness. At the same time, many Directors stressed that the scope of price controls and other government regulations needed to be reduced to stimulate domestic production and investment.

In the area of structural reforms, Venezuela's intention to negotiate a trade policy loan with the World Bank was welcomed. Directors indicated that the implementation of trade reform and trade liberalization, together with a more flexible exchange rate policy, would allow for a reduction of imports and exchange restrictions which would help to promote private investment and economic growth in the future. Wide-ranging action was needed to deregulate the economy and to develop an effective diversification strategy.

Directors expressed the hope that Venezuela would soon be able to present a comprehensive economic program for 1988 that would address the country's imbalances, strengthen confidence in its economic management, and help attract needed credit flows from foreign commercial sources. In this connection, Directors commended the efforts made by Venezuela in recent years to maintain good relations with its foreign creditors. The conclusion of the multiyear rescheduling agreement in 1987 and the reduction in Venezuela's external debt by about \$5 billion between end-1982 and 1987 were warmly welcomed.

Finally, several Directors reiterated their concern regarding the differences of views on policy that persist between Venezuela and the Fund and recorded their reservations regarding the effectiveness of the enhanced surveillance procedure. The Venezuelan authorities were urged to begin substantive discussions with the Fund in the formulation of their economic policies and to take into account the views of the Executive Board in the spirit of the enhanced surveillance arrangement with Venezuela.

Directors recommended that the next consultation with Venezuela under enhanced surveillance be held within six months.

### 3. NIGERIA - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Nigeria (SM/87/280, 11/25/87; and Sup. 1, 1/4/88). They also had before them a background paper on recent economic developments in Nigeria (SM/87/293, 12/17/87).

The staff representative from the African Department said that the staff had recently received additional information on three policy areas: the 1988 budget, recent monetary policy measures, and the status of Nigeria's negotiations with its creditors.

The 1988 budget had been announced by President Babangida on December 31, 1987, but since the staff did not have the full budget document, it could make only a few preliminary comments. The budget was clearly reflationary, and the staff estimated that the deficit on a commitment basis would be about 11 percent of GDP, or slightly larger than envisaged in the staff report. Nondebt-related expenditure, both capital and current, was about 75 percent higher than the 1987 budgeted level. About \$1.7 billion had been allocated to external debt servicing, which was equivalent to about 21 percent of projected exports of goods and nonfactor services. No major revenue initiatives had been announced in the budget, and in particular, there had been no reference to raising the domestic price of petroleum products. However, it was possible that some of the revenue estimates had included some revenue to be raised from a price increase later in the year. In addition, the wage freeze that had been in effect since 1982 had been ended.

In the area of monetary policy, the 1988 budget envisaged an increase in the rate of credit expansion to the private sector from the 7.4 percent planned in 1987 to just over 13 percent. Also, a few days before the President's budget speech, it had been announced that the rediscount rate would be lowered from 15 percent to 12.75 percent; the minimum liquidity ratio had been reduced from 30 percent to 27.5 percent.

Finally, as far as Nigeria's relations with its official creditors were concerned, the Minister of Finance had announced on January 4, 1988 that bilateral agreements had been signed with 10 of the 19 Paris Club creditors, and that two further agreements were ready for signature.

Mr. Abdallah made the following statement:

The analysis of developments in the Nigerian economy as presented by the staff is comprehensive and detailed, reflecting to a large extent the process of implementation of the structural adjustment program and the underlying economic problems that remain. Although my authorities do not fully share the staff conclusions on some issues, they are highly appreciative of the positive role that their excellent report would play in the country's economic management. Moreover, my authorities feel strongly that a combination of Article IV consultation with program review has tended to blur, as in this case, the separate objectives of the two exercises. They would have preferred a separate report on the Article IV consultation which would have brought into clearer focus Nigeria's economic achievements since the last consultation.

1. Recent developments

Reflecting the radical economic reform measures implemented forcefully in 1987 under the ongoing structural adjustment program, overall developments were generally positive. The pervasive distortions and imbalances in the economy were replaced by a largely decontrolled and price-determined system coupled with an appropriate incentive framework that has significantly enhanced efficiency and resource base. The decline in economic activity of the non-oil sector, which in the past had been a major concern of the authorities, has been successfully arrested; output in this sector is now expected to grow by 2.6 percent as against the declines of 0.3 and 3.4 percent recorded for 1985 and 1986, respectively--an encouraging outcome of the export diversification efforts. In the manufacturing sector, the result of a recent country-wide survey by the authorities showed some increase in the level of capacity utilization, especially for industrial enterprises such as paper manufacturing, breweries, textiles, vegetable oil, paints and cement.

According to the authorities, this sector has grown by an estimated 10 percent in 1987 in contrast to a decline of 6.3 percent in 1986. There has also been a steady growth in the volume of locally produced raw materials in virtually all the industrial subsectors while investment as a proportion of GDP increased from 9 percent to 14.0 percent, indicating the favorable impact of the program. Owing to very favorable agricultural output and the squeeze on credit, inflation rate has been effectively contained at about 5 percent since 1986, despite substantial depreciation of the naira, while the balance of payments deficit declined in 1987. Commodity prices were boosted in naira terms and the incomes to farmers were enhanced, promoting a steady transformation of the rural sector and improvement in the living standards of the people in the rural areas. Unemployment, however, remains a difficult problem in the process of economic adjustment, although through the new Directorate of Employment as well as the Directorate of

Food, Roads and Rural Infrastructure, some investments have been made in the labor-generating sectors and, together with the boost to industrial production, a better rationalization of human and material resources are expected. Thus, even though the resumption of growth might have been slow and the fiscal deficit larger than programmed, the impact of the structural adjustment measures was generally satisfactory.

## 2. Policy issues

The radical change in economic policy initiated in 1986 was maintained in 1987 with the structural adjustment program significantly altering the way in which the Nigerian economy had hitherto operated. Trade and payments system was liberalized and a market-determined exchange rate policy fully implemented. The fairly controversial deduction accounts were abolished and action taken toward commercialization and rationalization of parastatals.

### a. Fiscal policy

Of great concern to the authorities is the deterioration in the fiscal position due to the need to meet outstanding commitments such as payments of a large amount of debts owed to local contractors, suppliers, and consultants; and the assumption by the Federal Government of the massive burden of foreign exchange liabilities of the States and parastatals, following external debt rescheduling arrangements. This largely accounts for the fiscal slippages, although my authorities do not agree that this would be as large as 14.2 percent in 1987; in fact, they expect the deficit to be very much lower than that.

Some of the fiscal measures taken in 1987, though apparently revenue neutral, were necessary to complement the new exchange rate system and enhance macroeconomic adjustment efforts. Thus, the adjustment of some customs and excise tariffs were designed to rectify anomalies that had been identified, and enhance the competitiveness and productivity of the affected industries. To contain increasingly high cost of transportation which the public has had to put up with, duties on completely knocked-down components for buses, trucks, and light commercial vehicles as well as parts and accessories of commercial vehicles were reduced. Similarly, the general relief on income tax was intended to enhance disposable incomes, especially of the lower-income earners who had been severely affected by the austerity of the 1985/86 Economic Emergency Program. While these measures may be regarded as expansionary of fiscal policy, they, nevertheless, assisted in stimulating national economic activity.

As regards the tightening of the fiscal policy stance and elimination of slippages, the authorities generally share the views expressed in the report on the measures that should be

implemented, although they differ on their scope and timing of implementation. A ceiling of \$320 million was placed on the 1987 letters of credit commitments while other public sector foreign exchange requirements were to be contained within a ceiling of \$300 million. All dedication accounts, which the Board had in the past advised against, were abolished. Steps were taken to improve the structure of the finances of the States such as encouraging them to exploit the Nigerian capital market, by way of floating State bonds, in funding their projects, where such projects could not be accommodated within their resources.

Aware of the financial and economic losses that stem from subsidies in general, public policy has accepted the need to phase them out gradually, especially those relating to domestic consumption of petroleum products and the strategy to achieve this is being worked out. Tariff of parastatals would be increased--that of the Nigeria Airways has gone up considerably. A plan for the commercialization and privatization of certain public enterprises has been approved by the Government and its implementation will commence as soon as the enabling law has been promulgated. Meanwhile, all insurance companies are to be privatized and government holdings in commercial banks are to be reduced to 40 percent.

b. Monetary policy

In keeping with the desired monetary stringency under the structural adjustment program for the maintenance of internal and external equilibrium, the stance of monetary and credit policy in 1987 has been restrictive. Determined efforts were made to observe targets set for the expansion of monetary and credit aggregates consistent with the program. Growth in money supply and aggregate bank credit was initially targeted at 11.8 and 4.4 percent, respectively, while rates of credit expansion to government and the private sectors were kept at 1.5 and 8.4 percent, respectively. But this was subsequently replaced by a much tighter package of monetary policy with very much reduced credit ceilings; and in order to ensure strict compliance with credit guidelines, severe penalties were stipulated for banks that breached the limits while the minimum liquidity ratio specified for the commercial banks was raised from 25.0 percent to 30.0 percent. All controls on interest rates were abolished, thus allowing deposits and prime lending rates to be determined by the forces of supply and demand in the financial market, reflecting the authorities' determined efforts to encourage mobilization of deposits, stem destabilizing demand for credit and ensure greater efficiency in its allocation under a more competitive financial system. The impact of these and other measures, among other things, resulted in the effective control of inflation rate, which at 5.0 percent was very much below the programmed rate.

My authorities do not share the staff's view that monetary expansion in 1987 has not kept within program limits. The report seems to have placed emphasis on the broad measure of money stock, M2, whereas the authorities consider movements in the narrow money, M1, to be more relevant and policy measures were designed to curb the excessive growth of M1. In fact, available statistics through end-September 1987 show that M1 had remained persistently below its end-December 1986 level, declining by ₦ 325.3 million or 2.6 percent over the period--a movement appropriately in the direction of policy target. Although M2 rose by ₦ 1.8 billion or 7.5 percent during the same period, this was not unexpected because the substantial increase in interest rates was expected to boost savings and time deposits which was the growing component of M2.

c. External sector

The substantial depreciation of the naira as well as the various export incentive schemes, including the 100 percent retention of export proceeds, have already begun to boost non-oil exports and could provide the basis for gradual reduction of overdependence on crude petroleum. Until then, Nigeria's balance of payments remains largely trapped by both the declining trends in the world oil prices and the limited oil production possibilities. Given the current state of the oil market, the authorities are of the view that the projected annual increase of 10.0 percent in oil export receipts might be overly optimistic, although they generally agree with the medium-term scenario for Nigeria's balance of payments as the prospects are broadly in line with their expectations.

As for foreign exchange reserves, the financing gap of \$3.2 billion projected for 1988 includes reserve accretion which is expected to raise the level of official holdings from the assumed figure of \$325 million at the end of 1987 to \$1,325 million in 1988. The authorities could not allow reserves to fall to such an embarrassingly low level in the year just ended. Indeed, the level of reserves at the end of October 1987 stood at \$963 million and current official estimates put the level at \$1.3 billion at the end of 1987 compared with \$1.1 billion at the end of 1986. Recognizing the urgent need to build up reserves, controls of the public sector consumption of foreign exchange have become tighter in line with the recommendations of the Committee set up early in the year on the management of foreign exchange resources. In addition to closing all dedication accounts, a freeze was placed on new letters of credit, except on items considered absolutely necessary.

External debt payments including arrears have been given first priority in the disbursement of available foreign exchange, as my authorities are committed to restoring and strengthening debtor/creditor confidence. This is already evidenced by the increasing rates of repayments made to various creditors. However,

because of the need to also pursue the growth objectives of the program and the anticipated shortage of external capital inflow required to stimulate economic activity, my authorities do not share the view that debt repayment should be accelerated, even though higher debt service ratios of 74 percent and 60 percent have been projected for 1988 and 1989, respectively. They intend to continue limiting debt service to 30 percent of export receipts. If account is taken of the second stage rescheduling exercise for 1988/89 maturities, the debt service burden might not be as high as projected for 1988. Moreover, there appears to be no guarantee that the expected inflow of new capital would materialize after a much higher than 30 percent of export receipts had been used for debt service. My authorities consider a more viable option to be that of rescheduling payments in excess of the prescribed limit in order to provide for essential imports and growth.

As the staff has already noted, a new system of determining exchange rate has been a central element in the structural adjustment program and my authorities would like to stress the achievements which have been made. With the introduction of a two-tier foreign exchange market on September 29, 1986 and subsequent unification of the official and auction rates on July 2, 1987, the problem of finding an appropriate and realistic exchange rate for the naira--a problem that had hitherto bedeviled economic management over the years--has been successfully addressed. Substantial depreciation of the naira has occurred--by 311.5 percent, from an average of 1.33 naira to the dollar in August 1986, to 4.143 naira to the dollar in December 1987, remaining at about that level thereafter. The wide margins between the parallel and the official exchange rates which, according to the authorities, rose persistently from about 65 percent in 1980 to 312 percent in the last quarter of 1985 plummeted to about 10 percent in 1987. The low and falling parallel market premium clearly reflects considerable elimination of the overvaluation of the naira, thus enhancing the credibility of macroeconomic policy and providing the incentive to investors, both foreign and domestic.

The operation of the foreign exchange market is largely in line with the original understandings of the structural adjustment program and my authorities are determined to maintain that course. Transactions in foreign exchange are now market determined by the interaction of supply and demand at bidding sessions. On the issue of raising the amount that individual banks can bid for, as urged by the staff, the official policy stance is that the market must be conducted in a manner that will make for effective competition. Accordingly, banks are required to intensify their efforts in securing foreign exchange from autonomous sources to supplement that acquired from the bidding sessions; to this end, with effect from June 1987, my authorities allowed participating banks to bid only for their own accounts and not for use in interbank transactions. Official intervention has been kept to the barest minimum

consistent with the need to ensure market depth through adequate funding as well as its orderliness and reasonable rate stability. In this connection, and considering the existing circumstances, my authorities believe that the staff urging of a reduction in the current levels of sales of foreign exchange to the private sector through the foreign exchange auction could result in an "overkill" particularly in relation to the manufacturing sector which, despite recent improvement, has been operating very much below capacity levels.

It is admitted that there is a divergence between the auction price and the interbank market price. However, in the view of the authorities, this is the lesser evil than that of allowing the big Lagos-based banks to acquire all the foreign exchange and retail it at a substantial profit in the interbank markets. The authorities are looking into the matter and would take appropriate action as soon as possible. Meanwhile they urge the Board to approve further retention of this practice.

3. Concluding remarks

The Nigerian authorities are concerned about the fiscal slippages and would take appropriate measures to prevent any derailment of the program. The 1988 budget, announced a couple of days ago, embodies some of the measures such as regular, periodic adjustments in the tariffs of parastatals, program for privatization and commercialization of public enterprises, ceilings on aggregate bank credit to the economy and the direct involvement of the banking system (no longer the Department of Customs and Excise) in the determination and collection of duties payable on international trade; and the computerization of the Nigerian customs procedures and trade statistics has been approved. Government has also provided for the possible conversion of debts owed to willing foreign creditors to local equity. More stress is now being placed on budgetary discipline and strict adherence to the 1988 foreign exchange budget targets.

The removal of the control syndrome which had hitherto pervaded the Nigerian economy, the fostering of a more rational economic behavior as well as efficiency and competition by economic agents on the basis of price mechanism, the improvement in the allocation of resources in terms of foreign exchange and in manpower utilization in the public and private sectors, and the growing capacity utilization in the manufacturing industries largely through locally sourced raw materials--all these are some of the positive impact of policy developments which are conducive to growth. My authorities have repeatedly stressed to the staff team that structural adjustment without growth is not an acceptable policy option in a low-income country. Without growth, the authorities would have virtually nothing with which to justify the sacrifices made in the process of adjustment, and subsequent



repayment of financial obligations to external creditors would become very difficult. In this context, my authorities are concerned about the delay both in the disbursement of the \$320 million new money package by commercial banks and in the resumption of cover from export credit agencies--all of which were expected in 1987. There is an urgent need for the international financial community to show stronger support for the adjustment efforts of Nigeria.

Mr. Mawakani made the following statement:

I am pleased to note from the staff report that the implementation of the authorities' comprehensive adjustment program, which was launched in mid-1986 and subsequently strengthened to merit Fund support under a stand-by arrangement, has already yielded some positive results. The generally satisfactory impact of the structural adjustment measures on the economy in 1986 and 1987 was amply described by Mr. Abdallah. However, the surge in export-oriented activity, the return to enhanced efficiency and resource allocation, and the beginning of some private capital reflows should be emphasized as signals of growing confidence in the system in place. Although the structural changes that occurred in the economy did not translate into an improvement in the economic and financial indicators in 1987, they have reduced the structural rigidities that have been causing so much damage to the economy. These commendable structural changes have also put Nigeria in a better position for the resumption of sustained economic growth, a significant achievement.

Unfortunately, in spite of the positive structural changes that took place over the past two years, some developments in the fiscal and external sectors in 1986-87 are cause for concern. The deficit of the budgetary operations of the Federal Government, which was reduced significantly in 1985, widened in 1986 and 1987. While the discharge of outstanding commitments together with the exchange rate adjustment were the primary cause of the sharp deterioration in the fiscal situation during the past two years, it appears from Table 2 of SM/87/280 that both current and capital expenditure overruns also contributed to that deterioration. As the authorities recognize, the deterioration of the fiscal position calls for remedial action, if the hard-won gains are to be preserved. In this context, the various measures that were taken in 1987 are encouraging, particularly those related to the "dedication" accounts, the structure of the finances of the state governments, and the subsidies. The encouraging measures embodied in the 1988 budget, as described by Mr. Abdallah, should go a long way in addressing the deterioration of the fiscal situation.

With respect to developments in the external sector, it is regrettable that most of the capital inflows contemplated in 1986 and 1987 failed to materialize. As was indicated in the staff report and Mr. Abdallah's opening statement, this lower than expected inflow has led to decreased imports and increased downward pressure on the naira. The inadequacy of capital inflows is worrisome, because it could undermine the authorities' efforts to achieve their stated economic objectives. Because it is one of the Baker Plan countries, substantial financial resources could have been expected to flow into Nigeria to enable it to finance a truly growth-oriented program while restoring and strengthening debtor/creditor confidence. In this connection, my authorities are very concerned about the statement on page 13 of SM/87/280 that: "Over the medium term, import growth will have to be restrained, and a considerable part of export earnings will have to be devoted to debt service, and in particular to interest payments...." I sympathize with the authorities' view that it would be difficult politically to devote more than 30 percent of export earnings to debt service. For a country such as Nigeria, which has embarked on a comprehensive structural reform of its economy entailing hardship for a large segment of the population, the prospect of having to devote 60-74 percent of export earnings to external debt obligations at the expense of economic growth is not only politically and socially unbearable, it is also economically unsound. Therefore, the international financial community should adequately support Nigeria's adjustment efforts, so that economic growth and external debt servicing can go hand in hand.

Mr. Lankester said that he generally supported the staff appraisal. Developments in the economy over the past year seemed to have been somewhat mixed. The structural adjustment program represented a brave step by the authorities to tackle the severe imbalances. The liberalization of the foreign exchange system, the focal point of the program, was intended to help reorient the economy and promote growth, while easing external constraints on development. As Mr. Abdallah had pointed out, the economy already showed clear signs of a positive response to the reform measures.

The complication data posed considerable problems in Nigeria, but it appeared that agricultural activity had picked up, that investment and capacity utilization had been rejuvenated in some important parts of the industrial sector, and that manufacturing production had increased significantly, Mr. Lankester noted. The output picture for 1987 was somewhat mixed, which was probably inevitable, because as the production structure responded to the new incentives, some industries would suffer from the new price levels and others would benefit.

The authorities had clearly encountered some difficulties in the implementation of the structural adjustment program and there had been slower than expected progress in restoring normal relations with the international financial community, Mr. Lankester remarked. Despite the

difficulties of implementation, the broad approach of the structural program remained appropriate. The most important need was to re-establish the momentum of the adjustment effort. That discussions were continuing between the authorities and the Fund on policy measures that the Fund could endorse was encouraging. The sharp increase in the fiscal deficit in 1987 was obviously a particular source of concern and had contributed to the strains on the external position. According to the staff report, the underlying deficit, including an allowance for arrears that had built up, might have deteriorated by as much as 7 percentage points of GNP, compared with the deficit expected in the original program--although that estimate was disputed by the authorities, there could, in fact, be some more up-to-date information on that significant deterioration. Re-establishing control over the fiscal position would be essential, if the structural adjustment program was to succeed in accomplishing its stated objectives, and establishing that control would require action on both the revenue and the expenditure fronts.

At the opening of the meeting, the staff representative had projected a deficit for 1988 amounting to 11 percent of GDP, and had stated that the 1988 budget was expansionary, Mr. Lankester noted. However, it was difficult to form any substantial opinion about the budget, because not enough information was available yet. Perhaps the staff could make a further assessment of the budget at a later date, and particularly a determination as to whether the budget was consistent with the effort to attain the program's agreed objectives. He certainly hoped that the measures included in the 1988 budget would be firmly implemented, with a view to avoiding some of the slippages that had occurred in 1987.

Revenue in 1987 had apparently suffered as a result of the authorities' holding down domestic petroleum prices, Mr. Lankester commented. Their concern about the inflationary consequences of raising domestic petroleum prices was understandable--the issue of domestic petroleum prices arose in many consultations with oil-producing countries, particularly with respect to the effect of higher domestic prices on real income. However, bringing domestic petroleum prices in those countries more into line with international prices would have many allocative benefits. For example, it ought to reduce the smuggling of petroleum to neighboring countries. More importantly, raising domestic petroleum prices would seem to be the most feasible way of substantially increasing revenue and helping to correct the fiscal position.

Revenue performance in 1987 had suffered as a result of problems in the collection of taxes, Mr. Lankester continued. Apparently, there had been a particular problem with the collection of taxes by one department of government, and some changes had been made which were expected to improve that situation. However, the authorities should pay particular attention to revenue collection in the future since any deterioration in that area was worrisome. The staff could perhaps comment on any recent developments in revenue collection.

The authorities had had particular difficulty in controlling spending at the lower levels of government, which was understandable, Mr. Lankester observed. Although the United Kingdom did not have states, it did have local authorities which often spent a lot more than the Central Government would like. It was hoped that Nigeria's Central Government would be able to persuade the states that it was in their interest and in the interest of the national economy to support the overall thrust of the Government's expenditure policies. The recent assumption by Government of the debt-servicing obligations of the lower levels of government, had placed an additional burden on its finances. Furthermore, similar problems had arisen in controlling the spending of the parastatals, which had required more financing from the Government in 1986 than had been envisaged, in part reflecting the authorities' reluctance to allow the full effects of the naira's devaluation to pass through into all sectors of the economy. While that reluctance was perhaps understandable in terms of wanting to avoid severe problems of adjustment, by avoiding the full pass through, the authorities had reduced the overall effectiveness of the devaluation in promoting renewed growth and had added to the strains on the fiscal position.

Continued efforts to improve the performance of the public enterprises were also needed, Mr. Lankester went on. However, where subsidies were regarded as unavoidable, the authorities should make them explicit, instead of relying on artificially depressed prices to bolster key enterprises.

On the external front, there seemed to be little doubt that the depreciation of the naira had been beneficial, and that it would continue to be so, Mr. Lankester remarked. Investment activity was responding to the improved incentive structure, and the unification of the first and second tier exchange rates in July 1987 was encouraging. However, he shared the staff's concern about some aspects of the operation of the foreign exchange markets. The authorities had apparently imposed various exchange restrictions that impeded the efficient operation of the system; such measures were not an effective way of tackling the downward pressure on the exchange rate, that had resulted from inadequate demand-management policies.

The authorities had already achieved considerable progress in the area of structural reforms, including abolishing the factory-gate system of price controls and the agricultural commodity boards. There were several examples in the staff report and the background paper that illustrated the positive impact of the measures taken under the structural adjustment program. He wondered whether it would have been helpful if the staff had compiled the information on the stimulatory effects that a more realistic exchange rate had had on the economy in a special section of its report. It was clear that continued structural reform efforts would be called for, if growth was to be promoted during periods in which access to external finance was likely to be limited. It would have been helpful to have had more discussion in the staff report on structural reform policies. Appropriate public investment policies obviously had an

important role to play in that regard, and it was gratifying that the authorities had shifted the emphasis in the public investment program to activities with a quicker payback.

During the past year, the authorities had made important progress in tackling the distortions which had impeded the economy, and the overall thrust of their efforts seemed to have been appropriate. Although difficulties had arisen in the program's implementation, particularly on the fiscal side, the current key objective was for the Fund and the authorities to reach agreement on the measures that would be required to bring the program back on track with a view to concluding a new stand-by arrangement.

Mr. Nimatallah said that the four major areas of adjustment in Nigeria were: the external sector, monetary policy, structural adjustment, and fiscal adjustment. The authorities had performed commendably in managing the external sector, which involved the exchange rate in particular, and the expansion of exports in general. The authorities had also performed well in conducting monetary policy, which involved credit to the private sector, interest rates, and inflation.

Although it was too early to judge the authorities' performance in the area of structural adjustment, which included, among other things, the rehabilitation of parastatals, they appeared to be on the right course. Structural adjustment required time; nevertheless, the authorities needed to accelerate their efforts, particularly in improving the management of the public enterprises, with a view to putting them on a sound commercial footing.

The record in fiscal adjustment was disappointing, Mr. Nimatallah commented. The large jump in the budget deficit, from about 4 percent of GDP to about 14 percent of GDP, indicated that the authorities had chosen to sustain economic activity and effective demand at levels commensurate with higher revenues, perhaps in the hope of a favorable turnaround in present oil revenues. He remembered when Saudi Arabia had been faced with a similar difficult choice between adjusting government expenditures in line with the sharp decline in oil revenues, or sustaining expenditure at high levels by financing them either through available reserves or borrowing. Saudi Arabia had opted for expenditure adjustment. The Saudi Arabian budget for 1988 was about half as large as it had been in 1983. Similarly, Nigeria needed to adjust its expenditures, particularly since its reserves had dwindled to dangerously low levels. If oil revenues increased at a later date, the extra revenue could help to build reserves or to repay external debts.

In its report, the staff had indicated areas in which public expenditure could be curtailed, Mr. Nimatallah noted. It should be emphasized that savings could be realized from speeding up the reform of the parastatals and improving their financial position. Containing public investment expenditure and postponing new investment projects was also recommended. In addition, there was considerable scope for enhancing non-oil revenues, especially in the administration of the collection of customs duties and the reduction of subsidies.

The most critical policies were those which promoted the diversification of exports, Mr. Nimatallah concluded. He hoped the authorities would persist in that effort, and that Nigeria's trading partners would help by keeping their markets open.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/1 (1/4/88) and EBM/88/2 (1/6/88).

4. ASSISTANT TO EXECUTIVE DIRECTOR - EXTENSION OF OVERLAP PERIOD

The Executive Board approves the recommendation of the Committee on Executive Board Administrative Matters relating to the extension of the overlap period for the appointment of an Assistant to Executive Director as set forth in EBAP/87/286 (12/31/87).

Adopted January 5, 1988

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 87/97 through 87/102 are approved. (EBD/87/335, 12/23/87)

Adopted January 4, 1988

APPROVED: September 2, 1988

LEO VAN HOUTVEN  
Secretary

Venezuela: Transfer of Resources Abroad Resulting from the Terms of  
Trade Effect, Import Adjustment, and External Debt Service

(In billions of U.S. dollars)

	1984	1985	1986	1987 Prelim.	
Exports of goods and services	15.9	14.1	8.6	10.4	
Of which,					
Petroleum	14.8	12.8	7.2	9.1	
Imports	<u>-7.3</u>	<u>-7.4</u>	<u>-7.8</u>	<u>-8.1</u>	
Trade balance	8.6	6.7	0.8	2.3	
Current account	4.9	3.0	-2.0	0.07	
<u>Debt service</u>					
<u>Public</u>					
Amortization	2.4	1.0	1.3	0.9	
Interest	<u>2.7</u>	<u>3.2</u>	<u>2.6</u>	<u>2.3</u>	
Total	5.1	4.2	3.9	3.2	
<u>Private</u>					
Amortization	0.02	0.08	0.7	1.2	
Interest	<u>0.4</u>	<u>0.7</u>	<u>0.4</u>	<u>0.6</u>	
Total	0.42	0.87	1.1	1.8	
<u>Total debt</u>					<u>Total</u>
Amortization	2.4	1.0	2.0	2.1	7.5
Interest	<u>3.1</u>	<u>3.9</u>	<u>3.0</u>	<u>2.9</u>	<u>12.9</u>
Total	5.5	4.9	5.0	5.0	20.4