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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/7

3:00 p.m., January 16, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	M. K. Bush
	D. C. Templeman, Temporary
J. de Groote	
	X. Blandin
M. Finaish	T. Alhaimus
	K. Murakami, Temporary
	B. Goos
	M. Rasyid, Temporary
	G. W. K. Pickering, Temporary
	H. A. Arias, Temporary
H. Lundstrom	
	A. S. Jayawardena
E. I. M. Mtei	
	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuâldez
	O. Kabbaj
	T. A. Clark
S. Zecchinii	
Zhang Z.	Wang E.

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

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Also Present

Administration Department: L. A. Wolfe. African Department: R. J. Bhatia, Deputy Director; E. A. Calamitsis, P. C. Ugolini. Asian Department: W. G. L. Evers, L. Mendras. European Department: P. Dhonte. Exchange and Trade Relations Department: G. Begashaw, J. O. Bonvicini, J. T. Boorman, E. H. Brau, E. B. Maciejewski. External Relations Department: H. O. Hartmann. Fiscal Affairs Department: M. Z. Yucelik. Legal Department: G. P. Nicoletopoulos, Director; Ph. Lachman, A. O. Liuksila, J. M. Ogoola, S. A. Silard. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; J. G. Borpujari, P. L. Clawson, F. Drees, M. A. El-Erian, S. H. Hitti, Z. Iqbal, H. E. Jakubiak, B. A. Karamali, K. Nashashibi, A. Ouanes, G. Tomasson, S. von Post, M. Yaqub. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; J. C. Corr. Treasurer's Department: D. Berthet, D. Gupta, W. E. Hermann, T. B. C. Leddy. Advisors to Executive Directors: L. K. Doe, D. Hammann, S. M. Hassan, H.-S. Lee, G. E. L. Nguyen, J.-C. Obame, M. Z. M. Qureshi, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: E. M. Ainley, J. R. N. Almeida, J. Bulloch, M. B. Chatah, J. de la Herrân, J. J. Dreizzen, C. Flamant, G. D. Hodgson, H. Kobayashi, S. Kolb, R. Msadek, A. Mustafa, E. Olsen, W. K. Parmena, D. J. Robinson, A. A. Scholten, L. Tornetta, A. J. Tregilgas, A. H. van Ee, E. L. Walker.

1. SENEGAL - 1984 ARTICLE IV CONSULTATION AND STAND-BY ARRANGEMENT

The Executive Directors continued from the previous meeting (EBM/85/6, 1/16/85) their consideration of the staff report for the 1984 Article IV consultation with Senegal, together with a request for an 18-month stand-by arrangement in an amount equivalent to SDR 76.6 million and a proposed decision concluding the 1984 Article XIV consultation with Senegal (EBS/84/267, 12/21/84; and Sup. 1, 1/14/85). They also had before them a report on recent economic developments in Senegal (SM/85/13, 1/10/85).

The staff representative from the African Department said that in Senegal an important aspect of the authorities' cereal policy was the upward adjustment in the retail price of rice. That measure had been necessary to shift the relative terms of trade from imported rice in favor of locally produced cereals so that they would become more competitive. Of course, there were other essential aspects of agricultural policy, including the need to improve marketing arrangements, which the World Bank was considering with Senegal.

There undoubtedly had been a substantial decline in real wages in recent years, the staff representative continued. However, to further reduce the fiscal deficit, wage restraint was unavoidable. Nevertheless, to the extent that the number of government employees was stabilized and possibly reduced, there would be scope for providing increases to the remaining employees in the years ahead.

With regard to gross domestic savings in 1985, the staff representative noted that, in view of the adjustments envisaged in the program, private consumption, as a percentage of GDP, was projected to decline by about 5 percentage points and public consumption by some 2 percentage points, which was reflected in a 2 percentage point decline in total government expenditure and net lending. Developments in those areas would be closely watched by the staff.

Discussions for the first review of the program under the Fund stand-by arrangement for The Gambia had been held in October 1984, and further contacts were under way, the staff representative said. Developments in Senegal would obviously be taken into account in future discussions, with a view to achieving maximum coordination of policies.

The stock and evolution of domestic arrears were shown in Table 5 of the staff report, the staff representative continued. The staff had also emphasized that the authorities planned to reduce the stock of outstanding arrears, which amounted to CFAF 53.7 billion at the end of June 1984, to CFAF 46.7 billion at the end of June 1985.

There was no linkage planned between the stand-by review process and examination of the Seventh Development Plan, which was scheduled to start in July 1985, the staff representative from the African Department said. However, the staff would monitor developments, including the preparation of the Plan, with colleagues in the World Bank. The next meeting of the Consultative Group for Senegal was expected to be held in 1986, probably after expiration of the present stand-by arrangement with the Fund.

The staff representative from the Exchange and Trade Relations Department said that he regretted that the usual notice regarding the Paris Club meeting on Senegal's debt rescheduling had inadvertently not been circulated to the Board.

Mr. Alfidja remarked that it would be difficult to link Fund reviews to a planning process, such as the Seventh Development Plan, particularly in a country like Senegal where adoption of the Plan would follow regional and parliamentary government consideration. The authorities intended to reduce arrears to the extent possible through increased revenue measures and improved economic management. In addition, the authorities hoped that friendly countries would provide Senegal with the resources necessary to reduce arrears vis-à-vis some public enterprises that would thus, in the medium term, be able to pay their debts and reduce the burden on the budget.

Senegal was going through a period of depressed economic activity and the pace of adjustment should be considered in a medium-term framework with due regard for the external resources available to Senegal, Mr. Alfidja observed. The democratic character of the Senegalese society should also be considered; the steps taken--cited by Directors as courageous--had been worked out through consensus. The present pace would allow Senegal to adjust in an orderly manner.

The Chairman made the following summing up:

> Executive Directors concurred with the thrust of the views expressed in the staff appraisal. They warmly commended the Senegalese authorities for the considerable progress made under the adjustment program in 1983/84 toward reducing the large internal and external financial imbalances. Although Senegal's economy had been hard hit by severe drought, the 1983/84 adjustment program had been kept on track, its financial objectives had been achieved, and all performance criteria had been met. In particular, the overall fiscal deficit--on a commitment basis--had been reduced substantially, from the equivalent of 8.2 percent of GDP in 1982/83 to 4.7 percent of GDP in 1983/84, and so had the rate of domestic credit expansion. As nontraditional exports had grown markedly, and export prices of groundnuts had turned out to be higher than anticipated, the external current account deficit had been brought down from 14.0 percent of GDP in 1982/83 to 11.1 percent of GDP in 1983/84. Directors noted with satisfaction that these results had been due not only to the strength of the adjustment measures adopted in August 1983 but also to the further corrective actions taken by the authorities when faced

with a shortfall in budgetary revenue. The importance of a continued flexible readiness to adopt, if needed, additional policies in the light of changing circumstances was underscored.

Directors emphasized that, despite the improvement registered in 1983/84, Senegal continues to face major structural and financial problems. They were concerned in particular with the weakness of the agricultural sector, the still sizable overall fiscal deficit, the high level of domestic arrears, and the unsustainably large deficit in the current account of the balance of payments. In view of these problems, Directors considered the prompt and full implementation of the new adjustment program for 1984/85-1985/86 necessary to achieve further progress toward satisfactory economic growth and a viable financial position over the medium term.

Directors stressed the importance of full implementation of the new agricultural policy aimed at expanding and diversifying domestic production and reducing the cost of state intervention in the rural sector. They noted the comprehensive nature of Senegal's medium-term agricultural strategy, and the part played by the country's principal creditors and donors, notably the World Bank, in assisting the authorities to formulate the appropriate policies; and they emphasized the need for the World Bank to play an active part in the implementation and financing of the necessary structural adjustments.

The authorities were commended for the measures taken to improve production incentives through substantial increases in producer prices of the major food and export crops. Directors welcomed the most recent and courageous decision to increase the retail price of rice, which they regarded as essential not only to shift relative consumer prices in favor of locally produced cereals, so as to reduce the heavy reliance on rice imports, but also to avoid subsidizing rice consumption. It was considered important that a more flexible rice pricing policy be pursued in the future, which would help to avoid large price adjustments. Directors also welcomed the measures taken to eliminate subsidies on consumption of groundnut and vegetable oils. In addition, they recommended that urgent steps be taken to strengthen the operations and financial management of the Price Equalization and Stabilization Fund.

Directors considered that the authorities' new program rightly placed major emphasis on the continuation of the fiscal adjustment. However, they expressed concern regarding the projected decline of government revenue in relation to GDP and the financial performance of public enterprises. While noting the additional revenue measures recently enacted, they stressed the need for sustained efforts to strengthen tax administration, particularly at the customs level, and, more generally, to improve revenue performance. They also urged resolute action to contain government outlays and to limit the wage drift. The achievement of the new program's objectives to further reduce significantly the fiscal deficit and domestic arrears was seen by Directors to be of the essence. The question was raised whether the sharp rise in domestic savings implied by the program in 1985 could be realized on present fiscal policies.

In view of the weakness of the present and foreseeable external position of Senegal, Directors emphasized that the authorities would need to pursue strong adjustment efforts for several years to attain a viable balance of payments position. They strongly hoped that, in implementing the 1984/85 program, the authorities would show the same firm determination that they had demonstrated during the 1983/84 program.

A number of Directors shared the views expressed at the recent Consultative Group meeting on Senegal, particularly the emphasis placed on instituting more effective planning and investment budgeting, and on adequately reflecting the authorities' investment priorities in the new plan to be launched in 1985/86. They also noted that, while continued progress was being made to reduce the overall fiscal deficit, much more needed to be done over the medium term to restructure and rehabilitate the parapublic sector. Several Directors expressed their disappointment at the slow pace of reform of the parapublic sector; they felt that it was urgent to move from study and review to decisive corrective action in that area with the assistance of the World Bank's expertise.

Considerable emphasis was placed on Senegal's serious external debt situation and the consequent need for prudent debt management. Directors stressed that Senegal needed not only Fund support but, perhaps even more, concessional assistance and appropriate external debt relief from official and private creditors, in addition to domestic adjustment. Directors emphasized that close cooperation between the Fund and the World Bank would be important in assisting Senegal in its adjustment efforts.

It is expected that the next Article IV consultation with Senegal will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Senegal, in the light of the 1984 Article IV consultation with Senegal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Senegal continues to maintain an exchange system which is free of restrictions on payments and transfers for current international transactions.

Decision No. 7887-(85/7), adopted
January 16, 1985

Stand-By Arrangement

1. The Government of Senegal has requested a stand-by arrangement in an amount equivalent to SDR 76.6 million for a period of 18 months from January 16, 1985 through July 15, 1986.

2. The Fund approves the stand-by arrangement set forth in EBS/84/267, Supplement 3.

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

Decision No. 7888-(85/7), adopted
January 16, 1985

2. KUWAIT - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Kuwait (SM/84/268, 12/11/84). They also had before them a report on recent economic developments in Kuwait (SM/85/2, 1/2/85).

The Deputy Director of the Middle Eastern Department noted that oil market prices had declined since the conclusion of the consultation discussions with the Kuwaiti authorities in late October 1984. In addition, under the OPEC agreement reached at the end of October 1984, Kuwait's oil output had been reduced from 1.05 million barrels per day to 0.9 million barrels. Most of Kuwait's oil production consisted of medium and heavier grades, the demand for which had recently increased, and more than half of Kuwait's total exports were refined oil products. Given those factors, and assuming no further changes in either government policies or in the demand for, and price of, oil, the staff estimated that the overall budget surplus would be reduced by KD 0.4 billion in 1984/85 over 1983/84 and that oil exports would be $1.1-1.2 billion lower than estimated at the time of the discussions. Accordingly, the external current account surplus for the fiscal year ending June 1985 would be about $4 billion, rather than the $5.1 billion mentioned in the staff report. He pointed out that, assuming output of 0.9 million barrels per day, a change of $1.00 in the official price of oil in the coming period would yield a change in the same direction of about $330 million in Kuwait's oil export receipts.

Mr. Finaish made the following statement:

The development strategy that has been followed in Kuwait for a number of years now concentrates on the conversion of revenue derived from export of the country's principal asset--oil--into alternative types of income-generating assets that can lay the basis for sustained, broad-based growth in the future. This policy in pursuit of a transition to a pattern of growth that is less dependent on a single, and depletable, asset has consisted of two main elements; namely, the investment of a substantial proportion of the oil revenue in the development of infrastructure and industry at home and the use of the surplus investable funds for acquiring a diversified protfolio of assets abroad. At the same time, domestic social services have been expanded considerably in order to translate the increase in oil income into a higher standard of living for the people.

In the decade to 1981, high growth rates were recorded in activities comprising the non-oil sector. This was made possible by a rapid increase in public expenditures financed from the growing oil revenues. Toward the end of the 1970s, increasing inflationary tendencies and greater attention to efficiency in resource use led to a move toward a somewhat less expansionary public expenditure policy. The need for exercising restraint in financial policies was accentuated considerably in the period after 1981 as a result of a sharp fall in oil revenues. Total receipts from petroleum exports in 1983 and 1984 were 45-50 percent less than in 1980, notwithstanding some recovery in these receipts after mid-1983. Just as a rapid growth of public expenditures was a key factor contributing to the high rate of growth of the non-oil sector prior to 1981, so the slowdown of expenditure growth after 1981 triggered by the delcine in oil revenues contributed to a sharp drop in the growth rate. The recent experience thus points to the continuing close dependence of conditions in the economy upon developments in the oil market. Also, together with the continuing uncertainties in that market, it brings into sharper relief the case for sustained, concerted efforts toward economic diversification.

The strategy of industrial development that has been followed thus far in Kuwait is three pronged. First, with a view to developing a fully integrated oil sector under national ownership, domestic refining capacity has been expanded greatly and a substantial amount of investment has been made in acquiring facilities abroad for oil exploration, refining, and marketing. Second, in line with the comparative advantage provided by the country's extensive petroleum resources, and to diversify the range of marketable products made from these resources, several downstream productive units have been established that manufacture a variety of petrochemicals, both for domestic use and export. Third, some nonhydrocarbon-based industries have also come up, the majority of which are engaged in producing different kinds of building materials for the domestic construction industry. The development of these industries has been left essentially to the private sector, with the Government providing encouragement through substantial investment incentives.

During the past year, and as part of the 1984/85 budget, the authorities have taken several measures to revive activity in the non-oil sector where, as noted above, the rate of growth fell sharply during 1982-84, reflecting not only the shift toward restraint in the stance of public financial policies but also the adverse effect on private sector confidence of the security situation in the region and the 1982 crisis in the unofficial stock market. The budget for 1984/85 has a more expansionary stance, and investment incentives to the private sector have been strengthened. At the same time, a high-level committee has been appointed to consider further means of stimulating non-oil activities.

The authorities attach importance to the need for the country's efforts toward industrial diversification to proceed within the framework of a well-defined medium- to long-term strategy of development, and the aforesaid committee will be looking at the prospects for the development of industries in the non-oil sector within such a context. Moreover, the Ministry of Planning has been preparing a development plan for the period 1985/86-1989/90, which is viewed as part of a longer-term (20 years) development strategy. Given the country's relative factor endowments and the limited size of the domestic market, there is a case, as noted by the staff, for concentrating new investment on industries that are capital-intensive and export-oriented. Beyond the outlining of the general character of the development strategy, however, lies the important and difficult task of identifying opportunities for profitable investment at the level of individual industries, a task that would require carefull assessment of the feasibility and comparative profitability of alternative investment schemes.

In the future development of the non-oil sector, the authorities envisage an expanded role for the private sector and lesser reliance on continued public expenditure growth. To that end, they intend to maintain an appropriate set of incentives, supplementing the good foundation already laid for private investment by the heavy public investment over the past decade in basic infrastructural facilities. Furthermore, the authorities recognize that an important condition for broadening the market for Kuwait's existing and prospective industries is that their development and operation are guided along lines that would serve to make them internationally competitive, and are mindful of the role of appropriate domestic pricing and exchange rate policies in that connection. Another necessary condition is that the exportable products that are developed are accorded adequate market access abroad, and the authorities attach particular importance to this factor in the case of petrochemicals, a key component of the country's industrialization program (and also of the industrial strategies of similar other countries in the region). With respect to foreign direct investment, the authorities have a pragmatic policy, whereby each case is judged on its own merit and in accordance with the established regulations that can be reviewed in the light of changing requirements. Given Kuwait's own financial resources, the key input that foreign participation in the country's industrial development can provide is technology, and not capital. Thus, cooperative arrangements that emphasize--and facilitate--the transfer of technology, rather than the standard foreign direct investment package, are of primary interest to the host country in such cases.

In the field of fiscal policy, attention is being given to broadening the revenue base and rationalizing expenditures. Several proposals have been under consideration for diversifying the sources of government revenue which would permit a more stable pattern of revenue and expenditure growth, thereby facilitating medium-term fiscal planning as well as providing a more stable environment for private sector decision making. However, significant progress in this respect would inevitably take time. Some cushion against fluctuations in oil receipts is already provided by investment income. Active consideration is being given to raising some fees and charges, and proposals for introducing certain direct and indirect taxes have also been the subject of discussion. A review of the structure of revenues is among the issues being considered by the high-level committee referred to above. With respect to improving the structure of expenditures, several significant steps have been taken. The growth of current expenditures has been kept in check, and strict control has been exercised on public sector employment. In the allocation of capital outlays, precedence has been accorded to the completion of ongoing projects and the proper maintenance of existing capacity. To reduce the expenditure on subsidies, domestic prices of petroleum products were raised substantially. Moreover, the adjustment of electricity and water rates has recently been under active consideration within the framework of the Gulf Cooperation Council, and some recommendations to that effect have recently been formulated. The authorities have reaffirmed their policy of seeking further reductions in subsidy expenditure; however, they have also noted that practical considerations necessitate due gradualism in this respect.

Reflecting the restrained public expenditure policy and the drop in the level of economic activity, monetary expansion has slowed down considerably since 1981. These trends have contributed to reducing inflation to a very low level in 1984. The monetary authorities have sought to ensure that an adequate supply of credit is maintained for productive purposes. The ceiling on the proportion of bank credit in the form of overdrafts was further lowered. A sizable upward adjustment in interest rates on domestic currency deposits in June 1984, coupled with the temporary introduction of a separate and more depreciated dinar exchange rate for financial transactions in April 1984, helped reverse the increasing flow of private funds abroad or into foreign currency deposits with domestic banks that had been observed earlier in the year. The authorities have also been taking a number of steps to ensure the soundness of the domestic banking system. These steps include, in addition to the measures taken to protect the system from the disruptive effects of the 1982 stock market crisis, the regulation that banks report regularly to the Central Bank on the quality of their assets; the policy of ensuring adequate capitalization levels; encouragement of the modernization and strengthening of bank management and operational procedures; and the bringing of exchange dealers' operations under the supervision of the Central Bank and their debarment from conducting banking business.

With a view to preventing a recurrence of excessive speculation in stocks, a series of measures have been taken to strengthen the regulations relating to stock market activities. Substantial progress has been made in the settlement of claims and issues arising from the 1982 stock market crisis, and the final settlements are to be made soon.

With respect to the balance of payments, a slowdown of the previously rapid growth of imports, caused by the policies of financial restraint and the weakening of economic activity, has contributed to cushioning somewhat the impact on the payments position of the large drop in oil receipts occurring between 1980 and 1982. A significant, though much reduced, current account surplus has been maintained. Income on foreign investments made out of the surpluses of earlier years has also served as a cushion, notwithstanding the decline in the flow since 1981 as a result of the progressive fall in world interest rates. However, the payments position in the period ahead would remain highly sensitive to oil market developments.

Kuwait maintains a liberal trade and payments system. Over the past decade or so, it has provided substantial financial assistance to developing countries, and it is noteworthy that its foreign aid program has been maintained at a high level despite the recent weakening of its external position.

Mr. Nimatallah remarked that, despite the continued weakness in the international oil market, Kuwait's domestic and external financial position was strong. The authorities had successfully adjusted to lower oil revenues without disrupting domestic economic activity, and their prudent fiscal and reserve management policies in particular had yielded budget and balance of payments surpluses.

In recent years the authorities had created a modern infrastructure and had improved the quality of life of the Kuwaiti people by expanding and upgrading educational, medical, and other social services, Mr. Nimatallah noted. The authorities recognized the need to consolidate their development gains and to diversify the economy in the coming period, and their strategy to achieve those objectives should be based on available resources. In that connection, it was noteworthy that, while Kuwait's domestic market and labor supply were limited, the Gulf Cooperation Council (GCC) provided opportunities for a wider market and joint ventures. The Kuwaiti authorities could encourage the private sector to take advantage of the scope for expanding activities in services, agriculture, fisheries, and small-scale manufacturing, but he doubted whether the staff was correct in suggesting that Kuwait could implement a development strategy based on capital-intensive manufacturing mainly of non-oil exports; the staff should comment further on the matter. The development strategy should perhaps be aimed at achieving closer coordination between Kuwait and the other GCC countries and at providing incentives to Kuwait's own private sector; indeed, some progress in those areas had already been made.

The authorities should maintain their policy of restraint in public finances, particularly by continuing the freeze on wages and salaries, Mr. Nimatallah said. In addition, there was room to rationalize expenditures through reductions in subsidies and transfer payments. The authorities had already started reducing subsidies, for example, by increasing petroleum product prices.

The authorities had appropriately decided that in allocating development expenditures priority should be given to ongoing projects and to maintaining the existing capital stock, Mr. Nimatallah went on. He agreed with the staff that increased user charges for public utilities would reduce wasteful consumption as well as enhance revenues. However, in light of institutional realities in Kuwait and the country's comfortable financial position, he disagreed with the staff that incomes and sales taxes would be appropriate at present.

The authorities had limited the impact of the 1982 stock market crisis on the financial system, Mr. Nimatallah noted. The new regulations governing stock market operations, and the various measures to strengthen and monitor the banking system were welcome.

Kuwait continued to enjoy a strong balance of payments position and a comfortable level of reserves, and there were no exchange and trade restrictions, Mr. Nimatallah remarked. The authorities' maintenance of a generous foreign aid program despite the sharp decline in oil income in recent years was commendable.

In sum, Mr. Nimatallah said, the economy was strong, and the present economic and financial policies were in the right direction. The bright prospects for Kuwait's economy would be reinforced by continued cooperation among the GCC countries.

Mr. Templeman agreed with the staff that priority should be given to formulating a medium-term development strategy. The effort to take advantage of oil-based revenues to expand and improve the infrastructure and to provide an array of social services had been completed, but the prospects for the oil sector were uncertain. Given the small size of the domestic market, the staff had correctly concluded that non-oil, export-oriented industries and modern services were the most likely sources of future economic growth. Accordingly, Kuwait's development strategy should stress profitable opportunities for private sector investment in Kuwait as an alternative to investing abroad. Containing private sector wages would be an important factor in achieving the profitability and competitiveness needed to attain the desired industrialization and economic diversification. The staff should comment further on recent developments in those wages.

Prudent financial policies had helped the authorities to maintain both a noninflationary environment and an open economy, Mr. Templeman commented. However, the staff discussion, including the reference to the authorities' support for "coordinated planning for economic development," did not clearly indicate the likely extent of government intervention in the future development of the economy. The substantial government involvement in the development of the infrastructure was understandable, but a similar degree of involvement in the much more complex industrialization stage would probably be unwise. In that connection, he agreed with the staff that administrative procedures, such as those governing domestic and foreign investment, should be streamlined, and that the medium-term development strategy should not be based on excessive protection and subsidization of industries that could not survive without such artificial support.

The authorities' handling of fiscal policy in the wake of the sharp drop in oil revenues and investment income was commendable, although recent efforts to use fiscal policy to stimulate the private sector apparently had not yet been effective, Mr. Templeman said. He was pleased that the control of current budget expenditures, including restraint on public sector wages and hiring, had played an important role in preserving the budget surplus. However, the Government had been less successful in containing the growth of subsidy and transfer payments, and while the political problems in those areas and the wish to unify utility rates and prices within the GCC area were understandable, subsidy and transfer payments should be reduced in the coming period. The authorities had concluded that the volatility of revenues from oil and foreign investment suggested the need for a more diversified revenue base, including, perhaps, a personal income tax and a general sales tax. However, such taxes should be devised carefully so that they would not discourage saving and investment. Greater stability in fiscal income and expenditure should provide a more favorable environment for investment.

The serious problems created by the collapse of the unofficial stock market had contributed to the pervasive involvement of the Government and the Central Bank in the financial system, Mr. Templeman observed. To some extent, that outcome might well have been unavoidable, but there were some questions about the Government's future role in the financial system. For instance, he wondered whether the authorities intended to dispose of the Government's equity holdings in private companies and banks. In any event, further serious problems in the financial system should be avoided, and the banks' increased capacity to assess credit risks, the shift from unsecured overdraft lending to term loans, and the improved disclosure requirements and other regulatory reforms in the stock market were steps in the right direction. The high-level committee created in October 1984 to review activities in a number of economic and financial areas was due to report to the Government in February 1985, and he wondered whether the staff had any information on the committee's preliminary conclusions.

Additional attention should be paid to exchange rate policy, Mr. Templeman considered. The staff had noted that the real effective exchange rate had appreciated by about 20 percent between the final quarter of 1980 and the third quarter of 1984, non-oil exports had been declining since 1981, capital outflows were large and persistent, and some import tariffs had recently been raised. While those developments might not constitute overwhelming evidence that the currency was overvalued, they did raise questions about the appropriateness of the present exchange rate policy. Given Kuwait's good record on trade and payments restrictions, he hoped that in the coming period the authorities would not hesitate to use the exchange rate tool, rather than restrictive measures, to provide any necessary encouragement to economic recovery and export diversification.

Mr. Goos considered that the authorities' policies in the recent past had generally been satisfactory. Their continued relatively high level of foreign aid, despite the depressed oil and budgetary receipts, reflected their responsibility to help other countries meet their development needs.

The economy had entered a new development phase, Mr. Goos noted. Accordingly, in the coming period, the overall policy stance should be aimed at strengthening the non-oil sector in order to establish a foundation for continued and self-sustaining economic growth. In that connection, he agreed with the staff that the development strategy should concentrate on capital-intensive industries, particularly manufacturing of non-oil exports. That approach would be compatible with the economy's resource and institutional constraints and the country's comparative advantages, and it would help to provide attractive domestic investment opportunities as an alternative to foreign investment. Although the potential for growth in agriculture and fisheries was not as promising as that for non-oil exports, it should be fully developed.

To achieve the development objectives, certain policy adjustments would have to be made to encourage private investment, Mr. Goos continued. That the authorities had already taken steps to rationalize budgetary expenditure was welcome; additional corrective measures in that area should be given priority, as the remaining considerable subsidies and transfers to consumers were a disincentive to private initiative. The authorities should also review the structure of expenditures with a view to channeling additional resources to productive uses. He agreed with the staff that the authorities should increase user charges and broaden the revenue base.

In considering the appropriate role of exchange rate policy in the medium-term development strategy the authorities faced a dilemma, Mr. Goos commented. On the one hand, the real effective exchange rate had been rising, reflecting the considerable current account surpluses; on the other, the need to develop new industries suggested that a lower real effective exchange rate might be appropriate, at least in the longer run. For the time being, he favored the authorities' view that the importance of the exchange rate in supporting the competitiveness of new industries should not be overemphasized while the industries were becoming established. Of course, in the longer run, the viability of non-oil industries should not depend on the existence of subsidies, and, to that end, some adjustment of the exchange rate might be necessary.

The appropriateness of the authorities' credit policy was reflected in the recent significant decline in the rate of inflation, although the pronounced slower pace of economic activity had also been an important factor, Mr. Goos said. The authorities' pragmatic handling of the stock market crisis in August 1982 was commendable. While the immediate threat to the financial system had been successfully countered, the authorities should persevere in their efforts to strengthen the system; the recently adopted measures to that end were welcome.

Mr. Alfidja remarked that Kuwait's economic performance in recent years had been strong and steady, as the substantial oil revenues had been prudently managed and had supported the development of the infrastructure and the provision of extensive social welfare services. The rate of growth of non-oil real GDP had increased from an average of 3.5 percent in 1978-79 to 6 percent in 1980-82, and the annual rate of inflation had been kept to an average of 7 percent in 1980-82. In addition, there had been substantial budget and balance of payments surpluses, and sizable foreign exchange reserves had been maintained.

Since 1982, however, the economy's growth had weakened, mainly as a result of adverse developments in the oil sector, Mr. Alfidja commented. The reduction in oil revenues due to lower oil production levels and lower export prices had led to a deceleration in net government expenditure. At the same time, the difficulties in the unofficial stock market and the armed conflict between neighboring countries had contributed to the depressed activity in Kuwait's non-oil sector. Despite the authorities' timely measures in mid-1983, the moderately expansionary fiscal policy under the 1984/85 budget, and the special financial assistance to the private sector to revive non-oil sector activity, output in that sector had apparently declined in 1984. The continuing uncertainties in the oil market underscored the need for sustained and concerted efforts to diversify the economy.

The authorities' intention to exploit the extensive petroleum resources, their recognition of the need to strengthen the performance of the non-oil sector in both the short and medium term, and the appointment of a high-level committee to examine industrial development possibilities in the non-oil sector were evidence of the authorities' commitment to diversify the economy, Mr. Alfidja remarked. In that context, the preparation of the development plan for 1985-90 as part of a longer-term economic strategy was a step in the right direction; World Bank technical assistance would certainly be helpful. The staff should comment further on the World Bank's involvement in Kuwait's development efforts.

The economic diversification effort should help to meet the objective of increasing non-oil government revenues, thereby lending greater stability to budgetary receipts, Mr. Alfidja said. The measures that had already been introduced to restructure expenditures, reduce subsidies, control public sector employment, and give priority to completing ongoing development projects were commendable.

Money and credit policy had been appropriately geared to supporting the restrained fiscal stance, Mr. Alfidja noted. The new discipline in the operations of the stock market and the steps the authorities had taken to restore confidence in the banking system were reassuring.

The authorities were to be commended for Kuwait's high level of official development assistance, Mr. Alfidja stated. The Government's willingness to participate in joint ventures with developing countries was welcome.

Mr. Kabbaj said that for four years Kuwait and most other oil producing countries had had to cope with the adverse effects of the weakening oil markets on their economies in general, and their development efforts in particular. However, as a result of prudent domestic and external management, and owing to its relatively small ratio of population to total income, Kuwait had been able to withstand the declining oil production and export trends better than other oil exporters. After a large decline in oil production and prices in 1979-82, Kuwait's oil output and export volume had risen in both 1983 and 1984.

In setting their energy policy the authorities had taken stock of adverse international developments and the need for further diversification of the energy sector, Mr. Kabbaj noted. To limit the heavy government subsidies the authorities had raised retail oil prices in early 1982. There had also been a gradual shift in the structure of energy exports toward refined products. To support and complement that strategy, investment in the energy sector had been concentrated on enlarging refining capacity and reducing the production of residual fuel oil in favor of lighter crude oil which commanded higher prices and made a larger value-added contribution. Moreover, the authorities had acquired distribution networks in, and energy exploration and oil field services from, industrial countries in an attempt to address the marketing and other problems that might emerge while bringing the integrated petroleum industry under national ownership and control.

The non-oil sector had benefited from the authorities' efforts to strengthen the economic infrastructure, Mr. Kabbaj said. In oil producing countries petroleum revenues accrued to the government, and the pace of government expenditure determined the level of general economic activity. Until 1982, the acceleration in the pace of economic activity in Kuwait caused by increased government spending had been concentrated in communications, transport, and construction. Since then, government expenditure had significantly moderated in response to the unfavorable oil market trends, and non-oil production had declined. However, foreign investment of surplus funds had generated a steady stream of income that had more than offset the serious shortfall in petroleum revenues.

The authorities intended to maintain the moderation that had characterized fiscal policy for several years, Mr. Kabbaj remarked. Accordingly, the control over current expenditures would be improved, civil service recruitment would be kept to a minimum, spending on subsidies would be stabilized, and government expenditure would be rationalized with a view to achieving a more appropriate distribution of income. The rationalization effort would be aimed at shifting resources away from nonessential consumption and toward productive uses.

The pace of monetary expansion and the level of liquidity were significantly affected by the Government's role in general, and by the pattern of government expenditure in particular, Mr. Kabbaj noted. The authorities had shielded the financial system from the effects of the collapse of the unofficial stock market by redeeming postdated checks that had been used to pay for shares purchased in that market. They intended to take steps specifically designed to prevent a recurrence of the speculation that had led to the difficulties in the unofficial stock market.

The share of non-oil exports in total exports in recent years had been about 14 percent, although the absolute value of those exports had declined since 1982, Mr. Kabbaj commented. Detailed data on exports in 1983 and 1984 were not yet available, but it appeared that non-oil exports had been adversely affected by developments in the region and in the world economy. The efforts of a small country like Kuwait to diversify production were constrained by its limited natural and manpower resources. In theory, those constraints could be dealt with through an appropriate exchange rate regime, sound fiscal management, increased reliance on non-oil taxation, the reduction or elimination of subsidies, the adoption of supportive monetary measures, and the introduction of incentives for specific industries, and in fact, many such measures had already been adopted in Kuwait. But the authorities' choice of policy options was constrained by the limited natural resource endowment and small domestic capacity characteristic of the entire region. For instance, diversification of revenue sources in the direction of non-oil taxation could create a disincentive to production in the non-oil sector. Similarly, a flexible exchange rate would ultimately benefit the economy; however, in considering whether such a policy should be introduced forthwith, the authorities had to bear in mind its likely effects on fiscal receipts and domestic inflation, and the small size of the domestic market.

The authorities had taken steps to encourage the private sector but had clearly recognized the constraints on their efforts in that area, Mr. Kabbaj remarked. They had provided investment incentives, including long-term investment loans at concessional interest rates, subsidized land leases, and opportunities for equity participation. Finally, their generous foreign aid, despite the decline in oil export earnings, was commendable.

Mr. Nimatallah agreed with Mr. Goos that the time was not ripe for the authorities to attempt to use exchange rate policy to bolster non-oil exports. At a later stage, after Kuwait had developed a sizable non-oil export sector, the exchange rate might well prove a useful policy tool.

The Deputy Director of the Middle Eastern Department said that the staff felt that exchange rate policy could play a role in the development strategy by encouraging the growth of efficient domestic enterprises. The present level of the exchange rate was not a cause for concern, but it should be viewed in light of the incentives for industries in the form of highly subsidized inputs and interest rates. As and when the authorities moved to eliminate those subsidies, the staff would expect to see the exchange rate play a more active role in encouraging efficient development of the domestic economy.

The oil sector would obviously be the main source of economic growth in the coming period, the Deputy Director commented, but the authorities intended to diversify the economy away from oil, and the staff and the authorities had discussed at some length the most promising areas for such diversification. The staff had noted that, although there had been some interesting developments in agriculture and fisheries, there were significant constraints on further development of those sectors; indeed, the authorities had already had to subsidize considerably activities in those areas. One of the major constraints on development in Kuwait was the small size of the domestic labor force. Apparently the authorities wished to gain a better balance over time in the mix of nationals and expatriates in the domestic labor force. In the circumstances, the staff had concluded that the development strategy should emphasize capital-intensive manufacturing industries. Such industries could not operate efficiently if their production was to serve only Kuwait's relatively small market, and the staff had encouraged the authorities to view their development effort in the context of the regional market. A World Bank mission in February and March 1984 had reached the same conclusions.

There was some difference of opinion between the staff and the authorities about the usefulness of certain traditional fiscal instruments in the effort to increase revenues, the Deputy Director remarked. The total estimated revenues for 1984/85 of KD 4.5 billion consisted mainly of KD 2.9 billion in oil and gas revenues and KD 1.3 billion in investment income, largely from foreign investments. The staff felt that the authorities should carefully consider the various advantages and disadvantages of imposing additional taxes on the economy's main growth sectors in the interest of reduced volatility of potential revenue sources. Also, the staff had concluded that, since the authorities wished to reduce subsidies only gradually, consideration of certain additional revenue sources was in order. There were already three forms of taxes in Kuwait, but the revenues they produced were fairly small. There were many exemptions to the import duties, and although the tax rates on non-oil corporations ranged from 20 percent to 55 percent, the revenue in 1983/84 had been only KD 20 million, suggesting that the authorities had considerable difficulty in collecting those taxes. There were also problems of undervaluation and collection in connection with the tax on real estate. Broadening the tax base and improving the collection of existing taxes would give the Government more stable revenue sources, improve the overall revenue performance, and enable the Government to reduce its reliance on external revenue sources.

Wages in the private sector were determined by market forces and had basically moved in line with wages in the public sector, the Deputy Director noted. Current private sector wages were estimated to be roughly 20 percent greater than comparable wages in Singapore. However, nonwage costs in Kuwait added approximately 70 percent to total labor costs, causing such costs to be relatively high. No further firm conclusions on private sector wages in Kuwait could be drawn on the basis of the limited available data. For instance, an index of wages in the private sector was not available.

The reference to "comprehensive planning" in the staff report was not meant to suggest that the authorities had introduced a system of central planning, the Deputy Director said. Indeed, Kuwait was a market economy. In referring to comprehensive planning, the authorities had in mind their wish to ensure that adequate attention would be paid to all the various institutional and other aspects of the development effort. For instance, they wished to consider carefully the available choice of labor policies, population mix, and share of the Government in overall economic activity.

The recently appointed high-level committee would probably consider whether the Government should divest part of its large-scale purchases of shares in various companies that had been made in recent years, the Deputy Director remarked. The committee would also consider further measures to improve the functioning of the stock market and to ensure the stability of the banking system. The committee's report was expected to be completed in February 1985.

The performance of non-oil exports had been adversely affected by the conflict in neighboring countries, the Deputy Director of the Middle Eastern Department explained. In earlier years, a large share of Kuwait's total exports and re-exports had been directed to Iraq, and a smaller share to the Islamic Republic of Iran. Exports to other neighboring countries had performed fairly well in recent years.

Mr. Finaish commented that the diversification of the economy's productive base had been emphasized as a central objective of economic policy in Kuwait for many years. To that end, heavy investment had been made in establishing a variety of infrastructural facilities. In the field of directly productive activities, the petrochemical industry had been an important area of development, given the country's extensive petroleum resources. Several nonhydrocarbon-based industries had also been developed, with the production of construction materials representing the largest component. So far, the main impetus to growth in the non-oil sector had come from heavy public sector investment in infrastructure. The recent slowdown in non-oil sector growth was partly attributable to the completion of most of those projects. The growth of the non-oil sector in the future would therefore depend more on growth of directly productive activities.

The authorities had recently been reviewing the prospects for growth in the non-oil sector within the context of a medium- to long-term development strategy, Mr. Finaish went on. The staff had noted that capital-intensive and export-oriented industries represented the most promising area for future growth. Given the country's relative factor endowments--characterized by large energy and financial resources and a shortage of domestic manpower--as well as the limited size of the domestic market, a case existed for directing investment toward such industries, which would include both petroleum-based as well as nonpetroleum-based industries. Such a recommendation, however, pointed only to the general direction of the industrial strategy to be followed. The more important and difficult task was to give content to such a strategy by identifying opportunities for profitable investment at the level of individual industries. That task would require careful assessment of the feasibility and relative profitability of alternative courses of action and should be approached as part of the formulation of a well-defined, long-term development strategy.

The members of the GCC were moving forward cautiously in their efforts to coordinate their development strategies, Mr. Finaish continued. There were regular meetings of the governors of central banks, oil ministers, and ministers responsible for other important sectors of the GCC economies. Of course, there was room to strengthen the cooperation among the GCC members, and successful economic integration would require careful assessment of potential complementary lines of production. Through the GCC, members could have access to a larger market for their existing and potential industries.

Promoting the private sector while reducing the economy's dependence on the continued expansion of the public sector was an important aspect of the Kuwaiti authorities' development strategy, Mr. Finaish said. To that end, the authorities had provided substantial incentives, such as infrastructure development, investment finance, equity participation, favorable tax treatment, and a reduction and simplification of investment clearance procedures. In setting their domestic pricing and exchange rate policies, the authorities recognized that, if industries--particularly export-oriented ones--were to remain viable in the longer run, they would have to be internationally competitive. Accordingly, to the extent possible, the authorities intended to avoid protection or subsidization of domestic industries. Some protection of certain infant industries might be needed to enable them to become established. The authorities would of course carefully consider the kinds of industries that warranted such protection as well as the appropriate amount and period of the protection.

In assessing Kuwait's export diversification efforts, the question of market access for new exports naturally came to mind, Mr. Finaish commented. Indeed, the same question could be raised in connection with the development efforts of many other oil exporting countries. An important part of the answer had to do with the fairness of international trade: after all, oil exporting countries imported billions of dollars worth of goods and services from industrial countries, and they naturally expected industrial countries to be receptive to their exports. Oil exporting countries should be able to export goods and services in which they could develop a comparative advantage, an important example being petrochemicals, thereby increasing global efficiency. The Fund regularly advised many developing countries to adopt policies to increase their exports, but they could only do so if they were able to find adequate markets for them. He hoped that the issue of the marketing of oil exporting countries' exports would receive sufficient attention in the future.

He agreed that, in light of the fluctuation in oil revenues, Kuwait's revenue sources should be diversified, Mr. Finaish remarked. Such diversification would enhance the authorities' ability to plan their expenditure policies in a medium-term context and would provide a more stable environment for private sector decision-making. The relatively large revenues from investment income gave Kuwait a cushion, but they tended to fluctuate with changes in interest rates and other developments in the financial markets. As the staff had noted in its report on recent economic developments, the authorities were taking steps to diversify revenues. For instance, increases in certain fees and charges were being considered, and even the introduction of sales and income taxes was being discussed. As some Executive Directors had suggested, there might be no immediate need for income and sales taxes. In any event, some time would be required to develop the political consensus and administrative machinery for such taxes before actually introducing them. The imposition of such taxes could also have favorable psychological implications; for instance, they would increase taxpayers' sense of participation in a country's various national developmental activities. That effect could be particularly important in an oil exporting country where the participation of nationals in the oil industry--which constituted the major sector--was usually very limited, as the industry was capital-intensive, oil operations were usually located outside population centers, and revenues typically accrued to and were spent by the government. In considering issues of taxation, charges, and subsidies, the authorities in an oil exporting country were sensitive to developments in neighboring countries and to their effects on the distribution of income. Kuwait and other countries in the region had an opportunity through the GCC to discuss issues of common interest with a view to facilitating common action, where appropriate. For instance, there had been discussions in the GCC on water and electricity rates.

Kuwait was on the 18-month consultation cycle, Mr. Finaish noted. In light of the schedule for considering the budget, the authorities preferred to hold the next Article IV consultation, sometime after March 1986.

The Chairman made the following summing up:

Directors noted that for a decade after the early 1970s, economic developments in Kuwait were marked by the implementation of a major program of economic and social infrastructure development financed with sharply higher oil and gas export earnings. Prudent financial policies and the application of liberal exchange and trade policies permitted inflation to be kept at moderate rates.

In recent years, however, the Kuwaiti economy has been affected by sharply reduced oil export earnings, which has necessitated a more restrained stance of budget expenditure policies. In turn, the deceleration of the growth of government expenditures has entailed a slowdown in the economy's non-oil sector. The lower oil export earnings and the receipts from investment income from abroad after 1981 also resulted in reduced current account surpluses of the balance of payments. This development has been accompanied by large private capital outflows.

Directors noted that the Kuwaiti authorities have taken various steps since mid-1983 to encourage activity in the economy's non-oil sector, including the adoption of a mildly expansionary stance in the government budget for 1984/85 and large-scale financial support for individuals and enterprises affected by the stock market crisis. However, activity in the economy's non-oil sector has remained sluggish, and the authorities are keeping under active consideration possible further measures to ensure more satisfactory growth rates.

While welcoming the steps already taken to maintain the level of domestic economic activity, Directors suggested that the problems of Kuwait's non-oil sector were partly structural in nature. Considering the completion of many major infrastructure projects, as well as the uncertain prospects for future oil market developments, they emphasized the need for alternative sources of economic stimulus in the period ahead. Kuwait's membership in the Gulf Cooperation Council, it was noted, is of valuable assistance in the diversification of economic activity.

Directors were also of the view that a redirection of development strategy would need to be supported by changes in the structure of budget expenditures as well as by medium-term diversification and broadening of budget revenue sources devised in such a manner as not to discourage saving and investment. Special emphasis was placed by Directors on further budget rationalization, including direct and indirect subsidization of electricity and other public utilities and services. These structural changes on both budget revenue and expenditure were believed by Directors to be particularly appropriate in view of the recent and prospective developments in the world oil markets.

Directors noted the substantial financial assistance extended by the authorities to the private sector since 1982 and emphasized the continuing importance of maintaining the soundness of the financial system. The stance of monetary policy was seen by Directors to be broadly appropriate. Directors welcomed particularly the recent decision of the Central Bank of Kuwait to institute regular reporting by commercial banks on the quality of their asset portfolios as well as the recent reorganization of the official stock exchange.

Directors were confident that the difficulties experienced by the economy during the recent past could be overcome through the continued pursuit by the authorities of appropriate adjustment policies. In particular, Directors stressed the importance of domestic resource allocation on the basis of market criteria and the avoidance of excessive import protection and subsidization of productive enterprises. In the framework of its medium-term growth objectives and for the development of international competitive activities, Kuwait was also advised to keep the appropriateness of its exchange rate under review.

Directors commended the record of the Kuwaiti authorities in the provision of foreign aid to developing countries.

It was agreed that the next Article IV consultation discussions with Kuwait would be held on an 18-month cycle.

3. OVERDUE PAYMENTS - MEMBER'S RIGHT TO PURCHASE

The Executive Directors considered a staff paper on the right of a member with overdue payments to the Fund to make purchases from the Fund (SM/84/281, 12/27/84).

Mr. Pickering noted that the proposed decisions reflected understandings and compromises reached during the discussion of the six-monthly report on overdue obligations to the Fund (EBM/84/167, 11/19/84) and were fully acceptable. On page 2 of its report the staff had described the positions that, on the basis of the draft decisions, the Fund should take on the right to purchase of a member country with overdue payments to the Fund. It was curious that the staff had not suggested that paragraphs (a) and (c) on page 2 should apply, along with paragraph (b), to a member that failed to meet a repurchase expectation pursuant to the guidelines on corrective action with respect to a noncomplying purchase. In order to maintain symmetry in the positions described in those paragraphs, it should be agreed that, if a member country was not fulfilling a repurchase expectation, staff and management should not discuss with the authorities, and the Executive Board should not approve, either a stand-by or extended arrangement or the country's use of the Fund's general resources outside an arrangement. Symmetry would also be achieved by agreeing that the rescinding of payment instructions described in paragraph (c) also should apply when a member country was failing to meet a repurchase expectation.

He made those recommendations somewhat hesitantly, as the Executive Board had already discussed the issues of noncomplying purchases and overdue payments at EBM/84/167, Mr. Pickering said. However, during that discussion, a large number of speakers, including his chair, had said that a member country's failure to meet a repurchase expectation in respect of a noncomplying purchase should be treated like an overdue obligation to the Fund. Although that view had not been supported by the necessary majority, the general view had been that the positions described in paragraphs (a) through (c) should be taken when a member country failed to meet a repurchase expectation. Finally, if the guidelines on corrective action remained unchanged and were applied in the way the staff had suggested, it was conceivable that a member country that was failing to meet a repurchase expectation could gain the Fund's formal approval of an extended or stand-by arrangement but be unable actually to make a drawing under the arrangement.

Mr. Mtei noted that the proposed decisions were meant merely to formalize the conclusions reached at EBM/84/167. However, the suggestion in paragraph (a) on page 2 that the Fund would not discuss or approve a stand-by or extended arrangement for a member with overdue obligations was inconsistent with management's need for flexibility in maintaining a dialogue with such a country. Indeed, it was not in the Fund's own interest to abandon a debtor member country; refusing to hold discussions of any kind would undermine the country's ability ultimately to repay the Fund.

In summing up the discussion on overdue financial obligations at EBM/84/167, the Chairman had stressed the need to keep open the channels of communication between the Fund and a member country in arrears, Mr. Mtei went on. The Chairman had also stated that, in some circumstances, a review under an existing arrangement with a member country in arrears could be carried out, provided that the staff paper on the discussions would not be brought to the Executive Board's agenda until the arrears had been eliminated. Accordingly, when the completion of a review under an arrangement would lead to an immediate purchase by the member country concerned once its arrears had been settled, it would be in the Fund's own interest to encourage the country to obtain a bridging loan to liquidate the arrears; that loan could then be repaid after the purchase had been made. It should be agreed that, if circumstances so warranted, a program with a member country with overdue obligations could be discussed with the authorities, provided that formal approval of the program by the Executive Board would not be requested before the country's arrears had been eliminated. The Fund could then maintain its contacts with the member country and provide an incentive for it to settle its arrears and make needed adjustments.

The proposed change in the texts of stand-by and extended arrangements would in effect make an unfulfilled repurchase expectation equivalent to an overdue repurchase obligation, Mr. Mtei remarked. That recommendation had not received sufficient support during the November 1984 discussions to warrant its consideration at the present stage. During their discussion on noncomplying purchases and misreporting of data, Executive Directors had noted the legal implications of requiring member countries to make a repurchase in respect of a noncomplying purchase; accordingly, it had been agreed that such repurchases would be an expectation rather than an obligation.

Mr. Zecchini said that the positions described on page 2 largely reflected the understandings reached during the earlier discussions on overdue obligations and a member country's right to purchase. However, he had reservations about the proposed treatment of a member country's failure to meet a repurchase expectation in respect of a noncomplying purchase. There was no reason why instructions for a purchase should be reversed if a member country became overdue in its financial obligations to the Fund but not if a member country failed to meet a repurchase expectation in respect of a noncomplying purchase. In addition, the staff should not negotiate, and the Executive Board should not approve a request for, a new stand-by or extended arrangement for a member country that had failed to meet a repurchase expectation. He was prepared to permit some flexibility in holding discussions with such a member country, but he was firmly opposed to Executive Board approval of an arrangement for the country.

The issue of a member's right to make purchases under the special facilities had merely been touched upon during the previous discussions, Mr. Zecchini recalled. However, it had been agreed that, in the context of the issues at hand, purchases under the special facilities should be considered separately from purchases under stand-by and extended arrangements. Hence, he agreed that paragraph (d) should not cover the special facilities. Finally, paragraph (c) and part of paragraph (a) should also apply to a member country that failed to meet a repurchase expectation; in paragraph (a), only the prohibition against approval of a stand-by or extended arrangement should be applied.

Mr. Arias said that the words "discuss or" in paragraph (a) on page 2 were misleading, as, under present practice, the Fund continued to hold discussions with a member country with overdue financial obligations. It should be clearly understood that, while the Fund would not negotiate a stand-by or extended arrangement with such a member, it would continue to hold discussions with it.

Mr. Jayawardena considered that the words "discuss or" in paragraph (a) should be eliminated. Unless he was mistaken, no reference to a prohibition on discussions with a member country in arrears had been mentioned in the relevant Chairman's summing up. The Fund should be flexible in dealing with member countries in arrears. It should not tie its hands unnecessarily by including the words "discuss or" in paragraph (a).

The Director of the Legal Department remarked that the positions described in paragraphs (a) through (d) on page 2 were meant to reflect the conclusions reached during the previous discussions on the right of a member with overdue payments to the Fund to make purchases. Accordingly, the staff had suggested that paragraphs (a) and (c) would not apply in the situation described in the first sentence of paragraph (d). During the earlier discussion, the staff had noted the asymmetry Mr. Pickering had described, but it was his impression that Executive Directors had not asked the staff to present a draft that would apply paragraphs (a) and (c) to unfulfilled repurchase expectations.

The reference to "discuss" in paragraph (a) was to discussions on the possible use of Fund resources by a member country that had overdue financial obligations to the Fund, the Director explained. As the Chairman had stated in his summing up of the discussion of the Fund's experience with and procedures for dealing with overdue payments, the staff would not bring to the Executive Board any proposal for the use of Fund resources by a member country with overdue financial obligations to the Fund (EBM/84/55, 4/5/84); moreover, the Fund would not even engage in negotiations with such a country on the possible use of resources. However, the staff would be able to discuss with the member country possible measures that would enable the country to eliminate its overdue financial obligations.

The present text of paragraph (d) was meant to avoid making in practice, although not in law, repurchase expectations equivalent to repurchase obligations, the Director remarked. In particular, the text provided that the principles set forth in paragraphs (a) and (c) would not apply to repurchase expectations. Mr. Pickering and Mr. Zecchini apparently preferred to change the text of paragraph (d) in order to make paragraphs (a) and (c), as well as paragraph (b), applicable to repurchase expectations.

Responding to a further question, the Director of the Legal Department explained that, under paragraph (c), if the Fund gave instructions for a purchase under an arrangement and subsequently discovered that the member country concerned had an overdue obligation, the staff would attempt to rescind the instructions. However, the staff could not be certain that the instructions could always be reversed. If the instructions were in the process of being carried out, it could be too late to reverse them and the purchase would have been completed.

Ms. Bush considered that, even with the changes suggested by Mr. Pickering, the proposed positions in paragraphs (a) through (d) would still be based on the important distinction between a repurchase expectation and a repurchase obligation. It seemed inconsistent for a member that was not fulfilling a repurchase expectation to be permitted to discuss its possible use of Fund resources while a member with an overdue financial obligation would not be allowed to do so. The prohibition on negotiating a stand-by or extended arrangement with a member in arrears to the Fund should be applied to a member country that was failing to meet a repurchase expectation. The procedure in paragraph (c) should also be applied to a member country that was failing to meet a repurchase expectation.

Mr. Clark said that his position was similar to that of Mr. Pickering and Ms. Bush. If the expectation of repurchase was to be given substance, the failure to meet such an expectation should be treated in the same manner as the failure to meet any other repurchase requirement. An unfulfilled expectation of repurchase should affect a member country's general relations with the Fund and not merely its right to purchase under a particular facility. Accordingly, paragraphs (a), (b), and (c) should apply in the situation described in the first sentence of paragraph (d).

Mr. Nimatallah agreed with Mr. Arias and Mr. Jayawardena that the words "discuss or" in paragraph (a) should be eliminated.

Mr. Goos said that he sympathized with Ms. Bush and Mr. Clark. It seemed odd to include the possibility of canceling purchase instructions for a member country with overdue financial obligations but not for a member that had failed to meet a repurchase expectation. Hence, paragraph (c) should apply in the situation described in the first sentence of paragraph (d). However, given the legal distinction between a repurchase obligation and a repurchase expectation, it seemed reasonable not to apply paragraph (a) to the situation described in the opening sentence of paragraph (d).

He preferred to retain the words "discuss or" in paragraph (a), Mr. Goos remarked. His chair had consistently and firmly maintained that a member country with overdue financial obligations to the Fund should not be permitted to engage either in negotiations on a stand-by or extended arrangement, or in discussions that could lead to the reactivation of an arrangement.

Mr. Jayawardena said that by deleting the words "discuss or" from paragraph (a), staff and management would have the discretion and flexibility they needed to hold discussions with a member country that had overdue financial obligations to the Fund. If the text remained as it was, staff and management would not have any flexibility to use their discretion in deciding whether or not discussions with the authorities concerned would be helpful. Finally, it was important to maintain the distinction between a repurchase obligation and a repurchase expectation.

Mr. Polak said that it would be awkward to permit the kind of asymmetry that Mr. Pickering had described. Accordingly, paragraphs (a), (b), and (c) should apply in the situation described in the first sentence of paragraph (d). As to the text of paragraph (a), the words "discuss or" should be eliminated. Management would then have the discretion to decide how far discussions with the member country concerned should be taken; accordingly, the discussions could be stopped short of negotiations. In any event, staff and management would know that the Executive Board would not approve either a stand-by or extended arrangement with a member that had overdue financial obligations to the Fund.

Ms. Bush commented that she understood why the inclusion of the words "not discuss" in paragraph (a) caused problems for some Executive Directors. As she understood it, under present practice, staff and management did not enter into formal negotiations with a member country that had an overdue financial obligation to the Fund; at the same time, however, staff and management did hold various kinds of discussions with such a member country, particularly when there was some hope that the discussions could result in the elimination of the overdue obligations.

The Chairman said that Ms. Bush's understanding was correct. Staff and management did not negotiate a program with a country that had overdue financial obligations to the Fund, but stood ready to discuss economic policy adjustments that would help to place the country concerned in a position to eliminate its overdue obligations. That practice was perhaps not clearly reflected in the language of paragraph (a); the words "discuss or" were ambiguous and could be eliminated. Alternatively, the text could state that the Fund would not "negotiate or approve" either a stand-by or extended arrangement with a member country that had overdue financial obligations to the Fund, thereby making it consistent with the existing practice that management and staff intended to maintain.

Mr. Wang considered that the words "discuss or" should be eliminated. Alternatively, the word "discuss" should be replaced by "negotiate."

Mr. Pickering recalled that, during the discussion on noncomplying purchases at EBM/84/165 (11/16/84), it had been concluded that provision should be made for suspending further purchases under a stand-by or extended arrangement for a member country that had failed to meet a repurchase expectation. At the same time, the question had been raised whether that provision would also be applied to first credit tranche purchases and purchases under the compensatory financing facility. It was his understanding that his proposal at the present meeting to apply paragraphs (a), (b), and (c) to the situation described in paragraph (d) was consistent with the earlier discussions and would not in effect require the Executive Board to enter into new policy territory.

The Director of the Legal Department noted that, in summing up the discussion at EBM/84/165, the Chairman had stated that "the question of whether a country that had not met the expectation to repurchase would be suspended from drawing on the special facilities was a separate issue that could be considered by the Executive Board in due course." The matter of the special facilities had not been taken up at the subsequent discussion, namely, at EBM/84/167, when Executive Directors had considered the consequences of overdue financial obligations, so that the staff proposals in the report before the Board would maintain the distinction between a repurchase expectation and a repurchase obligation. That was a distinction that had been reaffirmed by the Executive Board during its discussions on misreporting and noncomplying purchases; the Executive Board had decided that noncomplying purchases should result in a repurchase expectation, not a repurchase obligation.

As Mr. Pickering had noted, a member country that was failing to meet a repurchase expectation could conceivably gain the Executive Board's approval of a new stand-by or extended arrangement but would be unable to make a purchase under the new arrangement until it became current in its obligations to the Fund, the Director said. However, a member that had failed to meet a repurchase expectation could make a purchase outside a stand-by or extended arrangement. Finally, the staff had not suggested applying paragraph (c) to the situation described in paragraph (d) because the staff had concluded from the earlier discussions that the Executive Board had not reached a consensus to change the present practice concerning the instructions for a purchase by a member country that was failing to meet a repurchase expectation.

Responding to a question by Mr. Clark, the Director of the Legal Department explained that the words "during any period" in paragraph (b) would not prevent a member country from making a purchase under a stand-by or extended arrangement once the member country had become current in its obligations to the Fund. The country would be unable to make a purchase as long as it continued to have overdue financial obligations to the Fund.

Mr. Lundstrom said that he had no strong feelings about applying paragraphs (a), (b), and (c) to the situation described in paragraph (d). As to paragraph (a), including the word "discuss" would not be appropriate. The intended meaning of the text of paragraph (a) would be more precise if the word "discuss" was replaced by "negotiate." It would then be clearly understood that the Fund would not enter into formal negotiations on a stand-by or extended arrangement for a member country with overdue financial obligations to the Fund.

Mr. Blandin agreed with Mr. Goos that paragraph (c), but not paragraph (a), should be applied in the situation described in the first sentence of paragraph (d). The word "discuss" in paragraph (a) should be replaced by "negotiate."

Mr. Murakami commented that he preferred to use the word "negotiate" instead of "discuss" in paragraph (a), but that he could go along with the suggestion to delete the words "discuss or." Paragraphs (a) and (c) should apply in the situation described in the opening sentence of paragraph (d).

Mr. Clark said that he preferred to apply paragraphs (a) and (c) to the situation described in paragraph (d). In paragraph (a), the word "discuss" should be replaced by "negotiate."

Mr. Pérez agreed that the word "discuss" in paragraph (a) should be replaced by "negotiate". The present text of paragraph (d) was acceptable.

Mr. Polak remarked that it might not make sense to apply paragraph (c) to paragraph (d) without applying paragraph (a) as well. If paragraph (c) alone were applied to paragraph (d), the Fund could conceivably approve a compensatory financing purchase by a member failing to meet a repurchase expectation but then be forced to rescind immediately the instructions for that purchase.

Mr. Nimatallah said that if paragraph (c)--but not paragraph (a)--were to apply to paragraph (d), the Fund could approve a purchase request but not permit the resources actually to be transferred to the member country until it was current in all its obligations and expectations.

The Chairman commented that, if paragraph (c) were to apply to paragraph (d), and paragraph (a) were not, the Fund would be warning a member country failing to meet a repurchase expectation that although the Fund could negotiate and approve a stand-by or extended arrangement the country would not be able to make use of the Fund's resources until it became current in its obligations to the Fund. However, the same solution would be technically inconsistent with respect to compensatory financing purchases or any other purchases made outside an extended or stand-by arrangement.

Executive Directors seemed to have accepted the word "negotiate" instead of "discuss" in paragraph (a), the Chairman continued. The staff would carefully examine the implications of applying paragraphs (a), (b), or (c) to the situation described in paragraph (d) and prepare a further paper on the various possible solutions mentioned at the present meeting. 1/

The Executive Directors took note of the Chairman's statement and agreed to conclude their discussion for the time being.

APPROVED: October 24, 1985

LEO VAN HOUTVEN
Secretary

1/ See SM/85/40 (2/4/85), Supplement 1 (2/22/85), and Correction 1 (2/25/85) discussed at EBM/85/26 (2/20/85).