April 2, 1997
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/96

10:00 a.m., October 2, 1995

Contents

Executive Board Attendance

S. Fischer, Acting Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	A. Fayolle
	D. Desruelle, Temporary
	P. Cailleteau, Temporary
J. Bergo	
	V. J. Fernández
	J. Guzmán-Calafell, Temporary
I. Clark	S. O'Connor, Temporary
	C. Duenwald, Temporary
B. S. Dlamini	
H. Evans	J. Shields
K. P. Geethakrishnan	W. Hettiarachchi
J. E. Ismael	L. M. Cheong
D. Kaeser	D. Gotz-Kozierkiewicz
	W. C. Keller, Temporary
	A. L. Coronel, Temporary
W. Kiekens	V. Rigász, Temporary
	A. R. Ismael, Temporary
	N. Coumbis
	G. Schlitzer, Temporary
K. Lissakers	B. S. Newman
	J. M. Abbott, Temporary
H. Mesaki	T. Fukuyama
A. Mirakhor	
C. Saito	J. Justiniano, Temporary
S. Schoenberg	B. Esdar
A. S. Shaalan	Y. Y. Mohammed
	T. K. Gaspard, Temporary
	A. V. Mozhin
	J.-H. Kang
	M. Petrie, Temporary
J. de Beaufort Wijnholds	
	Wei B.

L. Van Houtven, Secretary and Counsellor
T. Ranaweera, Assistant

Also Present

IBBRD: C. Delvoie, Middle East and North Africa Regional Office. Central Asia Department: B. B. Aghevli, Deputy Director. European II Department: M. Shadman-Valavi. IMF Institute: S. Elkhouri. Legal Department: P. de Boeck, S-d. Gong, J. L. Hagan, J. K. Oh. Middle Eastern Department: P. Chabrier, Director; M. A. El-Erian, Deputy Director; M. D. Knight, Deputy Director; T. Enger, S. N. Erbas, A. C. A. R. Furtado, Z. Iqbal, G. M. Iradian, O. Liu, E. K. Martey, A. Mazarei, R. Moalla-Fetini, K. Mukhopadhyay, B. K. Short. Monetary and Exchange Affairs Department: H. Mehran. Policy Development and Review Department: D. N. Lachman, Deputy Director; T. Leddy, Deputy Director; C. Puckahtikom. Research Department: S. H. Samiei, R. T. Smith. Secretary's Department: W. S. Tseng, Deputy Secretary; A. Mountford. Southeast Asia and Pacific Department: A. M. Browne, H. Faruqee, M. R. Kelly, H. E. Khor, R. P. Kronenberg, J.-H. Lin, L. E. Molho, J. D. Ostry, P. Reynolds, D. J. Robinson, M. S. Singh. Statistics Department: P. L. Joyce. Advisors to Executive Directors: P. A. Akatu, B. Anderson, G. Mucibabici, S. N'guiamba, T. Oya, R. Rainford, K. Sundara, R. von Kleist. Assistants to Executive Directors: S. E. Al-Huseini, P. I. Botoucharov, A. G. Cathcart, J. A. Costa, J. C. Estrella, C. M. Gonzalez, B. Grikinyté, D. Hakura, O. A. Himani, H. Kaufmann, E. Kouprianova, T. Lwin, J. Mafararikwa, Ng C. S., H. Petana, M. W. Ryan, K. I. Sakr, F. A. Schilthuis, S.-F. Yiu, Zheng H.

1. MALAYSIA - 1995 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1995 Article IV consultation with Malaysia (SM/95/200, 8/16/95; and Sup. 1, 9/29/95). They also had before them a background paper on Malaysia (SM/95/236, 9/15/95).

Mrs. Latifah Cheong made the following statement:

The Malaysian authorities generally agree with the broad thrust of the staff report. Latest developments indicate that the economy is now likely to show another year of strong growth, as real GDP increased by 9.5 percent in the first half of 1995. The 1994 growth rate has also been revised upwards to 9.2 percent from the earlier estimate of 8.7 percent. In this environment of strong growth performance, the authorities stand committed to ensure that appropriate macroeconomic policies are in place to promote a pace of growth that is sustainable over the medium and longer term. The Malaysian authorities are well aware that there is no room for complacency and recognize that problems exist. In this regard, policy adjustments have been initiated to ensure uninterrupted growth with low inflation.

The most pressing issue discussed is the threat posed by the growing current account deficit. After 8 consecutive years of high growth, it is understandable that staff has voiced concern that the Malaysian economy faces dangers of overheating. The authorities' view is that Malaysia's strong GDP performance is the result of the high rates of investment over the past 8 years (averaging about 35-40 per cent of GDP per annum). This has resulted in substantial increases in the economy's potential GDP. Furthermore, supply shortages are not pervasive throughout the economy, but exist in few areas. In these circumstances, the authorities recognize that such shortages are indicative of emerging signs of price pressures. Over the past several years, a comprehensive set of monetary, fiscal and administrative policy measures have been implemented to avoid a build-up of inflationary pressures, particularly inflationary expectations. Reflecting the effectiveness of the authorities' anti-inflation policy package, inflation remains under control, at an annual rate of 3.5 percent for January-August 1995. However, the authorities agree with staff that more is required to remove inflationary expectations, including the need for structural changes, especially in the labor sector. The view of the authorities is that conscious efforts are required to address the inflation problem at source, both in terms of relieving supply bottlenecks as well as managing aggregate demand.

The faster than expected GDP growth and larger trade deficit in the first half of 1995 have raised several areas of concern to the authorities. It is useful to draw attention to current policy actions being undertaken.

First, the authorities are aware of the limits to growth and dangers to inflation posed by labor shortages. Second, there is recognition that growth fueled by consistently high investment to GDP ratios, amidst a small labor force, will not be sustainable without appropriate measures to address supply bottlenecks and improve productivity. Third, the authorities are concerned by the recent acceleration in the trade deficit and the estimated widening of the current account of the balance of payments.

The Government plans to address the first two problems in a related manner, through a two-pronged approach--change the growth strategy to promote growth through productivity increases and at the same time take immediate measures to review its labor policies to ensure adequate supply of skills in line with growth requirements. The strategy toward a productivity-based growth strategy will likely entail gradual declines in ratios of investment to GDP in future years, although such ratios must indeed remain comparatively high to achieve industrial country status within the next two decades. Investment will, however, be technology driven and de-emphasize the use of unskilled or semi-skilled labor (i.e. emphasize capital and technology-based industries). At the same time, the labor policies are being reviewed to meet the requirements of this new investment strategy. In the immediate period, labor shortages will continue to be bridged by intake of selected categories of foreign labor.

With regard to the balance of payments, the authorities share the staff's concern on the widening of the current account deficit. The acceleration of the trade deficit in the second quarter of 1995 reflected mainly "lumpy" imports (imports of ships and aircraft). Excluding these imports, the trade deficit was much smaller in the second quarter and a surplus in the first quarter. Nevertheless, policy attention is being directed at reducing imports, which will also result in lower services payments abroad for freight and insurance. Other measures to increase exports of services are still being pursued.

As to fiscal policy, the public sector will continue to play a facilitating role in ensuring further progress in the development of an efficient infrastructure framework. The fiscal stance will be guided by the need to complement monetary policy to ensure price stability. In the first half-year, a budget surplus of 2.5 percent of GDP was recorded, as revenue performance was favorable in line with buoyant economic conditions, while expenditure increased moderately. In 1995, capital expenditure will remain relatively high, due mainly to the increased pace of implementation of projects in the last year of the Sixth Malaysia

Plan period (1991-1995). In the period ahead, the authorities recognize that the risks of overheating the economy should be avoided. As growth in private sector investments should not be constrained, the Government is committed to examine areas where public expenditure can be phased out. Notwithstanding the need to address infrastructure constraints over the near term, the authorities recognize a need to reschedule the lower priority projects to avoid any adverse implications on the balance of payments. This would also ensure the maintenance of a strong overall budgetary position. However, the authorities would prefer to refrain from setting specific budget surplus targets but would adjust the government finances consistent with price and balance of payments developments and the conduct of monetary policy.

Inflation, although moderating in August to yield an average increase of 3.5 percent for the first eight months of the year, is being monitored closely by the authorities. The main cause of the recent price increases is again higher food prices. The Producer Price Index, on the other hand, moderated significantly due to lower import prices arising from ringgit appreciation against the USD, and slower price increases for commodities (natural rubber and palm oil). Growth in broad money has decelerated to more sustainable rates of around 15-16 percent, a far cry from the 25-29 percent increases recorded in the days of excessive capital inflows. Capital inflows have also moderated and comprise mainly portfolio investments in the stock market, rather than arbitrage capital. The main determinants of M3 growth are mainly domestic and private sector driven, with strong loan growth in the banking system, mainly to the manufacturing and broad property sectors and for consumption purposes. In this environment, monetary policy has been appropriately cautious, generally skewed toward tightening to suppress excess demand. Reflecting this policy stance, interest rates have edged upwards, with the three-month interbank rates currently fluctuating at the 6 percent level, compared with 5.8 percent in June and July 1995. In the coming months and for 1996, monetary policy will follow this cautious approach. Although capital inflows have moderated, the monetary measures that are still in place to address this problem will be removed once the authorities are convinced that monetary conditions will remain stable over the medium-term.

The authorities noted staff's recommendation for further appreciation of the ringgit exchange rate. The authorities' strong belief that exchange rates should reflect economic fundamentals and that appreciation in response to short-term capital inflows is destabilizing, has, to a large extent, governed its approach to exchange rate developments. Exchange rate policy will continue to be based on a non-interventionist approach, with central bank intervention in the foreign exchange markets being limited to smoothening volatile movements in the exchange rates.

In this approach, the central bank will not go against the trend that is being dictated by economic fundamentals.

Recent exchange rate developments reflect the convergence of views between staff and the authorities. Despite the outflows of short-term capital following the Mexican crisis, by May 1995, the ringgit exchange rate appreciated by 3.6 percent against the US dollar (following an appreciation of 5.6 per cent at end-December 1994), but an overall ringgit appreciation in nominal terms did not occur due to the large depreciation against the Japanese yen, Swiss franc and the currencies of Malaysia's other major trading partners. However, since June, the ringgit composite has progressively appreciated in nominal terms.

In conclusion, I would like to convey to the Board, the Malaysian authority's appreciation of the mission's helpful analysis and their valuable advice on policy adjustments for the Malaysian economy. These advice are taken seriously and as in the past, many if not most of The Fund mission recommendations will be followed through. My authorities also value the Mission's endorsement of the structural adjustment strategy taken to date, and the favorable assessment of the underlying economic fundamentals and the prospects for Malaysia to continue to sustain strong growth over the medium term. Nevertheless, the authorities remain guided by the Fund in their efforts to pursue further the structural changes alongside measures to ensure price stability in order to promote greater private sector-led growth, while averting risks of overheating the economy. In this regard, my authorities expressed appreciation for the staff's concern on overheating and their special reports on the labor and capital inflows problems in Malaysia.

The authorities also reaffirm their commitment to maintain a tradition of making adjustments to ensure strong macro-economic policies at all times to preserve domestic (price) and external (balance of payments) stability.

Mr. Mirakhor made the following statement:

On reading this year's staff report, one can understand why Malaysia ranks among the best performing economies in the world. The country's achievements to date have been truly remarkable. The rapid economic growth has been led by a dynamic manufacturing sector and exports; investment has risen to record levels; the unemployment rate has been cut by more than a half; the fiscal position remains sound and although the external position has shown some signs of strain, it has found ready financing. Most importantly, inflationary pressures have remained subdued and confidence in the conduct of economic policies remains high. Much of the credit for these positive developments goes to Malaysia's policymakers for their adept and skillful management of the economy.

Not surprisingly, however, the economy's brisk forward momentum has raised concerns that the pace of nominal demand growth is beginning to place undue pressure on output. This is evident in the evolution of a number of indicators, most notably, in a tightening of capacity constraints, wage pressures and a widening of the current account deficit. Against this background, the key question posed in the staff report is whether "the balance of risks has now tilted toward possible overheating" and whether the authorities should take immediate measures to bring about a moderation of demand growth and help guide the economy toward a more sustainable growth path.

In her informative statement Mrs. Cheong suggests that the authorities are well aware of the risks of overheating and stand committed to ensure that appropriate macroeconomic policies are in place so as to promote a pace of growth that is sustainable over the medium and longer term. This is a welcome assurance.

On the fiscal side, the staff is worried that the stance of fiscal policy at this stage of the cycle--a projected budget surplus that would be reduced significantly in 1995--risks being strongly procyclical at a time when other components of demand are also growing rapidly and the economy is operating at almost full capacity. However, the authorities' view that, while fiscal policy could impart some stimulus to demand, its main impact would be felt through a temporary rise in imports, rather than on higher domestic inflation, has merit. Additionally, consideration should be given to the considerable benefits that would accrue to the economy from a large and discrete alleviation of supply constraints on growth as the pace of investment in vital public sector projects is quickened. These are cogent arguments.

While the staff's call for fiscal policy to play a supportive role in containing demand pressures is reasonable, the authorities' view that the high rate of investment has resulted in substantial increases in the economy's potential GDP is undoubtedly correct. Nonetheless, the task of determining whether capacity constraints are binding is difficult. The important question is whether the improvement in infrastructure and the ongoing rapid upgrading of the private capital stock might help weaken the normal relationship between rising capacity utilization rates and cost pressures. At the same time, the robust outlook for growth in 1995 could result in a fiscal position that imparts a smaller demand impulse. In this context, Mrs. Cheong's statement that the budget outturn for the first half of the year was indeed more favorable than expected is reassuring, a view that is also supported by the staff supplement.

On the monetary side, the information contained in the staff supplement is a cause for some concern. The growth in monetary aggregates has rebounded in the second quarter of 1995 and there has been a pickup in CPI inflation to 3.7 percent. This would seem to suggest that a tightening of monetary policy is warranted. With capital inflows having moderated somewhat, there would appear to be little risk of a recurrence of destabilizing inflows and a better opportunity to allow a tightening of monetary policy to feed into a market-induced adjustment in the exchange rate. In this context, we welcome the authorities' commitment to allowing fundamental market trends to determine the exchange rate and to continue to direct intervention to limiting short-term volatility.

The authorities' response to the challenge posed by large and volatile short-term capital inflows was prudent and appropriate and we note the fact that most controls have been lifted. The remaining measures will be removed when the authorities are satisfied that monetary conditions will remain stable. We support the authorities in their stand.

Malaysia's structural reform agenda has been ambitious and wide-ranging and promises to confer substantial and lasting benefits on its economy. It rightly focuses on improving infrastructure, addressing labor constraints and upgrading skills and technology, and enhancing the functioning of markets. The emphasis being given to improving labor skills and enhancing labor market flexibility is both timely and appropriate as the country moves toward a productivity-based growth strategy.

On the authorities' plans in the area of infrastructure, it is hoped that the claim on the budget will remain modest with increased private sector participation in these projects. Finally, in regard to structural fiscal reform, we welcome the intention to reduce the overall tax burden and introduce a broadly based consumption tax.

Mr. Mesaki made the following statement:

I congratulate the Malaysian authorities on having continued the remarkable economic performance. The authorities are to be commended for having achieved both high economic growth and moderate consumer price inflation.

However, it seems to me that there has been some clear evidence of overheating, which may warrant corrective measures. Producer prices accelerated in the first half of the year; private sector credit has continued to increase; and the trade deficit has widened sharply.

Whereas the staff believes that the balance of risks has shifted decidedly in the direction of overheating, my impression is that the authorities do not fully agree and do not believe that an immediate macroeconomic policy change is necessary.

As it appears to me the staff endorses the thrust of the authorities' structural adjustment strategy, I would like to focus my statements on the issue of the appropriate policy stance on macroeconomic management.

Regarding the risk of overheating, I am inclined to support the staff's more cautious view in light of the recent indicators mentioned earlier. Although the authorities emphasize that they have successfully contained inflation at a moderate level, I am more convinced by the staff's view that the moderate inflation is a reflection of the one-time effects of reductions in import duties and administrative measures on limiting the price increase of basic food items.

With respect to the monetary side, many indicators of monetary conditions, particularly broad money and private sector credit, clearly suggest that a more cautious monetary approach is warranted.

I am puzzled, in particular, about recent exchange rate developments. Despite the continued economic growth and the authorities' commitment to restraining interventions, the ringgit has not appreciated in line with Malaysia's strong economic fundamentals, and occasionally it has even depreciated. These developments might indicate that there is room for a further tightening of monetary policy.

Regarding fiscal policy, it is necessary to weigh policy considerations more carefully. Although I am of the view that tighter fiscal policy should be pursued in order to control demand pressures, I can understand the authorities insisting on the importance of sustaining a certain level of capital expenditure to sustain growth over the medium term.

I fully agree with the authorities that importance should be attached to speeding up the completion of the infrastructure projects. However, in my view the authorities should seek the possibility of meeting both of these goals: more infrastructure and fiscal consolidation. I would like to make two comments in this regard.

First, the authorities should make more efforts to enhance revenue. I am rather concerned that the total budget revenue is projected to decline by about 3 percentage points of GDP, despite the apparent risk of overheating. I believe that the authorities should at least maintain the current revenue level in relation to GDP if they wish to allocate sufficient capital expenditures.

Second, the authorities should consider having the private sector play a more active role in the implementation of infrastructure projects. While I believe that public resources must continue to play a major role in infrastructure development, it is desirable for the private sector to take on an active role in fields where the market mechanism can better achieve the efficient provision and operation of infrastructure. As this is not directly related to the Fund's mandate, I will not elaborate further; however, I would urge the authorities to give serious consideration to the coordination of private and public resources for the infrastructure development and the exploration of new financing and the mobilization of private funds.

Mr. Newman made the following statement:

Malaysia's record of strong growth and low inflation is evidence of the virtues of high savings and investment in the context of a generally liberal trade and investment regime. For the foreseeable future, the picture remains bright. The question is whether it is perhaps too bright.

The issue of overheating is the appropriate focus of the staff report. the staff believe current demand pressures are overtaking potential output and point to a range of developments that suggest this risk: the tight labor market and resulting wage pressures, producer price rises, widening current account deficit, etc. On the other hand, potential output in a dynamic economy like Malaysia's is subject to more than the usual uncertainties. The authorities, while not sharing the staff's sense of urgency regarding the inflation threat, do appear attentive to the risks. Monetary policy has been tightened and interest rates nudged upward. The track record on containing inflation is quite good.

Whether further actions are needed (e.g., some fiscal contraction to offset the pro-cyclical tilt of current budget policies, more aggressive monetary tightening) is a judgment call. The staff take a more conservative view of the situation than do the authorities, which is not uncommon or inappropriate in this case, but the differences do not appear substantial.

We do not have strong views in either direction at this stage. We would appreciate, however, some clarification of those factors and policy approaches that will guide the Malaysian authorities in the event that signs of overheating persist and intensify. In the absence of fiscal adjustment, the burden of stemming demand pressures falls to monetary policy. This implies higher interest rates and upward pressure on the ringgit. The current account can relieve some of the pressures on prices, but it is not clear that authorities are comfortable with the widening deficit. Mrs. Cheong's statement states that policy attention is being directed at reducing imports. We see some possibly conflicting tendencies at play here which prompt some questions:

How do authorities plan to limit imports? And, do their plans/concerns square with stabilization goals? It is not clear how authorities plan to reconcile a more expansionary policy mix than that recommended by the staff with concerns over inflation and concerns over a wider current account gap. Measures to slow imports would likely work against stabilization objectives since they would frustrate a "safety valve" for price pressures.

A follow-on concern is that if more "targeted" measures are taken to slow imports, might this lead to more reliance on administrative measures/pressures to control prices? The concern is that one distortion could lead to another, thereby increasing the possibility of lurches in underlying price movements and the need for more restrictive financial policies at some later point.

What leading indicators do authorities pay particular attention to in assessing inflationary prospects? Our impression is that certain common indicators, such as long-term interest rates, the shape of the yield curve, and capacity utilization, are not as useful in the case of Malaysia (the long-term bond market is apparently rather thin, capacity utilization is a moving benchmark.) Thus, we have a discretionary-based policy that has had good success but without the benefit of some of the indicators that guide policy elsewhere. Given current demand pressures, it would be useful to have a clearer idea of key policy triggers.

Finally, we certainly agree with the staff that a market-induced appreciation of the ringgit resulting from tighter monetary conditions should be allowed to take place. Mrs. Cheong's statement suggests agreement with this approach, which is encouraging, though she notes the authorities' desire to "smooth" potentially volatile movements in the exchange rate. This stated goal is reasonable, of course, but execution can be tricky and subject to backlashes if market trends are frustrated and exchange rate pressures bottled-up. This has happened in the past (i.e., following end-1993 interventions to drive down the ringgit), with disruptive results.

Mr. Newman, adding to his statement, said that, in a broader context, the Board had had many discussions, both general and specific, on how to deal with capital inflows, and there had been some suggestion that countries should be allowed to rely on controls for that purpose. Capital inflows posed a dilemma for monetary policy, the exchange rate, and competitiveness in many countries, and the Articles of Agreement did not provide for specific actions to prevent countries from imposing capital controls if they believed they were necessary. However, he wondered whether capital controls were altogether consistent with the requirements of Article IV, which enjoined a country from manipulating its exchange rate to gain an unfair competitive advantage, and which warned against measures to encourage or discourage capital inflows artificially. Indeed, he wondered whether Article IV provided the kind of authority for the Fund in the area of capital controls that would make an amendment of the Articles unnecessary.

That issue went well beyond the case of Malaysia, and had a more general application to the Fund's future discussion on capital account liberalization, capital controls, and capital inflows, Mr. Newman concluded. At some point in the future, the staff should examine the compatibility of the two approaches he had outlined in moving forward in its consideration of capital account convertibility.

Mr. Duenwald made the following statement:

I would like to begin my comments by commending both the staff on their very readable report, which presents a concise analysis of the Malaysian economic situation, and the Malaysian authorities for their track record of prudent financial management. Indeed, the Malaysian experience illustrates quite clearly the benefits of sound macroeconomic policies, and in many respects could serve as an example for other countries to follow.

Malaysia has experienced average annual real GNP growth of 8.5 percent since 1988, with relatively subdued inflation, a steadily declining unemployment rate, and, until recently, an overall balance of payments surplus. The overall federal government balance, as well as the public sector balance, was in a surplus position in 1994. Both the nominal and the real effective exchange rate have tended to depreciate in recent years, but the international reserves level remains comfortable.

Given this sound macroeconomic performance, it is difficult to find points of advice. Difficult, but not impossible. We agree with the thrust of the recommendations made by the staff in most areas. In particular, we share the staff's concern, and as reiterated by Mr. Mesaki, regarding the risk of overheating of the Malaysian economy. Several indicators point to a risk of rising inflation pressures, including sustained high rates of real GDP growth, falling unemployment, a depreciation of the real effective exchange rate, and a rapid expansion of domestic credit to the private sector. Indeed, some of these latent price pressures have already become evident in indicators of measured inflation, including the GDP deflator and producer prices. It is true that consumer price inflation has remained moderate, but I wonder whether the published index accurately measures underlying inflation in the economy, particularly considering the administrative price measures that have been implemented. In addition, the current construction boom in Malaysia raises concerns about real estate price bubbles.

We therefore agree with the staff that a tightening of monetary conditions appears appropriate at the current juncture. A real appreciation of the exchange rate, preferably via a higher nominal exchange rate as opposed to higher inflation, combined with higher interest rates, would help dampen aggregate demand pressures. There may also be some additional scope for the authorities' fiscal stance to play a supportive role for monetary policy.

In her statement, Mrs. Cheong acknowledges the inflationary risks facing the Malaysian economy. However, she downplays these risks, arguing that the investment boom has raised the country's growth potential. There is little doubt that the potential growth rate of GNP has expanded, but much more doubt about the degree of slack, following numerous years of high growth rates, remaining in the economy before inflation accelerates. Given the price pressures that seem to be emerging, we believe the Malaysian authorities should err on the side of caution, particularly given the long and variable lags with which monetary policy affects real activity in many countries. Moreover, even if goods market slack remains, I would note that the rate of unemployment has fallen significantly over the years, reducing slack in the labor market. There is now evidence of labor shortages in certain sectors of the economy. Consistent with tight labor market conditions, wage increases have been high in recent years, outstripping productivity growth. It is only a matter of time until such sustained high wage increases are passed on into domestic prices. We encourage the authorities to continue their efforts at increasing labor market flexibility, so that real wage increases are commensurate with productivity trends, thus containing increases in unit labor costs.

Finally, I would encourage the authorities to redouble their efforts with respect to financial liberalization, particularly in the area of banking. We would add, however, that much has already been achieved, and this success is evidenced by the growth of stock market capitalization and the expansion of the local bond market.

I commend the authorities for their skillful economic management, which has borne fruit in many ways.

Mr. Guzmán-Calafell made the following statement:

I wish to start my intervention by commending the Malaysian authorities for the impressive performance shown by the economy during the last years. Real GDP recorded average annual rates of growth well above 8 percent during the period 1990-94, fostered by an increase of nearly 8 percentage points in the share of investment in GDP to a level of 40.5 percent. In the meanwhile, inflation remained low, unemployment fell sharply, and gross national savings increased their share in GDP to 34 percent. It must be stressed that these developments took place within a period when the economy was subject to shocks resulting from huge net capital inflows in several years. If this were not impressive enough, exports doubled from 1990 to 1994, while gross international reserves nearly trebled in this period. Furthermore, after recording moderate deficits in the early 90's, the public sector balance showed a surplus of 0.9 percent of GDP in 1994.

There is widespread agreement that the most pressing issue at this stage is the danger of overheating. There are a number of indicators in this regard which give rise to concern. With the increase in employment observed in 1994, the economy has reached a level considered by the authorities as full employment. In addition, the staff notes that the rate of capacity utilization rose sharply last year and that the economy is currently operating at full capacity. As Mrs. Cheong points out, rapid growth of investment has increased substantially the potential GNP. However, supply rigidities have already emerged, price pressures are accentuating, and the current account deficit has widened.

Fiscal policy has a central role in containing demand pressures. In this context, the projected weakening of the overall balance of the public sector by over 2 percentage points of GNP in 1995 is worrisome. The Malaysian authorities are aware of the dangers of overheating and recognize the need to postpone lower priority projects and, in general, adjust government finances as required without setting specific budget surplus targets. With the support of an outstanding policy record, the authorities' capacity to manage the economy deserves a high credibility. I would only point out, nevertheless, that adequate consideration must be given to the fact that the speed of response of fiscal policy is slow since actions in this area usually take time to be designed and, particularly, to be implemented.

As expressed by the authorities and the staff, monetary policy must be prudent and also seek to suppress excess demand. In this regard, it is encouraging to note that the growth of domestic liquidity has decelerated sharply from the very high levels observed in previous years. On the other hand, I note that the growth of domestic credit is expected to accelerate substantially, from 14.4 percent in 1994 to 20 percent in 1995. Also, as explained in the updated staff report, growth of the monetary aggregates rebounded in the second quarter of this year. Furthermore, the staff believes that despite the recent interest rate hike, further increases are warranted.

The potential success of an additional tightening of monetary policy is linked to the way exchange rate policy is implemented. The experience of previous years shows that the interest sensitivity of capital inflows in Malaysia is high and, therefore, that the effectiveness of monetary policy would be rather limited if the exchange rate is not allowed to move flexibly. I concur with the staff that a tightening of monetary policy, to be effective, would need to be accompanied by a sufficient degree of flexibility in the exchange rate.

According to the Malaysian authorities, exchange rate policy is based on a non-interventionist approach, where exchange rate volatility is smoothed and where an appreciation in response to short-term inflows is considered destabilizing. I am aware of the merits of this approach. But it is not clear to me to what extent the exchange rate would be allowed to appreciate in case an additional tightening of monetary policy were to result in further capital inflows. In fact, movements of the nominal effective exchange rate in recent years have been relatively modest. In the absence of a more flexible exchange rate, demand management would need to rely on fiscal policy. Under these circumstances, the need for a cautious fiscal stance is underlined. I would like to hear the staff's comments on this.

The success of the Malaysian authorities in containing the destabilizing effects of capital inflows is noteworthy. Despite the fact that the latter rose from 13 percent of GNP in 1991 to 16 and 18 percent in 1992 and 1993 respectively, inflation remained subdued and macroeconomic stability was preserved. There are three elements I would like to stress from this experience. First, the usefulness of sterilized intervention to attempt to offset the adverse impact of capital inflows on aggregate demand was rather limited. Second, it was in fact the curtailment of sterilization activities and the subsequent decline in interest rate differentials that turned into a crucial factor to deter capital inflows. Third, the Malaysian experience shows clearly how administrative measures can be used successfully to help contain short term capital inflows without having distortionary effects on the economy. It would be interesting to hear a comment by the staff on the likely relative importance of the decline in domestic interest rates vis-a-vis the administrative measures introduced in discouraging the inflows of short term capital to Malaysia.

The efforts of structural reform introduced by the authorities in the areas of the labor market, economic infrastructure, the tax system, etc., will enhance the economy's productivity and represent an important step forward in the elimination of the most important constraints on future growth. One of the main challenges in the area of structural reform is to carry out the investments required to eliminate supply constraints while ensuring a fiscal policy stance consistent with the need to preserve internal balance.

Mr. Petrie made the following statement:

Like others, I note Malaysia's extremely impressive performance, with growth averaging 8 1/2 percent over a long period, with low inflation. The reasons for this appear to be a combination of macroeconomic stability and wide-ranging and impressive microeconomic reforms that Malaysia has introduced, which has made the country extremely attractive for foreign direct investment. These measures, together with measures to address structural bottlenecks and to raise skill levels, give confidence in the likelihood that Malaysia can continue to achieve impressive growth over the medium term, although perhaps not at levels quite as high as those of the last decade.

Nevertheless, I agree with the staff assessment and the views of earlier speakers that there are some real risks to the short-term prospects for the economy that justify a cautious approach to macroeconomic management. With a projected current account deficit of 8 percent of GDP this year, and unemployment at less than 3 percent, it seems to me that there must be a real danger of breaching some fundamental speed limits. In this regard, I understand there is little difference of view between the staff and the Malaysian authorities over the level of potential output; the debate is more about the risks of maintaining the current stance of policy. Given the asymmetries and the lead times involved in controlling inflation, it seems to me that the time has come for the authorities to lean rather more against inflation pressures than appeared to be necessary at the time of the consultation discussions. I am therefore inclined to agree with the staff's view that the budget should not be imparting additional stimulus to the economy, and that the authorities should aim at the same sort of fiscal outcome in 1995 as in 1994.

I also agree that some tightening of monetary policy is justified. Some slowdown in the pace of implementation of infrastructure projects would seem to be desirable. It is not clear that all of these projects are aimed mainly at reducing supply bottlenecks; a somewhat slower rate of implementation might have little short-term supply effects, but result in a greater reduction in the inflation risk.

On the issue of inflation risks, I would have welcomed some discussion in the staff report of the view of financial markets on what can be inferred about the markets' inflation expectations from interest rates and, perhaps, from asset prices. I would be grateful for the comments of the staff or Mrs. Cheong here. I also agree with Mr. Newman that some discussion of the key indicators that should guide monetary policy in the period ahead would have been useful.

Having said that there is a case for greater caution, it seems from Mrs. Cheong's statement that the stance of policies may have shifted somewhat recently on the side of greater restraint. I welcome her indication that lower priority infrastructure projects might be deferred, and that the fiscal outturn for the first six months of 1995 is stronger than expected.

With respect to capital controls, Malaysia provides an interesting example of the use of controls on capital inflows, and the country's experience seems to have been successful in achieving the objectives without adversely affecting the confidence of financial markets. On a related point, I welcome the recent public clarification by the Managing Director of the Fund's position on the use of capital controls, which I believe is very useful.

Mr. Hettiarachchi made the following statement:

The Malaysian authorities should be commended for a well-managed economy. The economy has posted exceptionally high growth for a number of years running with equally good performance on the inflation front. The unemployment rate has come down to very low levels, so much so that we read in the newspapers recently that the duration of undergraduate courses in the Malaysian universities has been cut back by one year in order to meet the demand for university graduates in the job market. The vibrant economic performance appear to have been further consolidated in 1995 with an estimated 9.6 percent real GDP growth in the first half.

The sustained high economic performance in Malaysia is no doubt the outcome of prudent and skillful management of the economy for which the Malaysian authorities deserve full credit. Central to the exceptionally high Malaysian growth performance is the very high investment rate which now exceeds 40 percent of GNP. The high investment rate has been underpinned by a relatively high national savings rate averaging around 32 percent. In addition, Malaysian has had the benefit of large capital inflows, particularly FDI, the outcome of prudent financial policies and viable investment opportunities. The substantial fiscal consolidation achieved in the recent past has helped restraints demand pressures.

More recently, the external sector has come under some pressure due to a deterioration in both current and capital accounts. The weakness in the capital account can be attributed partly to authorities' desire to discourage short-term capital flows and partly to the effects of the Mexican crisis. The ringgit too has come under pressure in the aftermath of the Mexican crisis. However, the more recent data provided by the staff shows that the situation has stabilized and the official reserves are once again on the increase.

The more immediate concern could be the prospect of a reversal in good performance in the inflation front. With exceptionally high growth rates and probably with high capacity utilization, there is the risk of the Malaysian economy getting into an overheated position. Lately, the private sector credit growth too had been relatively high. One wonders whether the recent reversal in the inflation rate, though marginal, is a sign that the economy is heading for an overheating. In this context, we agree with the staff that the Malaysian authorities should consider some tightening of monetary policy, even if the tradeoff is some moderation in the growth rate.

Now I wish to come to a more general issue pertaining to Malaysian economic management. This is the problem of capital inflows which has been discussed in detail in the background paper. Very briefly, Malaysia experienced considerable capital inflows during the period 1990-93. During this period, Malaysian interest rates remained at a level higher than international interest rates and with no appreciation of the exchange rate. In order to cope with capital inflows, the Malaysian authorities resorted to sterilized intervention which lend further support to keep domestic interest rates high, thereby further fueling capital inflows. Eventually, some capital controls in the form of administrative and monetary measures had to be brought in, which the Malaysian authorities have claimed were aimed at discouraging short term speculative flows. These measures appear to have had the desired effect of combatting short term capital inflows, but raises the question whether the Fund considers it to be the right policy.

On this matter, there appear to be some mixed signals coming up in the Fund lately. In a recent report issued by the Fund, one of the conclusions was that there could be situations when some amount of capital controls to discourage capital inflows might be appropriate. On the other hand, according to an article published by the Managing Director recently the Fund will continue to be a policy leader and standard-bearer of capital account liberalization and that imposing controls on capital flows is counter-productive. In this light, we wish to invite the staff comments whether the action of the Malaysian authorities in introducing capital controls in 1994 was appropriate and justified or instead whether they should have used an appropriate mix of monetary, fiscal and exchange rate policies in coping with the problem of capital inflows.

Mr. Cailleteau commented that he agreed with Mr. Newman that the inflation phenomenon in Malaysia presented more questions than answers. The economy seemed to be operating at full capacity, real GDP growth had continued at 8 percent-10 percent since 1988, monetary aggregates had grown rapidly, the exchange rate was not overvalued, and the current account deficit had widened; however, inflation had remained between 2 percent and 4 percent since 1988. It was hard to understand why inflation remained so subdued in those circumstances. One plausible explanation, as offered recently by the Federal Reserve Bank of San Francisco, was that the capital inflows may have been associated with an increase in money demand in Malaysia, but he wondered whether that was the full explanation for the anomaly of an outstanding inflation performance.

The staff representative from the Southeast Asia and Pacific Department stated that the low rate of inflation could be explained in part by the reduction in tariff rates, as well as the factor identified by the Federal Reserve Bank of San Francisco. In any case, it needed to be borne in mind as well that some price indicators, such as the GNP deflator and the producer price index, were running considerably higher than the consumer price index. Mr. Newman had also pointed to the fact that the balance of payments had served as a temporary release valve for some of the demand pressures.

The staff agreed with the authorities that the tightness of the labor market was a cause of concern, and needed to be monitored closely, the staff representative continued. The authorities were not complacent about the outlook for inflation and were determined not to allow it to rise. The staff believed that the case of Malaysia at present was a good example of how a pre-emptive monetary tightening--in the sense that the consumer price index measure of inflation was still moderate--would be useful.

Malaysia's experience with capital controls had been fairly successful, in part because they were in place only for a relatively short duration, the staff representative pointed out. Nevertheless, the staff's view was that those measures probably would not have been necessary had the exchange rate been allowed greater flexibility, which would have dampened some of the flows while allowing interest rates in 1993 to remain high relative to rates in other major countries. The authorities were somewhat concerned that a tightening of monetary policy at present might precipitate another round of capital inflows and the reimposition of controls. To avoid that, they might allow the exchange rate to appreciate as a result of a monetary tightening.

The authorities were not opposed to allowing the exchange rate to appreciate, the staff representative emphasized. In fact, they tended to believe that that was the likely trend over the medium term, given the economic fundamentals. However, they were concerned about the impact of exchange rate and capital flow volatility on trade and investment. They were thus attempting to balance those concerns against the potential need to tighten policies.

The Deputy Director of the Policy Development and Review Department stated that the staff had taken note of Mr. Newman's questions relating to capital controls and the surveillance principles and guidelines. The articulation of the Fund's views on the matter was a broader issue, as was the later determination whether the provisions of Article IV and the guidelines and principles of surveillance would be sufficient to achieve the institutions's objectives in respect of the capital account--once those objectives were defined--or whether an amendment to the Articles of Agreement would be necessary. That basic issue would be at the center of the Board's work as the Fund moved ahead on the question of capital account liberalization.

Mr. Esdar stated that he wished to add his voice to the concerns expressed about the experience with capital controls. Given the mixed signals that had come from the capital markets study about capital controls and the role of the Fund in that regard, the Board needed to look very carefully at the experience of Malaysia and Chile. It would be important to analyze carefully the drawbacks and advantages of possible exchange rate alternatives to the imposition of capital controls.

Mrs. Latifah Cheong responded that a comprehensive study on capital account convertibility had been done, in which the cases of Malaysia and Chile had been well analyzed. Her authorities were of the view that, at the time, and under the circumstances, capital controls had been the best option. The inflows of capital and the effect on the market were rapid, and they needed to be dealt with quickly. In the Malaysian case, once the problems stemming from the inflows had been alleviated and the situation stabilized, the controls had been removed.

The authorities believed further that it would have been unwise to allow an exchange rate appreciation at the height of the period of capital inflows, Mrs. Latifah Cheong related. In that case, the appreciation would have been based primarily on short-term capital movements. When the funds flowed out, market volatility would have been generated, which might have adversely affected confidence of foreign investors. The authorities believed that they had a responsibility to long-term investors to manage temporary disturbances to the monetary situation, and in that respect, long-term policies could not be used to deal with short-term capital movements.

Mr. Al-Tuwaijri made the following statement:

Developments over the past year have, once again, reconfirmed the Malaysian authorities' exemplary track record of sound economic management. Ms. Cheong points out in her helpful statement that the authorities are in broad agreement with the staff appraisal. I will therefore make only three brief remarks:

First, the immediate challenge facing the authorities is to contain inflationary pressures while maintaining a high rate of growth. Here, the staff's argument in favor of a tighter fiscal stance has merit. At the same time, there seems to be a need to ensure the timely completion of certain infrastructure projects. Addressing some infrastructure constraints should, in itself, reduce cost pressures. Clearly, a delicate balance between these two considerations needs to be achieved. I am therefore reassured by Ms. Cheong's statement that "the fiscal stance will be guided by the need to complement monetary policy and ensure price stability."

Second, the recent indications of a further increase in inflationary pressures and growth in monetary aggregates suggest that a tighter monetary stance would be appropriate. I welcome the authorities' indication that monetary policy will continue to follow the cautious approach of the past year. The authorities' indication that the exchange rate will continue to be flexible to reflect economic fundamentals is also encouraging. The recent appreciation of the ringgit in nominal effective terms should help in attenuating inflationary pressures.

Third, like the staff, I welcome the authorities' decision to remove most of the controls on short-term capital inflows.

Mr. Rigász made the following statement:

Malaysia's overall economic performance continued to be remarkable in 1994. Real GNP accelerated to 9.2 percent, inflation remained below 4 percent, unemployment reached a record low, and the external position continued strong. The latest figures provided in Mrs. Cheong's interesting statement indicate that this picture will not change much by end-1995. The strong fundamentals and the authorities' record of prudent macroeconomic management guarantee a bright medium-term outlook for the Malaysian economy.

For the short term, however, the risks of overheating are becoming greater. As warning signals, the staff points to the evidence of supply shortages, intensified wage pressures, and a widening of the current account deficit. The recent rise in real estate prices in Kuala Lumpur is also revealing. Therefore, the staff is right to suggest somewhat tightening monetary policy, and allowing some appreciation of the ringgit. This will head off a recurrence of destabilizing short-term capital inflows.

While the authorities wish to avert overheating, they feel that the effectiveness of their inflation policies and the increase in growth potential after eight years of high investment make it unnecessary at present to restrain aggregate demand.

We would welcome a tightening of policies, if only for reasons of prudence. The government's considerable successes up to now should not make them overconfident. After eight consecutive years of high growth, the market is becoming prey to inflationary expectations. It is well known how hard it is to challenge market perceptions. The authorities therefore have much to gain and little to lose from a precautionary tightening, since at this stage these expectations can be dissipated much faster than after they have become entrenched.

We wonder whether the government's reluctance to tighten policies may not stem from an overreliance on the index of Consumer Price Inflation. According to the staff supplement, inflation measured by the Consumer Price Inflation during the first half of 1995 was basically unchanged from 1994. However, measured by the Producer Price Index, inflation averaged 7.2 percent in the same period of 1995, up from 3.3 percent in 1994. This large discrepancy may occur because actual household consumption patterns have changed since the most recent basket was defined. An increase in real household incomes may have led to higher spending on luxury items as opposed to non-discretionary items like food and other staples. However, in the 1995 CPI revision, the weight given to discretionary spending declined, and was further accompanied by a moderation of basic food prices in response to administrative measures. Can the staff or Mrs. Cheong inform the Board about the status of the government's work on the "parallel index" intended to address these concerns?

For all these reasons, I endorse the policy mix recommended by the staff. Monetary policy should play a key role in moderating demand, particularly in light of the credit expansion in the second quarter of 1995. After the successful deterrence of short-term capital inflows in 1994, there is now once more room for maneuver without risk of their destabilizing effects. I welcome that the government has allowed the ringgit to appreciate in line with Malaysia's economic fundamentals, as mentioned in Mrs. Cheong's statement. This will help keep Malaysia less attractive for arbitrage capital, at a moment when interest rates in neighboring countries are also becoming less attractive.

On fiscal policy, I also agree with the staff that, with the economy now operating at full capacity, fiscal stimulus is undesirable. I was therefore pleased that the government has given assurances, expressed in Mrs. Cheong's words, that "the fiscal stance will be guided by the need to complement monetary policy to ensure price stability." The intention of the government to seek cuts in public expenditures, as well as its intention to reschedule lower priority public investments, are steps in the right direction.

Finally, in the area of structural reforms, I welcome the authorities' two-pronged approach of stimulating growth by increasing factor productivity, including the improvement the quality of the labor force and enhancing labor market flexibility. This approach will go far to improve Malaysia's competitive position and enhance its prospects for continuing the present high growth rates over the long term.

Mr. Wei made the following statement:

I join the previous speakers in highly commending the Malaysian authorities for their outstanding achievements in maintaining a very high growth rate while keeping inflation at a low level. The authorities are also commended for their skillful management of the economy, in particular their successful policies in avoiding the risks the economy faced in the aftermath of the Mexican Crisis. The economic performance over the past year has been impressive with 9.2 percent growth as indicated in Mrs. Cheong's very helpful statement.

It is evident that the high consecutive growth over the past eight years can be attributed to the high level of investment--in common with other successful Asian economies. However, as demand pressure accumulates, the increase in supply becomes pressing even for a fast growing economy. In Malaysia, the shortage in supply manifests itself in the inadequate labor force and infrastructure facilities. These problems can only be tackled in the long-term strategy. In this respect, the measures listed by the authorities to increase labor market flexibility and increase infrastructure expenditure aimed at relieving the supply bottle-neck are most welcome.

In view of the demand pressure, inflation should be a cause for vigilance although at present it is at a low level. In this regard, the staff is of the view that interest rates should be increased in order to avoid higher costs in the future. However, the authorities have been observing an appropriate cautious monetary policy, generally skewed toward tightening to suppress excess demand. It is noted that the three-month interbank rates are being raised by 1.2 percentage points and the authorities are committed to following a cautious monetary policy. We believe that the authorities' cautious approach, in terms of monetary policy, should continue unless inflation increases beyond the current level.

The turnaround of the overall balance of payments from a large surplus to a deficit in 1994 is of concern to us. From the BOP data, this turnaround was brought about mainly by the sharp reversal of capital flows from the previous inflow to significant outflows. From our understanding, this may be the result of the policy intention to squeeze out the excessive liquidity. From Malaysian historical data, the inflow of short-term capital has contributed much to the achievement of a positive overall balance and we would stress that the judgment of the BOP performance should be based more on indicators other than short-term capital, given its volatile nature. To this end, more emphasis needs to be placed on improving the current account performance. In this regard, we note that the authorities are taking measures with the aim of improving the current account performance.

On the fiscal front, a surplus appeared in the overall balance, enjoying much from the strong growth. However, with the projected revenue decline of 3 percent of GDP in 1995, the estimated balance will be significantly reduced in 1995 and thus gives us cause for concern. The authorities' intention to reschedule the lower priority projects both to mitigate the pressure on the budget expenditure and to avoid the adverse influence on the balance of payments is indeed welcome. We share the staff view that "Maintaining a larger fiscal surplus during period of favorable economic conditions would also contribute to a further strengthening of the Government's balance sheet and provide the authorities with wider policy options to absorb any shocks in the future."

In conclusion, bearing the fruits of the opening policy and financial liberalization, the Malaysian economy is proceeding on a very healthy track. In order to achieve a sustained growth, vigilance should be observed in preventing inflation from surfacing. With the Malaysian economy's history of success, we believe the authorities will steer their economy in the right direction with appropriate measures.

Mrs. Gotz-Kozierkiewicz made the following statement:

Malaysia has been a country with a very impressive economic performance for the past eight years. The background paper and the staff report offer a comprehensive and clear picture of the Malaysian economy with a good analytical insight. Supplemented with Ms. Cheong's statement, pointing to the most important issues as they recently evolved and to the countervailing measures recommended by the staff and also recognized as necessary by the authorities, it leaves rather little room for doubts.

The main controversial point seems to be the one concerning the exchange rate and monetary policy in the context of the balance of payments development. More precisely, it has been once again the question of the best policy package with regard to short-term capital movements. The measures as recommended for 1995 plus the past (1992-1994) experience and its assessment by the staff offer a good opportunity to approach the question in a more comprehensive way, taking into account other developing countries' and emerging markets' potential and actual problems, both on theoretical grounds and in practice.

Let me just quote a statement published in the concluding remarks at the end of the background paper: "In an environment of rapid market reaction and large capital movements, the costs of inappropriate policies can be very high." The suggested answer is that the appropriate policy should allow the interest rate differentials to narrow in order to halt the capital inflows. Actually, there was no such attempt in Malaysia in 1992-1993 and, it is difficult to assess how much the domestic interest rates should be reduced to attain the expected result. The compatibility of the domestic interest level with inflation target must be of importance, however, both domestic interest rate and inflation in Malaysia have not been very high by international standards and, therefore, a scale of eventual adjustment also had to be relatively moderate.

The question concerning other countries' experience may be more fundamental: if the phenomenon of huge short-term capital inflow takes place in a country with the inflation rate much higher than that in Malaysia, what should then be the magnitude of the domestic interest rate adjustment to stop the excessive short-term capital inflow? Depending on the scale of the latter, the eventual required reduction may be of the magnitude resulting in the domestic real interest rate being clearly negative in real terms. Would such a solution be acceptable in the context of the viable stabilization targets?

The second part of the standard policy package would be the exchange rate. The question once again concerns the most adequate exchange rate level both in nominal and in the real terms. It should be maintained much closer to the programmed development of fundamentals rather than to abundance of foreign currency fueled by short-term, then volatile and highly reversible, capital inflow.

The Malaysian case may also be used to additionally highlight a discussion of the exchange rate regime best for eventual painless absorption of short-term capital flows. An argument often raised against the exchange rate nominal anchor and for a change toward managed float concerns the adjustment mechanism as much more smoothly eliminating then inconsistencies between interest rates and exchange rates. It is, of course, hard to dispute that the exchange rate nominal anchor must be less efficient in this respect than more flexible exchange rate systems. Managed float also does not, however, offer a good solution. Managed float must just "be managed," according to a concept of the medium-term real equilibrium exchange rate. The latter should not be the one determined with short-term speculative capital flows as included. Moreover, the floating exchange rate is to a considerable degree sensitive to changes in expectations of the market participants and to speculative assaults.

Notwithstanding a lack of a clear answer about effectiveness of the monetary and exchange rate policy to stop an excessive short-term capital inflow, being at the same time compatible with viable stabilization targets, the use of capital controls as a policy response to surging capital inflows is assessed by the staff as somewhat controversial. In the contemporary world of once again growing globalization of financial markets, the perfect behavior should be looked for in sound economic policy and good fundamentals preserving a very moderate attractiveness of individual countries for short-term capital investments. There are no doubts that it would be the best option. Approaching, however, facts as they are, let me quote one of the well-known Polish economists, M. Kalecki. He used to say that a choice in economic terms has usually been limited, just like in life itself. This choice does not in general consist in acceptance of the one of two options: to be young, beautiful, healthy and rich or just be old, ill, ugly and poor. The choice in economy aims rather at a compromise. Such a compromise must probably be taken into account also in case of countries transforming their economies and for the time being moderately successful in fighting inflation. This compromise should probably be looked for in temporary short-term capital control just as the second-best optimum.

Mr. Gaspard made the following statement:

It is a measure of Malaysia's impressive economic performance that the policies that have usually been recommended to the authorities in the last few years were more of the preventive than curative variety. This year's staff report is in the same vein as it stresses the need for vigilance over inflationary pressures in the economy. I only have two brief comments to make, one on the inflationary risks in the economy and the other on exchange rate policy.

Unlike last year, the staff's concerns in this report with overheating risks appear to be more justified since the signals originate, this time, from various sources on both the demand and cost side of the equation. The relatively high wage increases over a number of years and the emerging signs of supply shortages are bound to raise costs throughout the economy, exacerbated by the recent sharp increase in the rate of capacity utilization in manufacturing and by an eventual fiscal impulse in 1995. So the authorities need to avoid adding fiscal stimulus to an economy that is already operating at or close to full capacity. Experience shows, however, that fiscal projections in Malaysia have consistently erred on the conservative side. I wonder then about the extent to which this is the case in Malaysia in 1995? I would appreciate the staff comments.

On exchange rate policy, the staff's view is that the authorities need to support a tightened financial stance by refraining from interventions to stop an appreciation of the ringgit. These concerns are clearly addressed by Mrs. Cheong in her statement which underlines the authorities' currently tighter financial stance and their adoption of a general non-interventionist approach to exchange rate policy. Let me add, however, that I find more appropriate the authorities' position in this regard, namely that the non-interventionist approach should be governed less by short-term market considerations than by their views on developments in the economic fundamentals of the economy. This is a more flexible and appropriate exchange rate policy than the one advocating an appreciation of the ringgit or, more precisely, an unqualified passive stance in exchange rate markets. Given the deterioration of Malaysia's external current account, and especially the loss of competitiveness that would result from the impending reduction or abolition of tariffs on several thousand traded items, the authorities' exchange rate policy is indeed the more suitable one to Malaysia's present economic circumstances. It has, after all, served the economy quite well so far, whether with respect to non-inflationary growth and low unemployment or the confidence of financial markets in the economy.

I would like to close by noting Malaysia's continued exemplary economic performance.

Mr. Shields made the following statement:

Malaysia's recent record is so good it means that we should now be concentrating on receiving policy advice from the authorities, rather than giving it to them. I am inclined to agree with the staff argument about the risks of overheating. I also share the worried of some speakers about using the current account as safety valve for demand pressures, especially taking into account the fact that the current account deficit is quite high, and growing substantially.

I welcome the measures that have been taken in the labor measures aimed at producing a better long-term labor supply response.

Regarding the current stance of policy, fiscal policy seems to be adding to, rather than offsetting, intense demand pressures. I am not impressed by recent improvements in the statistics in this regard, as these could simply be reflecting higher output. The underlying stance of fiscal policy appears to be stimulative.

In that respect, I agree that it might be a good idea to postpone some infrastructure spending. Also, despite the recent increase in interest rates, rates are none too high in real terms, and signs of excess liquidity continue to appear. I am also worried about the absence of a clearly stated monetary framework.

I am pleased that the authorities are prepared to let the ringgit appreciate, and at the speed with which the capital controls were ultimately removed.

Mr. Dlamini made the following statement:

Recent developments in Malaysia represent what we would like to see in an economy: high growth, low unemployment, relatively low inflation, strong export performance, high saving and investment ratios, private sector confidence, exemplified by the large inflows of private long-term capital, and a strong fiscal position. With this kind of record, one is obliged to commend the authorities for the excellent way in which they are managing their economy.

I think that the economy can be expected to do well in the future. One of the encouraging signs is that growth is being driven by investment. This means expanding capacity, which will also help to keep inflation in check. It is also important that the manufacturing sector is taking a leading role. Studies show that this is the area where a country can benefit most from international trade.

The authorities appear to be aware of the risk of overheating, and I would trust that fiscal and monetary policies will be implemented in a way so as to contain excess demand pressures, should the problem arise. Steps being taken to raise female labor force participation and other structural measures aimed at promoting flexibility in the labor market should help to contain cost pressures.

We need to continue to make more in-depth analyses of economies like Malaysia's to see what lessons can be applied to developing economies.

The staff representative from the Southeast Asia and Pacific Department stated that, despite some technical improvement in the consumer price index, questions about its accuracy as a measure of inflationary pressures persisted, and in that vein, the authorities were looking at a wider range of indicators. The performance of the consumer price index appeared to have been more affected by recent tariff reductions than by the producer price index or the GNP deflator, which was why the staff had emphasized those other indicators.

Long-term interest rates were not widely quoted, the staff representative pointed out, and the market for long-term instruments appeared to be fairly thin. It appeared, however, that the yield curve had declined in steepness over the preceding year, and that the spread of long-term rates over short-term rates that had widened in early 1994--to about 2.8 percent--had since narrowed, to a little over 1 percent.

Fiscal performance had generally been better than expected, the staff representative observed. In fact, there was a good chance that fiscal performance in 1995 would be somewhat better than expected, and certainly better than in the original budget. Asset sales would probably be much smaller in 1995 than they had been in 1994, but that did not concern the staff unduly, as proceeds from privatizations in 1994 had been unusually large. Nevertheless, the reduction in privatization receipts should not be completely ignored in interpreting the fiscal situation, and it would be prudent to increase other revenues or--even better--to contain expenditure.

Mrs. Cheong made the following concluding remarks:

I wish to thank Directors for their useful comments and advice on management of the Malaysian economy. These will be conveyed to the authorities, and as is the tradition, this advice will be taken into account in the regular exercise of modifying economic policies to meet the changing circumstances.

Many Directors raised concerns of overheating of the economy. The term "overheating" is relative and its magnitude difficult to access, a point raised by Mr. Mirakhor. Mr. Newman made the same point when he referred to "moving benchmarks". Differences in perception of overheating is a matter of degree. The authorities are indeed concerned of the risks of overheating and are adopting tighter monetary policy and exercising fiscal restraint as well as ensuring greater flexibility in the exchange rate area. However, in doing so, they prefer to act cautiously in order not to tighten policies too fast and too soon. In other words, care is being taken to ensure that the economy is not put into reverse gear prematurely.

Mr. Cailleteau raised difficulties in understanding the inflation level. I should point out that the current 3.5 percent inflation level is considered high in Malaysia. Our Prime Minister would like to target a zero inflation rate. All government agencies are being geared toward this objective, to take the necessary steps to supplement the tight monetary policy already being pursued by the Central Bank.

On price developments and administrative measures, I would like to clarify the issue of controlled prices. There are indeed controlled items in the Malaysian consumer price index basket. But "controlled" does not mean that prices of these products are "fixed" artificially below market prices. Prices are determined for essential items like rice and sugar, to ensure fair prices and avoid excessive profiteering by producers and retailers. Prices are set by the Government, retailers and consumer groups based on cost of materials and a fair profit margin. Prices are reviewed every six months.

The consumer price index was rebased in 1993. I would like to draw Directors' attention to the dangers of a link between the producer price index and the consumer price index, as they are not equivalent. The producer price index is a function of commodity prices, which are dependent on demand and supply in the international markets. Any impact of the producer price index on domestic prices will be limited, as these commodities are not consumed locally, but exported.

On monetary policy, I would like to add some points for emphasis. With the short-term inflows no longer a problem, monetary policy has reverted to meet the medium-term objective of containing excess liquidity. The recent acceleration of M3 growth to about 15.4 percent in July is not unduly large, given the high growth and the inflation level. Nevertheless, to ensure more moderate loan growth in the banking system to avert unduly high loans for consumption purposes, the Central Bank continues to mop up excess liquidity. This is evidenced from the regular issues of Bank Negara Bills (BNB). The three-month interbanking rate is also now higher at about 6.10 percent compared with 6.05 percent at end-August.

On long-term interest rates, it is true that there is a thin market for long-term rates and the Central Bank is doing more work to encourage banks to lend longer-term to better match their assets and liabilities.

On fiscal policy, the authorities agreed on the need to exercise restraint. This must be balanced with the need to upgrade and expand infrastructure. Government expenditure will be prioritized according to importance to ease bottlenecks. For example, expenditure on education and training for human resource development will continue, while less urgent projects will be postponed. To ensure that such expansion would not create a fiscal stimulus, present policies of inviting the private sector to participate in projects will be continued, and possibly accelerated.

On budgetary forecasts raised by Mr. Mesaki and Mr. Gaspard, it is true that the forecast has always been conservative, particularly on the revenue side. This will likely continue.

Mr. Mirakhor suggested the introduction of a broader based consumption tax. The Government has for a few years now, been rationalizing the tax base to improve tax buoyancy. These included moderation in tax incentives accompanied by lower corporate and personal income tax rates. At the same time, preparations are under way for introduction of a broad-based consumption tax to replace the present sales and services tax. However, the date for this change has not been determined due to concerns about the impact of the value-added tax on inflation.

There are concerns that large government expenditure may strain financing requirements. With the development of the capital market, sources of finance have expanded, so that crowding out of loans to the private sector is not an issue. For large projects, private sector can also tap the large resources of the EPF. Big and small firms are also permitted to borrow and issue bonds abroad.

Mr. Mesaki raised the issue of further appreciation of the exchange rate. As stated in my statement, ringgit exchange rates have appreciated in recent months reflecting strong economic fundamentals. On Mr. Newman's concern that the policy of smoothing exchange rate volatility can be highly discretionary, I can only assure Mr. Newman that management is committed to act prudently in this area. Mr. Newman also asked how imports will be reduced. The only avenue to do this is to limit imports by Government, mainly through phasing out of government projects. The authorities will not take any administrative measures on the trade front beyond their commitment to make further tariff reductions on imports.

Some Directors raised concerns on asset price increases. Sharp increases in property prices are recorded primarily in key urban centers of Kuala Lumpur and Petaling Jaya. The impact of such price increases leading to a bubble economy is being avoided through prudential regulations. This is mainly effected through administrative limits on the share of lending by a bank to the broader property sector in its total lending portfolio.

Many Directors wondered whether Malaysia would react in the same manner if there were a resumption of large capital inflows. It would be difficult to say whether the authorities will act in the same manner as circumstances are not likely to be identical. The authorities are convinced, however, that administrative controls, when imposed temporarily, did work. They are also certain that, even if circumstances varied, appreciation of the exchange rate at the height of large capital inflows is not a wise move. It will only create greater exchange rate volatility when these funds leave the country, creating greater uncertainty. The Central Bank also has a responsibility to long-term investors with committed funds in the country. Its policy stance must be consistent with the maxim that exchange rates should reflect economic fundamentals. Therefore, long-term exchange rate policies cannot be based on short-term capital movements.

The Acting Chairman made the following summing up:

Executive Directors endorsed the broad thrust of the staff appraisal for the 1995 Article IV consultation with Malaysia. They expressed admiration for the impressive performance of the Malaysian economy over the past eight years, during which the economy had sustained one of the world's highest growth rates in an environment of moderate price increases and a generally strong balance of payments. This favorable performance, which had continued in 1994 when real GNP expanded by around 9 percent while inflation remained below 4 percent, owed much to the authorities' excellent policy record that had fostered high rates of saving and investment and the rapid development of a dynamic manufacturing sector.

Directors observed, however, that after eight years of rapid growth, the economy was now operating at full capacity, and signs of inflationary pressures had emerged. Capacity utilization had reached a very high level, and the unemployment rate had fallen below 3 percent, contributing to wage pressures and labor shortages. Moreover, the external current account deficit had widened markedly to about 6 1/2 percent of GNP in 1994, and the overall balance of payments had swung from a large surplus to a deficit.

In view of the ongoing strength of domestic demand and intensive resource utilization, Directors strongly endorsed the authorities' objectives of reducing inflation further, and most speakers were of the view that the balance of risks had now shifted decisively in the direction of overheating. They, therefore, emphasized the need for greater caution and supported an early tightening of financial policies.

Directors welcomed the strong improvement in the fiscal position in recent years, noting that the federal budget had moved from near balance in 1993 to a surplus equivalent to 3 percent of GNP in 1994. To reduce the risk of overheating, the budget should not have an expansionary impact on the economy and the authorities should aim at maintaining a significant surplus. While encouraging the authorities to enhance tax revenue and contain the growth in current expenditures, several Directors noted that the maintenance of a suitably tight fiscal policy may well require lengthening the implementation period of some large infrastructure projects, notwithstanding the importance of those projects to ease capacity constraints and to sustain satisfactory growth over the medium term. They also welcomed the authorities' decision to reschedule lower priority projects.

Directors welcomed the authorities' recognition that exchange rates should reflect economic fundamentals and their belief in a noninterventionist approach. Directors were concerned about the recent rebound in the growth of monetary aggregates and considered that a tightening of monetary policy was warranted. They welcomed the upward trend in interest rates, but considered that rates would need to rise further to contain the rapid growth in domestic credit. Directors generally agreed that the authorities should be prepared to see this tightening result in a market-induced appreciation of the nominal effective exchange rate.

Directors considered that the authorities' response to the challenges posed by large capital inflows had been generally appropriate, and they commended the authorities for the early removal of most of the restrictions that were imposed on capital inflows at the beginning of 1994. In this connection, they observed that the maintenance of market-based exchange rate policy should reduce the risk that changes in monetary conditions would lead to destabilizing short-term capital inflows that might require the reimposition of restrictions in the future.

Directors supported the thrust of the authorities' structural adjustment strategy. They agreed that, given the tight labor constraint, it would be essential for Malaysia to shift toward higher value-added industries in order to sustain high growth with price stability over the medium term. In particular, they supported the emphasis on upgrading the labor force, strengthening the economic infrastructure and the functioning of markets, and further liberalizing the trade system in order to foster competitiveness of the private sector. Some Directors called for a more active private sector participation in the development of infrastructure.

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

2. SAUDI ARABIA - 1995 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1995 Article IV consultation with Saudi Arabia (SM/95/227, 9/7/95). They also had before them a background paper on recent economic developments in Saudi Arabia (SM/95/232, 9/12/95).

Mr. Al-Jasser made the following statement:

On behalf of my authorities, I would first like to thank the staff for very useful and constructive Article IV discussions on Saudi Arabia's recent economic performance and prospective economic outlook.

The sound policies the authorities have implemented over the years are evident in the resilience with which Saudi Arabia's economy has withstood such major external shocks as the repercussions from the Gulf War and the sharp decline in oil revenues over the 1993-94 period. The authorities' strategy remains one of promoting diversification and private initiative through the continued implementation of credible macroeconomic policies as well as the maintenance of a market-based economy with liberal exchange and trade systems. At the same time, the authorities remain mindful of Saudi Arabia's role as a major source of the world's oil supplies and continue to provide, in the face of continuing budgetary difficulties, considerable financial aid to developing countries.

On the fiscal front, sizable gains have been achieved since last year's Article IV discussions. Spending was reduced in 1994 by a further 9 percent, mainly due to a reduction in current expenditures including more than 60 percent cut in subsidies. As a result, the fiscal deficit narrowed to 9.5 percent of GDP despite a 10 percent decline in oil revenues. This achievement notwithstanding, the 1994 outcome fell short of initial budgetary expectations and the authorities are fully aware that deficits of this magnitude are not sustainable in the long run. As such, the fiscal consolidation effort was intensified considerably in the 1995 budget in order to reduce the overall deficit to 2 percent of GDP.

In a break from the past, the 1995 budget supplements further spending cuts with significant measures to increase non-oil revenues by about 3 percent of GDP. The revenue growth is to come from increases of between 80 percent and 300 percent in domestic prices of petroleum products, a substantial rise in water, electricity, postal, and telephone charges, and higher licensing and other fees.

Preliminary estimates indicate that the fiscal deficit for the first half of the year amounted to SRls 4.6 billion in line with the budget targets. Revenues reached SRls 75.6 billion, while expenditures amounted to SRls 80.2 billion. In the external sector, the current account deficit, which was almost halved to $9 billion in 1994, fell further in the first half of 1995 to $1.2 billion compared with the staff projections of $5 billion for the whole year. During the same period, the underlying inflation rate remained low, private sector investments gained momentum, and stock prices increased.

This sizable adjustment effort notwithstanding, the authorities are cognizant of the need for further fiscal consolidation over the medium term. The Sixth Development Plan is accordingly set to balance the budget by the year 2000 and reduce the government debt level. At the same time, emphasis would be on improving the budget structure through lowering current expenditures and increasing non-oil revenues.

In addition to a reduction in, and better targeting of subsidies, spending cuts will focus on, inter-alia, containing the wage bill. This is in line with the strategy of the Development Plan which aims at enhancing employment opportunities in the private sector and paying special attention to human resource development. This strategy should allow for an orderly reduction in civil service employment over the medium term. These policies, along with continued restraint on other current expenditures, should allow for increased capital spending while achieving fiscal balance over the medium term.

On the revenue side, efforts will continue to focus on rationalizing prices of publicly provided goods and services. These efforts will not only reduce the budget deficit but also improve resource allocation and enhance efficiency. The authorities also expect further increases in revenues in the period ahead from the measures adopted in 1995.

Monetary policy continues to be supportive of the tightened fiscal stance so as to keep inflation subdued, ensure exchange rate stability, and maintain confidence in the domestic financial system. The authorities also continue to attach considerable importance to enhancing the efficiency of the financial markets. To this end, they have been adapting banking regulations to take into account the growing role of financial innovations. These prudent policies are already paying dividends, as evidenced by the decline in interest rate differential over the U.S. dollar to less than 20 basis points.

Increases in the number of mutual funds and continued expansion of electronic stock trading should also improve efficiency by broadening and deepening the financial markets. Here, it is worth noting that settlement on the Saudi stock market was moving to a same-day basis. Also, the Saudi stock market meets or exceeds all of the recommendations set out in the recent G-30 report on transparency and efficiency. In addition, the planned privatization of the few publicly-owned, non-oil companies should bode well for the markets. It is expected that the national airlines would be among the first to be privatized. The authorities' plan of a gradual increase in the private sector's share in the equity of the Saudi Arabian Basic Industries Corporation (SABIC) should further broaden and deepen the market. The recent transfer of majority control of Ibn Rushd--a former SABIC affiliate--to the private sector is a first step in that direction.

The authorities are fully aware that these adjustment efforts will continue to exert pressure on growth in the near term, as has been the case over the past two years. They are convinced, however, that the benefits of their adjustment policies over the medium term far outweigh the short-term costs. The increased resiliency exhibited by the private sector and the sharp increase in non-oil exports over the past year (18 percent) reinforce this conviction. The continued improvement in the fiscal and external current account deficits should enhance confidence, encourage capital inflows, and increase the availability of loanable funds for private sector investments. Indeed the authorities believe that a solid foundation has now been laid for sustainable private sector growth.

On oil policies, Saudi Arabia, the largest oil producer, has always taken its global responsibilities seriously. The credibility of its oil policy, predicated on maintaining stability in the global oil market, is bolstered by investing heavily in maintaining adequate spare capacity and readily accessible inventories. However, the commitment to persevere with that policy will be greatly facilitated by the cooperation of oil-consuming and oil-producing countries. Indeed, discriminatory and exorbitant taxes on oil can only hurt these efforts.

On exchange and trade issues, my authorities will continue to maintain an open exchange and trade system as well as the policy of effectively pegging the riyal to the U.S. dollar. These policies will continue to benefit the economy in the future as they have in the past. In this connection, Saudi Arabia has already applied to join the WTO.

As regards external development assistance policies, Saudi Arabia remains committed to providing assistance to developing countries despite budgetary pressures. As the staff report notes, such assistance will remain highly concessional, untied, and directed mainly at promoting private sector led growth in recipient countries.

Finally, let me convey my authorities' appreciation to the Board, Management, and the staff for their professional conduct of the Article IV consultations with Saudi Arabia over the years.

Mr. Shaalan made the following statement:

The volatile and declining oil revenues of the past decade had a most far-reaching impact on Saudi Arabia's fiscal and external accounts. Let me just cite two or three numbers to indicate how much the decline has been, and within that decline, the degree of volatility. In 1981, oil revenues, when they were at about their peak, amounted to SRl 328 billion. A decade and a half later, in 1995, they had declined to some 100 billion, less than one third. Similarly, government expenditures amounted to 284 billion in 1981, and they are projected to reach only about 60 percent of that level in 1995. In real terms, of course, the decline in both oil revenues and expenditures was substantially more. I cite this to indicate that, over the years, the Saudi authorities' adjustments to these rapidly changing circumstances have been prompt, decisive, and commendable.

At last year's Executive Board discussion, Directors called for a continued strengthening of fiscal adjustment to reduce both the budget and current account deficits. To this end, the authorities intensified their efforts to deal with the continued problems lingering from the Gulf crisis. A high degree of success was attained in both 1994 and 1995. More than in any other period, these adjustments were not only directed at reducing the budget deficit, but also at introducing improvements in the structure of the budget. This was particularly evident in the area of expenditure rationalization.

It will suffice to mention, as indicated in Mr. Al-Jasser's statement, that government expenditures were reduced by some 7 percent in 1994, and are budgeted to drop further in 1995. Subsidies were cut by more than 60 percent over their 1994 levels. This is a remarkable achievement, which served to reduce the 1994 budget deficit to 9 1/2 percent of GDP compared to 11 percent in the previous year, despite a 10 percent decline in oil revenues. The budget projections for 1995 bear testament to the strong commitment of the authorities to fiscal consolidation. Further expenditure restraint, in the form of significant adjustments in the price of a wide range of publicly supplied goods and services, was the hallmark of the 1995 budget. The fiscal deficit target is budgeted to decline by some 8 percentage points from the previous year to about 2 percent of GDP, a very ambitious--and perhaps too ambitious--target by any standard. More importantly, continued price adjustments, through which most of the consolidation is taking place, will further improve the budget structure, as well as lead to a more efficient allocation of resources.

The staff questions the attainability of the fiscal target and estimates that it is likely to be close to the 5 percent range. No explicit basis for this projection is given in the report. Mr. Al-Jasser indicated that the estimates by the authorities show that the deficit for the first half of the year is running at an annual 2 percent of GDP. Be that as it may, if the final outcome for 1995 is closer to the staff's 5 percent projection, then that would already be a respectable and significant achievement. It would represent an almost 5 percentage point reduction from the previous year.

The staff appears to call for an up-front fiscal retrenchment, in addition to what has been done. I believe that caution in this regard is called for. While the private sector has been growing at a rate of 3 percent in recent years, total output has been less than robust. Even though the level of government expenditures has less of an impact on economic activity than it used to, on account of the increasing resilience of the private sector, I am concerned that more front-loaded action on the budget front could accelerate recessionary conditions. This could have two adverse effects. First, a deepening of the recession may make it more difficult to gain public acceptance of the reform. The recent reforms that have been introduced have gained much acceptance, and it is important that the general consensus for the continuation of the adjustment effort be preserved.

Second, and equally important, intensification of recessionary conditions could render the authorities' efforts at reducing the wage bill more difficult in case of a decline in private sector activity. The above considerations are, in my view, supported not only by the absence of inflation, but also by developments in the external sector. The current account deficit was halved in 1994, and is projected by the staff to be more than halved again in 1995, reaching 5 percent of GDP in that year. Prudent monetary and fiscal policies, as well as the increase in non-oil exports, contributed to this outcome. Additionally, it must be recalled that the level of Saudi Arabia's official exchange reserves is very comfortable and represents no cause for concern.

On revenue mobilization, the authorities are considering some of the staff's proposals, but it appears they are not ready to consider at this time some of the tax measures proposed by the staff. I have sympathy for the authorities' position, on the grounds that if the budget could be balanced through cost recovery for public goods and services and the rationalization of the wage bill, then the case for taxation does not appear to be convincing at this stage.

A word on oil policy. Saudi Arabia has pursued a policy centered around providing adequate supplies in a manner aimed at avoiding sharp fluctuations in oil prices, as Mr. Mesaki has just noted. However, major oil consuming countries have practiced discriminatory energy taxation. In the interest of strengthening the cooperation between the producers and consumer countries, I would urge major consuming countries to review their energy tax policies with the hope, in particular, of eliminating discriminatory practices.

Saudi Arabia, in spite of its efforts at budget consolidation, is to be commended for continuing to provide financial aid to developing countries at levels higher than those called for by the UN. The aid is geographically broad based and untied.

Ms. Lissakers made the following statement:

I would like to comment on three aspects of Saudi performance: short-run adjustment, medium-term requirements, and statistical reporting.

We have been among those concerned that Saudi Arabia's financial commitments were running ahead of its resources. In this respect, developments over the past year have been very constructive. Cost containment made a major dent in budgetary expenditures, which were down nine percent in 1994, and will be down again this year. Since 1992, expenditures have dropped from SR 211 billion to SR 145 billion this year. There have been year-to-year dramas, but the cumulative record shows a clear determination by Saudi authorities to make the fiscal adjustments needed to keep the economy on an even keel. Retrenchment seems to be coming where it is most needed: in wage costs and subsidies.

The latest fiscal results, however, illustrate why consolidation is essential. In 1994, budgetary oil revenues dropped 10 percent. So, despite spending control, the budget deficit narrowed only marginally from 11 percent of GDP to 9.5 percent. This year, oil prices are coming in about $1.00 per barrel above budget projections. That, plus continued spending discipline, is now expected to squeeze the budget balance down to about 2 percent of GDP.

This better financial outcome has allowed external payments to be made without additional foreign borrowing and it has allowed a regularization of some internal arrears. We welcome this improvement. Nevertheless, the Saudi fiscal position still remains too vulnerable to developments in the oil market.

A sustainable fiscal position requires a better balance between structural expenditure levels and hard headed estimates of likely oil revenues. This is the message of the medium-term scenarios developed by the staff. Unless spending is further controlled or oil revenues come in higher than now anticipated, budget deficits will drive the debt to GDP ratio to about 110 percent by the year 2000. Oil market analysts, like economists, differ in their view of the future, but a number of reputable forecasters see oil prices holding present levels or declining in real terms over the next several years as the global energy market becomes more competitive. Saudi financial reserves remaining after many years of large budget and current account deficits are inadequate to buffer large oil revenue shortfalls.

The Saudi economy, not just the budget, is over-reliant on oil exports, merchandise imports, foreign labor, and government spending. The budget mirrors and, despite improvements, still contributes to this imbalance. An economic strategy needs to be followed that will create productive jobs for a growing indigenous population, that will expand non oil-exports, and that will reduce the dependency of the economy on public expenditure.

The new Sixth Development Plan, highlighted by Mr. Al-Jasser in his statement, is oriented in the right direction.

Privatization is essential to this strategy and faster progress would be desirable. To make privatization successful, prices must reflect true costs. This means elimination of most subsidies and introducing economic pricing of enterprises that still remain in the public sector. As Mr. Al-Jasser highlights in his statement, the new Development Plan proposes substantial increases in domestic petroleum prices as well a major adjustments in administered prices. I would encourage the authorities to pursue this plan vigorously, not just as a matter of covering budgetary outlays, but also with a view to moving many activities into the private sector and improving the efficiency of the economy.

We fully support the authorities' program for investment in the education of the growing population. Saudi Arabia is already a high income country. A thriving private sector will have to be built on high value added jobs. Education is fundamental to this. Over time, the same policies that help to absorb the population more fully into the economic life of the economy will also contribute to better internal and external balance. The budget will benefit from reduced subsidies and transfers and the external accounts will gain from reduced worker remittances.

While maintenance of an adequate defense and security posture is an inescapable responsibility, outlays in this category absorb roughly one-third of total government expenditures. Careful budgetary review to limit future growth in defense expenditures is needed to assure the most effective return from current outlays.

We associate ourselves fully with the staff recommendations for an improvement in the breadth, depth, and timeliness of Saudi economic data. We need better data for improved consultations; the markets need better data so that an expanding private sector can maker better investment choices with less risk; and Saudi administration itself needs better data for effective policy making in an increasingly complex economy.

I acknowledge and welcome the improvements that have been made in the last couple of years in the data provided to the Fund. Nevertheless, as Section V of the staff report notes, there are significant gaps in Saudi statistics that are overdue for improvement.

Mr. Kiekens made the following statement:

The most serious imbalances in the Saudi economy are the high budget and high current account deficits. I therefore commend the Saudi authorities for having intensified their adjustment efforts, which the staff expects will halve both deficits in 1995. However, there remain serious challenges in both the fiscal and external areas.

The heavy dependence on oil revenues and consequently the vulnerability to adverse developments in the oil markets continue. The non-oil revenues make up only one fourth of the total. The expected improvement in the fiscal deficit must therefore come mainly from substantial increases in the prices of publicly supplied goods and services, for which there is limited room. Moreover, the downward rigidity of public wages, which account for about half of total budget expenditures, and the rapid growth of domestic interest payments leave little room for further spending cuts without seriously impairing growth.

Long-term fiscal viability requires radical changes in the composition of government revenues. Taxes account for only about one percent of total revenues and are marginal in GDP terms. I agree with the staff's recommendation to introduce some new taxes in order to give them a more reasonable share in total revenues. I am sorry to learn that the authorities do not intend to do this. Shifting expenditures toward infrastructure and education would also be desirable for the long term growth prospects of the country. The figures published last year by the World Bank point to a primary school enrollment of only 62 percent, and an illiteracy rate of 38 percent.

Notwithstanding the large and persistent fiscal deficits, inflation is relatively low due to avoidance of monetary financing of the budget deficit. A persistent high fiscal deficit is nevertheless not sustainable, and will cause high costs in terms of future macroeconomic imbalances. Saudi Arabia's low real growth rate makes the situation worse, since it will contributes to the snowballing of the public debt. The ratio of domestic debt to GDP has risen rapidly, from 44 percent in 1991 to 81 percent in 1995. The staff foresees that, under current policies, the debt will soar to 110 percent of GDP by the year 2000. The need for a substantial fiscal adjustment could not be clearer.

It is encouraging to see that the current account deficit has fallen from 15 percent of GDP in 1993 to 8 percent of GDP in 1994 and is expected to be halved again, to 5 percent of GDP, in 1995. But on examination, the underlying factors of this impressive achievement reveal a less reassuring picture. The 1994 reduction came mainly from a contraction of imports, due to lower government expenditures and the completion of private sector projects, and sluggish growth. A resumption of growth would undo the improvement in the current account situation. The main source of 1995's improvement in the current account was an increase in oil export prices. In other words, under present structures, improvement in the current account depends on continued economic stagnation and favorable world oil prices. Diversifying the economy and promoting private sector growth are the long-term solutions to the problem. I would be interested in the staff's recommendations for achieving a more balanced external position in the short- to medium term without requiring the economy to stagnate.

Another source of concern is the low real growth rate of the Saudi economy. Here again the problem is overreliance on a single sector. The high growth rates of 1990 and 1991 were driven by the oil sector. Since the growth of the government sector tended to mirror the oil sector, the non-oil private sector's behavior seems to be a better indicator of the country's economic performance outside the oil industry. The limited role of the private sector and the high public deficit, if allowed to continue, will tend to prolong the low growth.

The task of the government is not easy. Reducing the fiscal deficit by cutting current expenditures will damage growth. Avoiding expenditure cuts and hence continued recourse to domestic borrowing to cover the deficit, will crowd out private investments, as already visible. The cure is to improve conditions for private sector investment. This means rapid implementation of structural reforms, including the privatization of state-owned enterprises, continuing the widening and deepening of the financial and securities markets, liberalizing foreign portfolio investment, and rationalizing incentive policies.

By discussing the complex policy agenda ahead for the Saudi authorities, I do not intend to diminish their remarkable achievements in reducing both their budget and external imbalances, and I wish them every success in their continued endeavors.

Mr. Mesaki made the following statement:

Saudi Arabia resembles a man walking in a storm: the wind blowing against him--the after-effects of the Gulf War and the sharp decline in oil revenues--is very strong, and from the outside, his steps seem slow. However, we know that he is making great efforts to go ahead and, indeed, he is going ahead.

As is widely noted, fiscal policy continues to be the key to reducing the economy's imbalances. In 1994, a ten percent decline in oil revenues was more than compensated--although only slightly--by a sharp reduction in spending, mainly in current expenditures. This was not an easy task, I believe, since the impact of the fiscal retrenchment lead to zero growth of real non-oil GDP.

Even more commendable is the fact that the authorities are trying to build on the achievements made in 1994, based on the clear understanding that the still high, though declining, fiscal deficit, as well as the external deficit, will not be sustainable in the long run. I certainly welcome that, in a break from the past, the 1995 budget included significant steps to raise non-oil revenue. It is encouraging to learn from Mr. Al-Jasser that the result for the first half of the year was in line with the budget targets.

Nonetheless, medium-term projections prepared by the staff--although of a hypothetical nature--illustrate the need for further consolidation efforts over the medium term. In this respect, I share the general thrust of the staff's recommendations, which call for a combination of various measures, including the introduction of new taxes and a reduction of the wage bill. I wonder how the authorities' seemingly cautious stance on new measures during the consultation discussions are in line with Mr. Al-Jasser's encouraging statement that the authorities are convinced that the benefits of their adjustment polices over the medium term far outweigh the short-term costs. This said, I do not preclude the possibility that the authorities may judge it appropriate to be slightly less bold than the staff envisages, at least in the immediate future, since they would naturally want to avoid too much downward pressure on the non-oil sector in consecutive years.

Concerning monetary policy as a demand-control measure, underlying inflation being nonexistent, I do not have much to say. It will not be difficult for SAMA to prevent the rise in the cost of living index from arousing general inflation expectations.

I do not have much to say on external policies, either, but I have one question. While Saudi Arabia relies heavily on oil exports, which are denominated in US dollars, Table 43 of the recent economic developments paper shows a wide range of sources of imports. Thus, developments in the dollar exchange rate seem to be exerting an unbalanced effect on the economy. I wonder how the Saudi Arabian authorities view the recent sharp swings in the dollar's value.

Structural policies are of great importance to establish a solid base for ensuring self-sustaining private sector-led growth. I note that the Sixth Development Plan points in the right direction in this regard and that the authorities are already making visible progress. I would just like to add that the importance of deepening the financial markets should not be undervalued since efficient transmission of resources is imperative for private sector development. In this respect, it seems useful to re-examine the staff's recommendation for opening the stock market to foreign competition and creating secondary markets for government bonds.

Finally, in view of the important role the country plays in the world economy, I welcome the enhanced discussions between the authorities and the staff on the improvement of data, especially those on external transactions, and hope that these efforts will bring about recognizable results in the near future.

I conclude my remarks with praise for Saudi Arabia, as the largest supplier of oil, for its contribution to the stability of world oil prices.

Mr. Mirakhor made the following statement:

The staff report and the accompanying document on recent economic developments, as well as Mr. Al-Jasser's statement, provide a comprehensive assessment of recent developments in the economy of Saudi Arabia and its medium-term prospects. As I agree with the thrust of the staff's analysis of the key requirements for policy action in the short and medium term, and in light of what has already been said by other Directors so far, I can be brief.

As indicated in the staff report, the authorities' recently announced Sixth Development Plan provides a clear indication of the country's development strategy. Appropriate emphasis is being placed on fostering the conditions for increased private sector participation and economic diversification. Supporting this strategy are policy efforts to enhance human resource development, complete infrastructure projects to support private sector initiative and growth, and delegate a wider range of economic responsibilities to the private sector. These steps are very much in line with the challenges facing the economy and constitute the key to sustaining high private sector-led economic growth and gradually reducing dependence on government expenditures as a major determinant of private sector activity.

Rightly, fiscal adjustment is also the center of the authorities' economic strategy. The plan is to eliminate the fiscal deficit by the year 2000. In this regard, the progress achieved to date has been encouraging. The budget deficit is projected to fall to 2 percent of GDP in 1995, as compared to an average of 10 percent of GDP in previous years and Mr. Al-Jasser tells us that preliminary estimates indicate that the fiscal deficit in the first half of the year is in line with the budget target. This reduction has been facilitated by the significant measures taken at the beginning of the fiscal year to adjust fees and charges for publicly-supplied goods and services and to further contain expenditures. The recovery earlier in the year in oil prices also played a role. However, the subsequent moderation in oil prices again highlights the sensitivity of the budget to international price developments and the risks posed to the economy. I am sure the authorities would want to press ahead with measures to enhance further non-oil budgetary receipts while aiming for a more ambitious improvement in the budget structure. As demonstrated in the staff's medium-term analysis, this would enable Saudi Arabia to maintain a strong external reserve cushion and gradually reduce domestic debt; external debt would remain at a basically insignificant level following the recent full repayment of the commercial bank syndication contracted in the aftermath of the 1990-91 regional crisis. The resulting reduction in the sensitivity to oil market developments would also assist the economic diversification efforts.

The approach set out in Saudi Arabia's Sixth Development Plan, and an oil policy aimed at maintaining stability in the international market for this important product, are key aspects of the country's important contribution to the world economy. Saudi Arabia maintains an open exchange and trade system and significant flows of concessional official financial assistance; it has initiated the process of joining the World Trade Organization. As Mr. Shaalan suggested, it is regrettable that this cooperative approach is not being reciprocated fully. Thus, like other oil-producing countries, Saudi Arabia continues to face considerable constraints on market access for its oil product exports.

In conclusion, the authorities should be commended on the country's economic and financial progress--particularly with regard to reducing macroeconomic imbalances and strengthening the basis for economic growth and diversification. The authorities' continued commitment to the pursuit of sound and credible macroeconomic policies and the maintenance of a market-based economy strengthen the expectation that a solid foundation has been laid for sustainable private sector growth.

The formulation of an appropriate set of economic policies is being accompanied by renewed emphasis on strong economic management and administration. Mr. Al-Jasser's imminent return to a top economic management position in Saudi Arabia is a clear illustration of this and augurs well for the future. We will sorely miss his contribution to the Board's deliberations. Nonetheless, our loss is Saudi Arabia's gain. We wish Mr. Al-Jasser and his country all the best.

Mr. Coumbis made the following statement:

I join previous speakers in congratulating the authorities for their 1994/95 adjustment efforts, which have succeeded in halving the budget deficit and the current account deficits, and narrowing the interest rate differentials vis-à-vis international market rates.

The basic problem facing the economy is the volatility of oil prices and oil revenues. The only way to deal with it is to create the conditions for sustained growth of the economy's non-oil sector, and thus create at the same time employment opportunities for the growing Saudi Arabian population. It is not an easy course, as evidenced from sectoral developments in recent years, with virtually no growth in the last two years, and approximately 1 percent in 1992/93 for the sector. Apart from the structural weakness of the economy, the basic obstacles seem to be the budget deficit, the structure of budget revenues and expenditures, and the high level and the upward trend of the debt-to-GDP ratio. The authorities are determined to face these problems through the Sixth Development Plan, 1995-2000, through which it is projected that the budget will be balanced by the year 2000, debt dynamics will be reversed by 1997, and the budget structure will be improved substantially, on both the revenue and expenditure sides.

There is no doubt that the authorities have made substantial efforts in the area of fiscal adjustment in recent years. This is particularly evidenced in the 1995 budget, owing mainly to measures that increased non-oil revenues, by increasing, inter alia, the prices of petroleum products, water, and electricity. These types of measures, applied for the first time in Saudi Arabia, are an important step in the direction of improving the budget structure by decreasing to a certain extent the vulnerability of the budget to oil developments, taking into account the fact that oil revenues constituted about 75 percent of total budgetary revenue during the period 1989-1994. From the staff's medium-term projection, we can see that the measures taken by the authorities to date, although in the right direction, are not enough to achieve a decisive budget breakthrough from a point of view of balancing the budget up to the year 2000 and reversing expeditiously the debt. It is clear from the staff's exercise that without new policy measures, both the budget deficit and the debt-to-GDP ratio will increase by the year 2000, thus crowding out the private sector and worsening pressures on the external current account and on the exchange rate. I agree, therefore, with the staff's proposals for new measures, both on the revenue and expenditure sides, that would reduce budget vulnerability to oil price developments, and improve the structure of budgetary expenditures toward infrastructure and education. These measures are necessary, but not sufficient conditions.

The staff points out that the initial effects of the proposed strict budgetary restructuring may be a decline in growth rates. Therefore, in order to attain the Sixth Plan's average rate of growth of close to 4 percent, the authorities should create the conditions necessary for a substantial increase in private investment. The authorities should therefore proceed with determination and without delay in the implementation of substantial structural reforms in the economy's real and financial sector.

I fully agree with the Sixth Plan's structural reform targets for the period 1995-2000 and the proposed strategy to achieve those targets. The balanced growth of four sectors of the economy, the completion of ongoing infrastructure projects, the efficient use of utilities, the elimination of subsidies, and the development of high quality human resources are necessary measures that will set the private sector in motion and encourage private investment.

The Plan's strategy also includes the upward adjustment in utility charges and of charges for publicly supplied goods and services, as well as the privatization of commercial activity. The staff recommends, moreover, the liberalization of foreign portfolio investment rules, and reforms aimed at deepening and widening the financial and securities markets.

The success of the Plan's structural reforms depends crucially upon the authorities' political will and the consensus of the social partners in order to carry through with the required measures.

The staff has indicated that the Plan's targeted average GDP growth rate for the non-oil sector of close to 4 percent per year is substantially higher than that realized under the Fifth Plan. This indicates that the efforts of the authorities and social partners should be significantly greater than under the Fifth Plan.

Saudi Arabia is a rich country. Therefore, it can afford to provide satisfactory assistance to vulnerable groups through targeting income subsidies and social security payments directly to them, thus easing the pain of the adjustment process. I encourage the authorities to apply with vigor and determination the Sixth Plan.

I join the staff and other Directors in requesting that the authorities address the limitations in their statistical systems as soon as possible, and in collaboration with the Fund, and that they provide data on a few current economic indicators on a more frequent basis. At the same time, I would like to welcome the progress that has been made in 1995 in improving the currentness and data coverage for many of the statistics. I would also like to join the staff and other speakers in congratulating the authorities again for their foreign economic assistance programs, which have been implemented despite the difficulties they face.
Mr. O'Connor made the following statement:

I agree generally with the staff's assessment and, therefore, have only a few comments to make. I commend the authorities for their efforts to reinvigorate their economy in the wake of the regional unrest and the downturn in oil revenues. I applaud, as well, their intention to intensify these efforts this year and urge them to follow up on these intentions with some vigor. I am concerned, however, that their reluctance to adopt some of the staff's policy suggestions with regard to fiscal reform and financial sector reforms is an ominous signal. The authorities could be underestimating the economic risks of encouraging greater private sector development, as they propose, without assuring that required macroeconomic stabilization policies and strong foundations of financial markets are firmly in place.

The staff's baseline projections are not comforting given the projected weakness in oil prices over the medium term. The authorities have responded on the fiscal side with increases in utility prices, domestic prices for petroleum products and licensing fees. However, more effort is required to raise public sector saving such as stronger expenditure control, particular in terms of current wage expenditures and, and improved revenue yield through tax reform. While the authorities indicate that some such initiatives are under consideration, they have indicated that adoption of a consumption tax, which the staff recommends, is not one of them. We would urge the authorities to reconsider this position. A consumption tax would reduce the reliance on trade taxes, improve revenue yields and promote the private saving necessary to fund private sector development.

The authorities, faced with a rising fiscal deficit, have drawn an increasing portion of the financing from private sector sources. As a result, the banking sector has reduced its net foreign asset position to fund the increasing loan demand. In its favor, the banking industry has maintained domestic liquidity ratios at a constant level and has increased the capital-asset ratio substantially in recent years. However, the authorities have apparently taken few significant steps to improve regulatory and supervisory procedures. This issue is even more cogent in light of the authorities intention to encourage the development of retail banking operations.

A stronger prudential regulatory effort is required in retail banking where depositors are generally less sophisticated than are institutional investors and where information for credit quality assessment and credit monitoring is often inadequate. The authorities concern with the derivatives activities of banks is legitimate, but experience indicates that problems generally arise from more traditional banking operations. I agree strongly, therefore, with the staff that improvements in accounting standards and in financial sector disclosure are fundamental to a robust financial system and urge the authorities to direct greater effort to achieve these goals.

I also note that the authorities are hesitant to open the financial sector to foreign investment and competition and to relax capital controls in order to integrate domestic markets more fully into the global financial system. Apparently, however, the authorities wish to increase the degree of securitization in markets through the development of more active secondary markets for securities. I would suggest that this objective can be most efficiently achieved through more liberalized financial controls combined with stronger prudential regulation and data disclosure. I am, therefore, puzzled by the authorities reluctance in this regard.

Following up on the disclosure requirements for market efficiency, I would like to comment on the data issues raised in the staff report. The report notes a number of improvements in the provision and quality of economic and financial data over the past few years, but suggests that there is still some way to go before reaching the basic standards expected from a member of Saudi Arabia's status. The greatest deficiency seems to be on basic national accounts data, both in timeliness and coverage. The staff has suggested that data available may be sufficient for the annual Article IV consultation but not to keep abreast of current economic and financial developments in a timely fashion. However, I would suggest that in the absence of stronger information standards, the staff's Article IV economic and policy assessments have less credibility and more pronounced risk than would otherwise be the case. I would urge the authorities, therefore, to redouble their efforts with regard to data provision and data standards.

My comments are not meant to minimize the substantial efforts that the authorities have already undertaken to resolve many of the problems facing their economy. I applaud these efforts and their obvious success and hope that these comments will only help to direct and support these efforts.

Mr. Ismael made the following statement:

The macroeconomic imbalances in recent years have contributed to Saudi Arabia's serious public debt burden. If not corrected, it could hamper its economic development process. The major source of the macroeconomic imbalances has been a continued practice of a sizable budget deficit, largely financed by accumulating public debt. This has, undoubtedly, induced a high level of consumption, deteriorated the current account and eroded the country's accumulated wealth. This practice has not only undermined confidence in the soundness of the macroeconomic policies pursued, but also proved to be unsustainable over the medium-term. I believe any delay in reversing this unfavorable trend would be even more socially costly and painful.

The intensified effort with regard to fiscal consolidation this year is a welcome development. While I agree with Mr. Al-Jasser that sizable gains in reducing the budget deficit have been achieved since last year, I am not very optimistic that the adjustment measures implemented this year are adequate to achieve an ambitious deficit target of 2 percent of GDP, down from 10 percent in 1994. According to the staff's base line scenario, while capital expenditure would stabilize at 5 percent of GDP, current expenditure is expected to reduce only by 1 percent of GDP and its level will remain high at 32 percent of GDP, well above the budget level of 27 percent of GDP. Even under the adjustment scenario, the impact of the recent adjustment in current expenditure would be only 2 percent of GDP. If no further cut in the wage bill is to be taken this year, the actual budget deficit is likely to register at 4 percent of GDP. These exercises attest that the authorities are quite optimistic in setting the targets but less ambitious in implementing sufficient adjustment measures.

Looking forward, the sixth five year development plan (1995-2000) has been set to balance the budget and reduce the public debt level by the year 2000, but measures to achieve these intermediate targets are yet to be specified. I note that the ultimate objectives of this development plan would be emphasized on diversifying the economy and reducing dependence on oil. As presented in Table 4, page 15 of the RED, the plan aims to double the annual growth of non-oil sector from an average 1.9 percent of the outcome of the previous fifth five year plan (1990-1995) to 3.9 percent, in which growth of the private sector will be tripled while that of the government sector will stabilize. Again, this plan is rather ambitious. In retrospect, these broad objectives, basically retrieve the previous development plan's objectives with some subsectoral modification within the non-oil sector. The outcome of the fifth five year plan has apparently failed to achieve the envisaged growth target of the non-oil sector, although overall GDP growth exceeded its targeted rate as a result of a much faster growth of the oil sector. Moreover, a plan to downsize the large public sector has yet to materialize. While growth of the government sector, instead of slowing down, accelerated even further, growth of the private sector fell short of the target rate. These developments cast some doubt on the authorities' ability to achieve the medium-term objectives under the sixth five year plan. Indeed, this plan calls for renewed authorities' steadfast commitment in undertaking much stronger adjustment measures, especially in restructuring the budget.

The medium-term adjustment scenario proposed in the staff paper, could serve as a useful guideline for the authorities' strategy over the medium-term. I concur with the thrust of this scenario, that is to contain the growth of consumption and foster domestic savings which would, in turn, contribute to a greater self-financed investment in the non-oil sector. The strategy is to cut current expenditure but maintain an adequate spending on public investment to secure the provision of adequate infrastructure and the development of human resources required to promote private sector growth, while, at the same time, continuing efforts to raise non-oil revenue. In cutting expenditure, the authorities are challenged to take a more decisive step, inter alia, to cut the wage bill which constituted a half portion of total expenditure. An early cut in the wage bill will accelerate the pace of fiscal consolidation. In this context, I do not see a strong ground for directly relating a cut in the wage bill and employment opportunities in the private sector. I believe, people tend to hesitate moving to the private sector as long as the employment opportunity, with a competitive salary, in the public sector remains intact. On the revenue side, an introduction of new taxes, along with the existing customs duties, would be an effective way to contain private consumption and, at the same time, increase non-oil revenue.

Finally, a "nasty" question on Saudi Arabia's oil policy. Saudi Arabia's oil policy since 1993 has been for a continuation of the present OPEC overall quota level, with no adjustment allowed for individual country quotas. While OPEC has helped support the price of oil by keeping a lid on its own production, this opened the opportunity for other oil producers to increase their market share at OPEC expense. In light of Saudi Arabia's fiscal problem and the oil market situation, is Saudi Arabia contemplating to change its oil policy?

Mr. Evans made the following statement:

I welcome the staff report and the remarks made by Mr. Al-Jasser. I welcome in particular the explicit commitments to more privatization, to some reductions in civil service employment, and the application to join the World Trade Organization. It ought to be recognized, as most Directors have, that much progress has been made in addressing the internal and external imbalances over the last few years. Clearly, the higher oil prices last year have helped, but much of the improvement is due to measures taken by the authorities. That is reflected as well in the somewhat less critical tone of the staff appraisal this year.

Nevertheless, some areas of the economy remain fragile. Total expenditure last year exceeded the amount budgeted, and it looks as though a similar overrun will occur this year. There may still be a problem with government payments arrears. As other speakers have said, the budget is still overdependent on oil revenues. The staff projections of the fiscal deficit reaching 10 percent of GDP by the year 2000, and government debt rising to 110 percent, would be worrying even in a European context.

Turning to fiscal policy, I welcome the medium-term objective of balancing the budget by 2000, but clearly, some major additional measures will be needed to make that objective a reality. I agree with the staff that a front-loaded and ambitious halving--again--of the deficit would be advisable. It may be that oil prices improve, reducing the pressure for further budgetary action, but the authorities' intention to pursue expenditure reduction, irrespective of oil price developments, is welcome and important.

I agree with the staff that there is fertile ground for expenditure reduction in the areas of the wage bill and subsidies. Indeed, one of the encouraging developments in 1994 was the reduction in grain subsidies. Perhaps the staff could comment on whether that is likely to be a permanent feature, or something simply reflecting a higher world grain price.

On the revenue side, I welcome the introduction of measures to raise non-oil revenues, but there is clearly scope for broadening the revenue base further in order to reduce dependence on oil. I also have much sympathy for the staff's suggestions regarding a consumption tax and the excise duty.

Government payments arrears have been a subject of some considerable concern. I very much welcome the issuing of Srls 3.5 billion in special bonds toward the settlement of budget arrears. My understanding was that the total amount of arrears outstanding was higher than that. I wonder whether it is only undisputed arrears that have been cleared, and whether there is a problem of disputed arrears that still needs to be sorted out. I would be grateful if the staff could comment on that. I note and welcome the clearing of Saudi Arabia's external debt earlier this year.

I agree with the staff's analysis of monetary policy. The authorities' pursuit of a tight monetary policy, keeping broad money growth tightly constrained while allowing strong credit growth, financed by the drawing down of banks' foreign assets, has been successful.

The Sixth Five-Year Plan points to the need for lower government spending, and the need to diversify the economy and tackle infrastructure and human capital constraints on growth, perhaps especially in the area of education. In that regard, the literacy rate and enrollment rate in schools are well below those in other countries with comparable living standards.

Mr. Ismael referred with some concern to the lack of growth in the non-oil private sector in recent years. If one looks at the non-oil sector over the past four years, there has been virtually no growth, which I find hard to understand. Perhaps the staff could enlighten us on that. I would also ask what is the basis for the staff projection of growth in the medium term of 2-3 percent a year.

The improvement in the timeliness of publication of some data is indeed welcome. I would encourage the authorities to pursue technical assistance in the area of statistics, and to reimburse the costs to the Fund for technical assistance provided to them by the Fund. The staff report refers to weak statistical systems, which is worrying. I urge the authorities to make further progress, not just in the provision of data to the Fund, but also in making data public. There is still too much mystery surrounding the budget and off-budget items, for example. I would encourage the authorities to put more information into the public domain, which would be in the interests of better Fund surveillance and of the markets, but above all, in the best interests of Saudi Arabia. While I welcome the continued progress, that progress needs to be sustained over the medium term.

Mr. Fernández made the following statement:

The Saudi authorities are well aware of the policy course required to correct what are essentially short- to medium-term disequilibria and to avoid the influence of those disequilibria on the economy. The basic macroeconomic policy issues facing the authorities are the reduction of the fiscal deficit and the maintenance of the stock of domestic debt within manageable levels. Beyond these macroeconomic issues, the main challenges are related to the diversification of the economy and the strengthening of the role of the private sector, with a view to diminishing the economy's dependency on, and vulnerability to, the oil sector. The Sixth Development Plan for 1995-2000 seems to address these issues adequately, although somewhat cautiously. Since the current budget shows that the current account disequilibria is manageable in the short run, I can understand the authorities' perception that there is enough time and economic space available to act without undue pressure, and that the target for fiscal balance by the year 2000 is adequate, especially given the anticipated favorable evolution of prices in international oil markets and the progress already achieved on the fiscal front.

The authorities should be commended for the progress achieved in reducing the macroeconomic imbalances through expenditure reduction and increases in the prices of public goods and services. However, imbalances have remained large, resulting in an increase in domestic public debt and a decline in net official foreign assets, suggesting a need for deeper adjustment to avoid additional adverse effects on the economy. I therefore find appropriate the staff's recommendations to frontload the necessary adjustment by building on the important fiscal measures introduced in 1995. Early actions would contribute to reducing the risk that the structural rigidities of the budget may become further entrenched, thus lightening the burden of domestic debt service, freeing up resources more quickly, and allowing the economy to generate employment more efficiently. This is an important issue in light of the economic weight of the capital-intensive oil industry, and given the well-demonstrated fickleness of international oil markets.

Regarding the high degree of oil dependence, progress toward a more diversified economy is essential to reduce the vulnerability of the balance of payments. In this context, I note that although non-oil exports are on an uptrend, the Sixth Five-Year Plan targets only a marginally more rapid growth trend for the non-oil sector--3.9 percent--than for the oil sector--3.8 percent. In addition, although world oil demand is projected to increase in the medium term, in light of potentially significant oil supply developments in various other countries of the world, there are also important downside risks in respect of the oil sector. As has been well demonstrated in the past, relatively minor variations in oil supply can induce sharp fluctuations in oil prices, thereby weakening the external position of the economies of oil-producing countries. I therefore share Mr. Al-Jasser's call for cooperation between oil producing and consuming countries, and his comments on the impact of excessively high taxes on refined products in consuming countries, which have been an important source of friction between oil producers and consumers in the past.

Significantly, the Sixth Five-Year plan targets a more rapid growth trend for the private non-oil sector of the economy than for any other sector. In order to ensure the achievement of this objective, rapid progress in reducing the fiscal imbalance will encourage private investment. The growth of domestic debt needs to be arrested rapidly, preferably through a stronger up-front adjustment effort, so as not to crowd out private investment, and so as to reduce more quickly existing rigidities in the execution of the fiscal budget.

On a related issue, I note that efforts are under way to intensify the privatization process, which could contribute to rapidly strengthening the role of the private sector. Related policies, as suggested by the staff, should include the elimination of distortions and indirect subsidies present in the economy, particularly those created through the functioning of public enterprises, and their substitution with direct income subsidies and social security payments to the more vulnerable groups. In any case, we encourage the authorities to establish and to follow a privatization timetable, which would also contribute to a more rapid normalization of government balances. I encourage the authorities to consider following a more rapid pace of economic adjustment to improve the efficiency of the economy.

The Director of the Middle Eastern Department stated that a number of Executive Directors had been particularly concerned about the slow growth in the non-oil sector. In recent years, the slow pace of growth in the non-oil sector had largely been a reflection of the policy of public expenditure retrenchment, even though the private sector was becoming less dependent on public expenditure. If there were to be no further adjustment, the pace of growth--about 1 percent a year--would continue to be slow over the coming four or five years. In that case, there would need to be a number of mutually reinforcing supporting policies based on a reorientation of expenditure and some budget consolidation, including a relative reduction in nonproductive expenditures and greater focus on some well-targeted public projects, such as electricity production. A strategy to encourage the private sector would also be needed, including a clear announcement of what units were to be privatized and an opening up of the financial market and the stock exchange, which would encourage non-debt-creating inflows. In that connection, it needed to be borne in mind that the correction of a number of price distortions would initially be inimical to the private sector, but would encourage an efficient growth of the sector over the medium term. Following the period of slow growth, growth at a pace of about 3 percent to 4 percent a year could be anticipated.

The pegging of the riyal to the U.S. dollar had caused it to depreciate in real effective terms, the Director acknowledged. In the view of the authorities, the key question was whether that had led to higher inflation. It appeared that exporters to Saudi Arabia had squeezed their profit margins considerably in order to maintain their market share. At the same time, the authorities had been shifting their procurement of commodities from countries whose currencies had appreciated substantially. For example, the share of Japanese exports in the total imports in Saudi Arabia had fallen from 14 percent to 12 percent in 1994.

The Saudi authorities placed great emphasis on pegging the riyal to a major currency, the Director related. Because most of the country's exports were denominated in dollars, the authorities had decided that the dollar should be the pegging currency. On the question whether it might have been better to use a different peg--perhaps the SDR--the authorities had argued that the dollar peg had served them well over time. The real depreciation that had occurred over time was one reason for the substantial increase--of about 18-20 percent in 1995--in non-oil exports, in the authorities' view.

The reduction in the wheat subsidy would be permanent, and it was not due to the recent substantial increase in world wheat prices, the Director confirmed. The reduction had been announced through a declaration of the Minister of Agriculture, which had stated as well that Saudi Arabia would stop exporting wheat.

Regarding domestic arrears, Srls 3.5 billion in arrears of the Central Government had been settled through the issuance of bonds to banks. The staff at present was not aware of any other arrears of the Central Government, the Director stated. However, public enterprises or private contractors in Saudi Arabia might have arrears, but the staff was not aware of them.

Mr. Schoenberg made the following statement:

There are few countries that can rival Saudi Arabia in the endowment of natural resources, and in the strong and steady flow of revenue arising from these treasures. While we share the concerns of the staff and other Directors about the possibility of future macroeconomic imbalances, we are nevertheless confident that the authorities do not have to exert themselves or the general public too much to return the country to a stable and sustainable growth path. Indeed, the message from the first round of speakers was clear--the necessity of bringing financial commitments in line with resources available over the medium term, and of continuing structural reforms with the objective of further diversification of the economy, by giving more room and channeling more resources to the non-oil sector. To the extent that these efforts prove successful over time, with the rising share of foreign trade being denominated in non-U.S. dollar currencies, Mr. Mesaki's suggestion to reassess the benefits of the dollar peg of the riyal may become quite relevant.

I take note of the favorable circumstances of the Saudi Arabian economy and the common thrust of Directors' comments. Regarding the still existing data deficiencies, while I welcome the authorities' recognition that the coverage of certain data remains weak, I find it difficult to accept the idea that the openness of the economy is a major explanation for these deficiencies. Many other open economies are able to supply the Fund with needed data to conduct the surveillance that is at the heart of this institution's functioning. With reference to our recent discussions on enhanced surveillance, I also truly hope that the remaining data deficiencies will be dealt with expeditiously. I am sure that, if needed, the Fund would be happy to extend technical assistance for this purpose. Perhaps the Fund would be even happier if it were reimbursed for its technical assistance efforts, as suggested by Mr. Evans.

Mr. Wijnholds made the following statement:

I am in broad agreement with the staff's appraisal and recommendations. I will therefore highlight only a few points. Like the staff and other Directors I would like to commend the authorities for the significant strengthening of their efforts to improve the fiscal and external imbalances.

On fiscal policy, I concur with the staff's view that fiscal adjustment remains indisputably the most important challenge facing the authorities. The intensified fiscal efforts in 1995 and the Government's adjustment strategy for the period 1996-2000 are promising and reaffirm the goal of eliminating the budget deficit by the year 2000. On expenditures, I share the staff's and the authorities' view that the maintenance of high-level capital expenditures, during the period when the infrastructure and utilities need to build up, is warranted, but it should be offset by a lowering of the wage bill and of subsidies to the public enterprises, and an acceleration of privatization. The fulfillment of this task will, ultimately, facilitate the attainment of the authorities' growth strategy reflected in the Sixth Development Plan (1995-2000). As regards the medium-term fiscal development, it is clear that on the basis of unchanged policies the already high domestic public debt to GDP ratio would continue to rise, thereby reducing the availability of resources for private sector investment. It is, therefore, of great importance that the authorities continue their policies for correction of fiscal imbalances and that they restore fiscal credibility through strict adherence to the goal of medium-term budgetary balance. I was pleased to learn from Mr. Al Jasser's informative statement that the authorities are cognizant of the need to move in this direction.

The authorities also recognize the need for further structural reforms as well as expansion and diversification of the private sector. Given the expected initial dampening effect of the intensified fiscal retrenchment on growth, it is essential for the Government to establish the preconditions for diversification of the narrow productive base and for enhancing the role of the private sector. This should foster rapid growth and assure economic viability in the medium term in the face of a rapidly growing population.

Finally, on the issue of data, the staff mentions a notable improvement in the currentness and coverage of data. I very much welcome this development and would encourage the authorities to improve their performance further, particularly in the area of data provision on the external sector which would clearly benefit the process of macroeconomic analysis and Fund surveillance.

Mr. A. R. Ismael made the following statement:

We commend the Saudi authorities for the important progress made in reducing macroeconomic imbalances, over the past decade. Mr. Shaalan, in his statement has given us an indication of the magnitude of the shocks faced by the Saudi economy as well as the courageous efforts made by the authorities to address them. However, imbalances, although at a declining tread, remain an additional measures are required, especially in view of the increasing trend in the debt-to-GDP ratio. In the circumstance, a broad based program of adjustment would seem to be appropriate, and we welcome the authorities' plan to achieve fiscal balance by the year 2000. However, we note the staff's analysis which indicate that this objective can only be achieve with a deepening of the adjustment efforts. We would encourage the authorities to give more attention to the staff's recommendation as continued imbalances can increase the structural rigidities in the economy, reduce the availability of resources for the private sector, and would make the objectives of the Sixth Development Plan more difficult to achieve.

More specially, and in view of the continued uncertainty in the oil market, the authorities should accelerate their efforts to diversify the revenue base, and to increase revenue. More attention will also need to be given to the tightening of expenditure. On these issues, Mr. Al Jasser's informative statement is very encouraging, as he states that his "authorities are cognizant of the need for further fiscal consolidation over the medium term".

Developments in the non-oil sector are on the whole encouraging, as it is becoming more diversified, and the value of its export is increasing. The planned privatization of some major non-oil companies such as the national airline, the electricity and telecommunications companies are welcome and should improve the efficiency of the Saudi economy.

Finally, let me conclude by commending the Saudi authorities for their excellent record as regards external assistance despite considerable financial pressures, and wish them continued success in their reform efforts. I would also like to join others in wishing Mr. Al Jasser success in his future career.

Mr. Wei made the following statement:

The Saudi authorities are to be commended for their remarkable progress in restoring macroeconomic balances and structural adjustments in recent years. In 1994 the economic performance was very impressive. With the budget and current account deficits declining, the economy is better equipped for steady growth in the near future. I am in general agreement with the staff on the main thrust of its report and therefore would like only to make a few comments on the fiscal and monetary policies for emphasis.

Regarding fiscal policy, the authorities' focus on the increase of non-oil revenue and containment of expenditures is highly warranted in view of the necessity of improving the fiscal account and the uncertainty of oil prices on the world market. On the revenue side, the authorities' decision to mobilize fiscal resources from fees and charges on public goods and services is conducive to further structural adjustment. The staff-recommended alternative tax levies could also be considered in the context of a rational tax system that may gradually take shape in the future. On the expenditure side, I concur with the staff in stressing the importance of curtailing the increase in wages for government institutions in the near future. The structural shift from administrative to infrastructure and educational expenses will certainly support the overall transformation.

Concerning monetary policy, a firm policy stance is not only consistent with the necessity of stabilizing the exchange rate but also necessary for an improvement in the structure of the banking sector. We are pleased to note from Mr. Al-Jasser's very helpful buff statement that "Monetary policy continues to be supportive of the tightened fiscal stance so as to keep inflation subdued, ensure exchange rate stability, and maintain confidence in the domestic financial system." In this connection, a further expansion of assets in the national currency with the banking sector will lead to a continued decline in foreign currency assets of commercial banks. Close monitoring of these developments and tightening of the lending policy by the monetary authorities would be conducive to an improvement in financial consolidation.

I would also like to acknowledge our appreciation to the Saudi Arabian authorities for maintaining a sizable economic assistance program to developing countries despite its own difficult financial constraints.

I would like to take this opportunity to wish Mr. Al-Jasser and the authorities of Saudi Arabia every success in their future endeavors.

Mr. Justiniano made the following statement:

Saudi Arabia's authorities should be commended for the adjustment efforts they have made since the end of the 1990-91 regional crisis. The Government's efforts on fiscal adjustment to reduce the budget and external current account deficits and to preserve a non-inflationary environment with exchange rate stability are welcome.

As I am in broad agreement with previous speakers and with the staff appraisal, I will confine my intervention to a few specific points.

Despite the progress made in 1994, both the fiscal and external current account deficits remain large and resulted in an increase of domestic public debt. As Saudi Arabia's revenue base is heavily dependent on oil, revenue declines when oil prices fall. The adjustment effort was intensified in 1995 through a budget which called for significant steps to raise non-oil revenues (by substantially increases in the domestic price of petroleum product, water, electricity, postal and telephone charges) and restrain expenditures. The goal of this budget was to reduce the government deficit to about 2 percent of GDP.

However, the staff still projects a deficit of 5 percent of GDP. Could the staff elaborate on this issue?

On the revenue side, I agree with the recommendation to introduce the consumption and turnover taxes. However, since these new taxes are not likely to be adopted, I wonder whether there may not be more room to increase the rates of other existing taxes to improve revenue performance. Moreover, I wonder whether tax administration could be strengthened in order to ensure compliance and collection. Staff comments on these matters would be appreciated.

Second, on the expenditure side, reductions are to be realized notably through a cut of 30 percent in the wage bill and a 24 percent reduction in supplies and services. However, I am concerned because the subsidy payments for 1995 are projected to be at the same level as those of the 1994 budget while capital expenditures will decline at a time when they are needed for investment projects to support private sector growth. Could the staff comment on this issue. Furthermore, as wage bill represents more than 50 percent of current expenditure --according to staff baseline projections--, I wonder whether there is not some scope for reducing government employment, or at least freezing new hiring in the public sector. To this end, it might be advisable to reduce the size of the public sector work force and to keep the wage bill under control in 1996.

Third, on the medium-term scenario, the Saudi Arabian authorities should move quickly to restore budget balance, and perhaps even achieve a modest surplus before the year 2000. In this regard, I share the staff's view that fiscal policies should be oriented toward the elimination of macroeconomic imbalances and improve the structure of the budget. These policies should include price adjustments, additional expenditure cuts and raising taxes, as recommended by the staff.

Fourth, implementation of the Sixth Development Plan should allow greater reorientation of the economy toward the private sector. In this context, the authorities' decision to develop a privatization program which covers, among other things, the utilities companies and the national airline is welcome. There is no doubt that this program will bring in substantial revenues and improve the government's fiscal position. In this regard, one alternative for improving the fiscal situation would be allocation of proceeds from the sale of these government assets toward reduction of the public debt. This would benefit both the budget and the balance of payments.

Finally, this chair welcomes the decision of the Saudi Arabian authorities to maintain their official external economic assistance, especially in light of their efforts at fiscal consolidation.

Let me conclude, Mr. Chairman, with a personal note on behalf of myself and all the members of this chair. I would like to express to Mr. Al-Jasser our best wishes and every success in his new position.

After adjourning at 1:00 p.m., the meeting reconvened at 2:30 p.m.

Mr. Bergo made the following statement:

The Saudi Arabian authorities have made further progress during 1995 in reducing the country's macroeconomic imbalances, but at the same time those imbalances remain most worrisome as witnessed by the clearly unsustainable medium-term baseline projection. Increased efforts are thus called for, and I note that the authorities agree with this. The strengthened emphasis on this in Mr. Al-Jasser's statement is most welcome. As I broadly agree with the staff appraisal, and other speakers have covered the issues in depth, I will only emphasize a few points.

With regard to budget expenditure, I find that our previous advice on the need to restructure expenditure toward education and infrastructure, within the context of overall deficit reductions, remain valid.

I am surprised and worried by the continued rise in the wage bill, both in nominal terms and as a percentage of current expenditure. The large discrepancies between the budget figures and the actual and estimated outcomes furthermore seems to indicate a lack of firm control over developments in this area. This should have the authorities full attention in the time ahead, which I am sure Mr. Al-Jasser's return to Saudi economic policy-making will contribute significantly to, and I wish him all the best in his new position.

On the revenue side, I agree with the staff and others that the authorities' strategy to mobilize revenues should be supplemented by the introduction of more broad-based taxes.

Finally, I welcome the improvement in the currentness and quality of data, but note that important weaknesses remain. I would urge the authorities to follow up decisively and speedily the staff's recommendation in this area.

Mr. Geethakrishnan made the following statement:

The Saudi Arabian authorities should be complimented for their continued efforts at encouraging diversification and a market based economic system. There are many impressive gains made by the Saudi economy in the past one year such as the containment of the budget deficit, rationalization of expenditures, cutting down subsidies, and success in keeping the increase in liquidity as low as 3 percent etc.

While these achievements and the ones planned in the future deserve full appreciation I am, Mr. Chairman, worried about the mounting domestic debt. The projections point to a more than doubling, to a little below 600 billion Saudi Arabian riyals in the seven year period 1993 to 2000. As a proportion to GDP, the domestic debt is projected to increase to 110 percent in the year 2000. This is highly worrisome. The authorities have no doubt charted out a plan to reduce the budget deficits and eventually balance the budget by the year 2000. The staff have raised doubts whether the measures as proposed would lead to the desired result given the downward risk of wage inflexibility as assumed and the uncertain medium term oil price scenario. Mr. Chairman, my query to the staff therefore is whether it would not be necessary to go for a more ambitious plan for achieving a balanced budget, and if so what more is required to be done than what has been proposed by the Saudi authorities.

In the last one year the Saudi authorities have sought to prune the budget in line with the falling oil revenues so as to ensure that the budget deficit does not get too much out of control. This is a welcome development. However, if we look at the expenditure composition after the budget cuts, it appears that the axe has fallen on the capital expenditures and foreign aid. I would welcome the staff comments on the possible outcome of this approach. Would not these cuts have an adverse effect on the much needed infrastructure development and growth prospects? If so, would there not be pressure for restoring these expenditures thus affecting the fiscal consolidation efforts?. In other words, is the present expenditure consolidation strategy a sustainable strategy?

Before concluding I would like to wish the Saudi Arabian authorities well in their efforts. I would also like to take this opportunity to wish Mr. Al-Jasser a fruitful, and highly satisfying tenure in the more challenging assignment that he will be taking up shortly.

Mr. Desruelle made the following statement:

Let me first thank the staff for a clear and concise report. I broadly share the staff appraisal and, therefore, I can be relatively brief.

The Saudi authorities have repeatedly stated their determination to bring back public finance on a solid footing and they have now announced, as part of the sixth development plan, the goal of eliminating the deficit by 2000. The analysis presented by the staff in this report--in particular, the figures presented in Table 1 on the evolution of the budget deficit and public debt under unchanged policies--fully substantiates the need for these consolidation efforts.

The authorities must be commended for pursuing this strategy of macroeconomic consolidation. As regards developments in 1995, they must specifically be commended for the breakthrough that the large increase in the price of petroleum products, fees and charges.

How best to implement this strategy? The staff recommends a broad fiscal package comprising the introduction of taxes, further increases in the price of petroleum products, fees and charges and expenditure reductions, especially on the wage bill.

The authorities do not appear to be inclined to introduce taxes. And, if I understand Mr. Al-Jasser right, they also seem to wish to adopt a more gradual approach than advocated by the staff on the wage bill, with developments there linked to progress in enhancing labor demand in the private sector.

On the revenue side, the differences of views between the staff and the authorities raise the following question: can an increase in non-oil revenue of, say, 3 percent of GDP, as contemplated in the staff's adjustment scenario, be achieved purely through increases in prices of publicly-provided goods and services?

On the expenditure side, the authorities' presentation raises some concerns about the probability of attaining the medium-term fiscal target. This concern is increased by the fact that, assuming of course that no help would come from higher oil prices, expenditures have run significantly ahead of their budgeted level in 1994 and, apparently, also in 1995. Thus, it would appear that either a more forceful approach on containment of current expenditures, including the wage bill, is required or a larger share of the fiscal effort will have to be borne by revenue increases. This, of course, brings us back to the question above on the necessity of taxes.

I fully share the staff appraisal and comments of previous speakers on structural reforms.

The improvements in the provision of data to the mission are welcome. Given the remaining deficiencies, I look forward to welcoming further improvements next year, in line with the strengthening of the Fund's general policies on these matters and the staff's specific recommendations.

Finally, let me repeat that my authorities welcome the Saudi authorities' determination to strengthen their economic fundamentals and they wish them full success in this effort.

Mr. Mozhin made the following statement:

I was pleased to learn that in 1995 the fiscal consolidation effort in Saudi Arabia has been radically intensified. Although, according to the staff estimate, the fiscal deficit in 1995 is expected to amount to 5 percent of GDP rather than 2 percent of GDP as budgeted by the authorities, this would still represent a remarkable improvement compared to the fiscal deficit of almost 10 percent of GDP in 1994. The turnaround in the external current account deficit has also been very impressive: from 15 percent of GDP in 1993 to 8 percent of GDP in 1994 to 4 percent of GDP expected in 1995.

I welcome the fact that under the Sixth Development Plan the authorities are committed to further adjustment efforts with the aim of balancing the budget by the year 2000. This is expected to be achieved on the basis of higher revenues from the non-oil sector and lower expenditures. On the revenue side, the key element is the upward adjustment of prices for publicly supplied goods and services. On the expenditure side, the key element should have been the containment of the government wage bill, given the fact that in 1994-95 the budgeted wage bill amounted to about a half of budgeted current expenditures. It is indicated in the staff report that the Sixth Development Plan provides for lowering the wage bill, although the authorities realize that this may be a difficult task. However, under the staff's medium-term fiscal projections, the government wage bill is expected to remain constant at 19 percent of GDP until the year 2000, as wages were assumed to increase by 4 percent per year. In fact, the difference in wage expenditures accounts for the bulk of the difference between the two alternative scenarios of medium-term fiscal developments provided by the staff. I would be interested to learn the reasons for questioning the authorities' commitment to lowering the wage bill under the Sixth Development Plan.

The baseline scenario of medium-term fiscal developments would lead to a further increase in the debt-to-GDP ratio up to 110 percent by the year 2000. The naive question that I have is to what extent the authorities are really concerned about such an eventuality. It is indicated in the staff report that about three quarters of domestic debt is owed to the Autonomous Government

Institutions. Would it be correct to understand that about three quarters of domestic debt is owed by the Government to itself?

I welcome the efforts of the authorities to reduce the dependence of the Saudi economy on the oil market, given the potential volatility of oil prices. In fact, these efforts have already been duly rewarded by the 18 percent increase in non-oil exports in 1994. At the same time, as Mr. Al-Jasser pointed out a year ago at our previous Article IV discussion, the Saudi economy will remain an oil-based economy. With this in mind, I would like to commend the Saudi authorities for their highly responsible oil sector policy, which is an important factor of stability in the global oil market.

Finally, I would like to join other speakers in extending our best wishes to Mr. Al-Jasser. I hope that, despite the policy of containing the government wage bill and other administrative expenditures, Mr. Al-Jasser will be a frequent visitor to the Fund.

The Director of the Middle Eastern Department stated that, in order to bring about an improvement in budgetary revenues and to ensure that the proposed adjustment was sustainable in terms of growth, additional measures would be needed on both the revenue and expenditure sides of the budget. On the revenue side, there was much scope for further increases in utility prices and in the domestic prices of energy. The staff had also recommended a menu of broad-based, but easily implementable, taxes, because it was judged important to supplement the adjustments in various prices with introduction of a broad based and efficient tax system. Those taxes included consumption taxes and a turnover tax, which would not require, at least initially, a substantial administration and collection capacity.

On the expenditure side, a further reduction in subsidies would be a priority, the Director continued. The recent steps to remove the wheat subsidy were particularly encouraging in that regard, but there might be other possibilities as well. An efficient containment of the wage bill over the medium term should also be targeted, without which there could be no confidence that the necessary adjustment would take place. A permanent reduction in the size of the civil service, accompanied by private initiatives to take the place of the public sector services, would also need to be a key objective. An strong education and retraining effort would help provide the human capital with the necessary skills for an expanded private sector.

The question was whether the containment of the public sector was going to be offset by a pick-up in the private sector, which would be needed to sustain the adjustment, the Director acknowledged. Private sector development was indeed the key, and that was why the adjustment needed to be accompanied by the structural measure the staff had been discussing with the authorities.

The fact that about 70 percent of domestic debt was owned by the Autonomous Government Institutions (AGIs) was not tantamount to the Government owning its own debt, because the contributions to the AGIs were made by the private sector, the Director explained. It represented, de facto, the mobilization and reshuffling of the private sector contribution to the social security funds through government paper. What was important was greater diversification of government debt, and a number of measures could be envisaged that would permit a broader ownership--both foreign and domestic--of government debt.

The authorities recognized that the coverage of certain data series remained weak owing, inter alia, to the openness of the economy, but the openness of the economy was no excuse for collecting statistics in an antiquated manner, the Director concluded. In the balance of payments, for example, it was not certain that investment income of the substantial financial assets held abroad by Saudi residents was properly allocated in full in the current account. That was an important analytical issue on which more work was needed. The question was whether the current account of the balance of payments reflected correctly the true size of the current incomes, and indeed, whether the size of the current deficit would be as large as was being reported if a proper methodology was used. The size of the current account affected not only the structure of the balance of payments, but also the national accounts and the type of adjustment that might be required.

The staff representative from the Middle Eastern Department stated that, in order to achieve the desired increase in revenue if no non-oil tax revenue measures were implemented, rates and charges might have to be raised to prohibitive levels, based on the staff's estimates of what had happened in 1995. For example, in the 1995 budget, the increase in non-oil revenue of 3 percent of GDP, stemming primarily from increases in fees and charges and the price of petroleum products, had required an increase in various petroleum product prices of from 80 percent to 300 percent. That had generated about Srls 9 billion for the year. If a revenue increase of a similar magnitude were to be planned for 1996, it would imply an increase in the prices of gasoline and diesel products of another 150 percent. If the revenue effort were to be distributed between petroleum product prices and utilities charges, an increase of about 50 percent in petroleum product prices and a doubling of utility rates for electricity and water would be needed. Those increases would generate about Srls 13 billion in 1996. That might be a difficult feat, especially given the significant increase in prices that had occurred in 1995. For that reason, it would be advisable to distribute the revenue effort across non-tax as well as tax sources. That would also allow for a better budget structure.

Mr. Shaalan said that he wondered whether the full cost recovery of publicly-supplied goods and services from all areas would generate the 3 percent increase in revenues that the staff assumed in the scenario.

The staff representative from the Middle Eastern Department replied that there was no room for cost recovery with respect to petroleum products, as their domestic prices were comparable to prices prevailing on an ex-refinery basis in the region. In that sense, there was no cost recovery issue as far as petroleum products were concerned. The staff did not know precisely what the cost was of other utilities in Saudi Arabia. Therefore, it would be difficult to make a precise judgment as to how much increase in utility rates would be needed to recover the costs and, therefore, generate a certain amount of revenue.

Mr. Shaalan commented further that, if it were assumed for the sake of argument that Saudi Arabia could balance its budget by cost recovery measures, then the question was whether it would be preferable in an economic sense to have measures that would raise taxes and bring about the same result.

The Director of the Middle Eastern Department responded that there were a number of ways to raise revenues. The staff's view was that the economy and budgetary management would benefit greatly from having a permanent source of revenue in the form of taxation, rather than having to rely on specific price increases on a annual basis, especially as the latter system was becoming difficult to implement. A broad-based consumption tax--a turnover tax--would lead over time to the introduction of a corporate income tax, which would equalize the treatment of foreign and Saudi firms, and was consistent with the authorities' objective of encouraging the private sector, including foreign private investment. The authorities took the view, however, that given the fact that Saudi Arabia did not yet have the machinery to collect the taxes, it was probably more efficient to stress cost recovery measures.

The staff representative from the Middle Eastern Department added that even if a balanced budget could be achieved through the adjustment measures currently envisaged and an increase in utility rates, the susceptibility of the budget to fluctuations in oil prices would remain. To that extent, a well-balanced revenue base would contribute to stability, which was critical for the self-sustaining long-term growth of the economy.

Mr. Abbott said that he wondered whether opportunity cost, export value, or incremental cost of domestic production was being considered in the cost recovery equation. It might be assumed that the domestic cost of energy was quite low.

The staff representative from the Middle Eastern Department replied that, with respect to petroleum products, the cost recovery assessment was based on the opportunity cost, in that the price being charged was comparable to the ex-refinery prices prevailing in the European market, in particular in Italy. To that extent, the price covered the cost. For other energy-related prices and utilities prices, the cost recovery assessment was dependent on the price that the utility companies were being charged for the gas and petroleum products.

Mr. Al-Jasser stated that he wished to thank his colleagues for their interest, intellectual advice, and practical recommendations on the economic policies of Saudi Arabia, which he would convey to his authorities. He shared Directors' judgment that the main issue facing the economy was the fiscal consolidation effort. Over the preceding five or six years, the authorities had embarked on an ambitious fiscal consolidation effort, focused on expenditure reduction. In the current year, a drastic effort had been made on the revenue side. Such a dramatic change had important ramifications for the economy, especially for private sector activity. For example, diesel oil prices had tripled overnight. That increase in price was justified from an efficiency point of view and a revenue perspective, but it needed to be borne in mind that diesel oil was an important input in a large country which depended greatly on trucking transportation. The full impact on the economy would take some time to work its way through, but it appeared that it was being handled successfully.

The private sector was showing great resilience, and the stock market was rising, Mr. Al-Jasser observed. Although the GDP data for 1994 did not show private sector activity clearly, the fact that there had been growth in the number of licenses issued and industries established pointed to the robustness of that sector. The private sector had also begun an export drive successfully. Years ago, import substitution had been in vogue in many of the developing countries. At present, many such countries, including Saudi Arabia, realized that export promotion was equally important. Non-oil exports had increased by about 18 percent in 1994. In the first half of 1995, non-oil exports had increased by 29 percent. The improvements in the current account for the first half, which were largely attributed to better prices for oil and oil exports, had also been affected by the improvement in non-oil exports, which he hoped would continue.

Fiscal consolidation remained the centerpiece of the adjustment effort in Saudi Arabia, and the Sixth Development Plan would provide detailed guidelines in that respect, Mr. Al-Jasser stated. The guidelines on the budget specified a balanced budget by the year 2000, and a ministerial committee was looking into concrete measures that would need to be taken on both the expenditure and revenue sides to bring about that outcome.

The financial sector in Saudi Arabia was fully liberalized, the banking sector operated on a market basis, and financial inflows and outflows were completely unhindered, Mr. Al-Jasser pointed out. The development of the financial system would focus on the development of new products and instruments, rather than on the elimination of barriers--as there were no barriers.

The free flow of capital had been a tradition in the Saudi economy for many years, Mr. Al-Jasser considered. In that vein, the Government had found that there was great sensitivity in trying to collect information on private capital flows, especially on private placements outside the country or private earnings from investments abroad, because private owners of capital did not think that the Government had anything to do with it. There had been rumors during the Gulf crisis that some capital restrictions might be introduced, which the Government, the Ministry of Finance, and the Saudi Arabian Monetary Authority (SAMA) had gone out of their way to disprove. SAMA had a program to try to demonstrate that data collection regarding capital flows was really for purposes of economic policy making, and for the benefit of the private sector, but persuading people was not easy. In time, however, the message would get across. At the same time, it needed to be borne in mind that Saudi Arabia had neither a tax system nor a history of restrictions, and the business of data collection that went hand in hand with those was not well established, and not well understood.

It needed to be borne in mind that the Saudi Arabian economy had begun to develop strongly only in the 1970s, Mr. Al-Jasser concluded. In the twenty years since, much infrastructure had been built and many human resource institutions established. Therefore, in looking at the enrollment of students--at 78 percent--the starting point needed to be recalled. From that perspective, the country had made great leaps. At the current juncture, Saudi Arabia was at the stage of rationalizing and organizing what had been done in a rush over the preceding 25 years. While much had been learned from the process and from the experiences of others, the authorities had no illusions about the challenges they would have to confront. They would approach them with seriousness.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. They commended the authorities for the intensification of the adjustment effort in 1995 through the adoption of important non-oil revenue measures as well as the containment of expenditures. In addition to reducing the budget deficit, these steps have improved the structure of the budget, contributed to reducing the external current account deficit, and advanced the reforms needed for a broadening of private sector activity. Directors welcomed the authorities' objectives, as specified in the Sixth Development Plan (1995-2000), to eliminate the budget deficit by the year 2000 and to strengthen the conditions for private sector led growth and diversification. The recent substantial increase in non-oil exports, and the increase in private sector activity that it implied were also welcomed.

However, Directors emphasized that, in the absence of significant additional adjustment measures, substantial macroeconomic imbalances would persist in the medium term. Uncertainty regarding future oil price developments was also an additional element of risk for the medium term. A number of Directors doubted whether the authorities' objective of reducing the budget deficit to 2 percent of GDP in 1995 would be achieved on present policies.

Most Directors considered that the achievement of the fiscal objective for the year 2000 required the implementation of a frontloaded adjustment effort aimed at increasing the size of non-oil revenues, further reducing unproductive expenditures, containing the wage bill, while also increasing the share of expenditure devoted to capital outlays and human resource development. They encouraged the Saudi authorities to give careful consideration to the staff views to further strengthen the fiscal position. The staff baseline projections were not comforting, as public sector deficits and public debt accumulation risked continuing beyond the year 2000. Most Directors emphasized the critical importance of giving consideration to the adoption of a broad-based general sales tax, excises on selected goods, a turnover tax, further adjustments in the prices of publicly provided goods and services, including petroleum products, and a reduction in subsidies.

Directors noted that sustained fiscal adjustment and rationalization of utility rates would contribute to sustainable private sector growth over the medium term and increase employment opportunities for the rapidly growing population. Containment of the government wage bill was an essential element to strengthen the fiscal position as well as to facilitate the transfer of workers to the private sector. In order to address the possible short-term dampening effect of intensified budgetary adjustment on growth, Directors encouraged the authorities to speedily implement the structural reforms embodied in the Sixth Development Plan.

In that regard, Directors urged an acceleration of the privatization of state enterprises and measures to deepen and widen financial markets--within a strengthened prudential and regulatory framework. Some Directors also recommended the liberalization of rules governing foreign portfolio investment, and opening up the financial sector to international competition.

Directors agreed that the current exchange rate arrangement had served Saudi Arabia well, and emphasized the importance of prudent fiscal and monetary policies for ensuring the stability of the exchange rate and maintaining confidence in the domestic financial system.

Directors commended the authorities on the maintenance of an open trade and payments system, and for Saudi Arabia's constructive role in support of the stability of the global oil market. Some Directors regretted that Saudi Arabia's exports were subject to protectionist measures in some export markets. Directors also commended Saudi Arabia for maintaining a sizable foreign economic assistance program despite financial constraints. Saudi Arabia's decision to apply for membership in the WTO was also welcomed.

Directors welcomed the recent improvement in the currentness and coverage of data and their provision to the Fund. However, they emphasized that deficiencies remained, and supported the provision of Fund technical assistance to help improve the quality and coverage of data on external transactions. With a view to strengthening the continuity of surveillance, Directors stressed the importance of more frequent provision of up-to-date core economic indicators to the Fund. Some Directors, pointing to Saudi Arabia's importance in the global economy and in the international financial markets, also encouraged the authorities to make more information available to the public.

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

3. ISLAMIC REPUBLIC OF IRAN - 1995 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1995 Article IV consultation with the Islamic Republic of Iran (SM/95/233, 9/11/95; and Sup. 1, 9/28/95). They also had before them a background paper on recent economic developments in the Islamic Republic of Iran (SM/95/240, 9/19/95; and Cor. 1, 9/27/95).

Mr. Mirakhor made the following statement:

My Iranian authorities are in broad agreement with the staff's assessment of developments and policy challenges facing the economy and wish to express their appreciation for the hard work of the staff. During the previous Article IV consultation discussions with Iran (EBM/93/145, 10/20/93), the Board's focus of concern was the intensification of inflation and balance of payments pressures, including, in particular, the emergence of external payments arrears. To address these issues, my authorities undertook to: intensify efforts to normalize relations with creditors, continue market-oriented exchange rate policy, tighten financial policies, and proceed with structural reforms.

On normalizing relations with creditors, after long and intense negotiations, Iran reached bilateral agreements with its major creditors. Providing the ways and means of servicing the rescheduled debt and meeting all maturing obligations incurred after March 1994 became the overriding objective of the authorities. In the absence of any fresh flow of external financing, the only way to achieve this objective in the immediate time frame was through import compression.

The authorities were fully aware of the implications of this strategy for economic growth. However, they reasoned that throughout its modern economic history, Iran had an excellent record of debt repayment; this was true even during the war. And they sought to maintain this reputation. As the staff report and supplement make clear, by far the largest part of the arrears have been rescheduled; all new obligations maturing in 1994/95 have been serviced without delay; the country has a healthy level of reserves; and, based on the balance of payments outlook, prospects for servicing the rescheduled debt on time are excellent.

On exchange rate policy, exchange rate unification, at Rls 1,450 per US $1 in March 1993, was initially quite successful. However, fiscal and monetary expansion subsequent to unification, together with a sizable liquidity overhang, resulted in excess demand for foreign exchange. Combined with unfavorable external circumstances, the pressure led to a widening gap between the official and market rates. In early 1994, the free market rate had fallen to Rls 2,400, while the official rate was depreciated to Rls 1,750. Between early 1994 and May 1995, enhanced uncertainty and fragile expectations created conditions under which the exchange rate took on its own dynamics.

After a careful consideration of the costs of exchange rate volatility in terms of its impact on expectations the authorities announced, in May 1995, a fixed exchange rate system. The new rate was set at Rls 3,000 per US $1 within the banking system, the official rate was retained at Rls 1,750, and all foreign exchange transactions were required to be channeled through the banking system. The new fixed rate was set to preserve the competitiveness of exports, and the authorities publicly declared their commitment to the rate until March 1996, at which time the rate is to be reviewed. The policy change ended panic selling of the currency, restored order to the market, and slowed inflationary momentum.

While a fixed exchange rate requires financial discipline and limits the scope of independent monetary policy action, it cannot by itself guarantee fiscal discipline. In the case of Iran, however, fiscal expansion is circumscribed. An act of Parliament has barred the Government from financing its deficits through the Central Bank. Consequently, the likelihood of an inflationary fiscal policy is reduced. The Central Bank has begun targeting reserve money, which in combination with a joint daily monitoring of revenues and expenditures by the Central Bank and the Ministry of Finance has strengthened coordination between monetary and fiscal policies in an effort to support the parity, reduce inflation, and stabilize expectations. While the authorities are determined to maintain a fixed rate until inflation is brought firmly under control, the law enabling the Second Five-Year Plan has mandated unification of the rates during the Plan period. To achieve this the authorities will move commodities now covered by the official rate to the more depreciated rate.

On fiscal policy, over the period 1993/94-1994/95, the Government budget was in near balance. However, the sizable exchange rate devaluations had created obligations for the Government arising from the Central Bank's settlement of the inadequately funded Foreign Exchange Obligations Account. Thus, considerable quasi-fiscal losses were incurred, leading to an increase in the fiscal deficit from 1.2 percent of GDP in 1992/93 to 6.3 percent and 4.9 percent in subsequent two years, respectively. Without these expenditures, the budget would have been in balance. This account has now been closed and its operations have been integrated into the budget. The projected balanced budget in 1995/96 relies on expenditure reduction of about 4.4 percent of GDP. As the staff supplement shows, budget performance in the first four months of 1995/96 indicates that the budgetary objective can be achieved.

Since 1993/94, considerable efforts have been directed to improve budget transparency. Subsidies are now incorporated into the budget, as are quasi-fiscal losses owing to exchange rate changes and the operations of the Organization for the Protection of Consumers and Producers. On the revenue side, tax administration has improved substantially. Tax categories have been collapsed into fewer classes, and the computerization of the tax system has proceeded. Additionally, there are plans to convert all excise taxes to ad valorem taxes, in line with recommendations provided through Fund technical assistance. The customs valuation basis was shifted in 1994/95 from Rls 70 to Rls 1,750. Implementation of a value-added tax is on the agenda and is pending the completion of computerization and identification of firms that have to be subjected to the tax. During the period of the Second Five-Year Plan, the authorities will continue to vigorously pursue the objective of increasing the share of taxes in the GDP.

In the monetary policy area, the main objective is the strict control of domestic credit. The present monetary conditions are tighter than they have been in recent years. Money supply growth is targeted for a reduction to 20 percent, while domestic credit has been assigned a ceiling of 15 percent growth in the current year. Combined with day-to-day monitoring of budget performance, the tight monetary and credit stance is expected to exert considerable downward pressure on inflation. Methods to be used to ensure that the credit ceilings will be observed include moral suasion, heavy penalties on commercial bank overdrafts, the requirement that 100 percent of payments deposited by government agencies for letters of credit opened by commercial banks be transferred to the Central Bank's account, and sales of treasury bills to the commercial banks. If and when needed, changes in reserve requirements could also be used. Additionally, the authorities concur with the staff recommendation to impose direct credit controls, if necessary, to achieve compliance with credit ceilings.

The staff has expressed concerns regarding the present negative real rates of return. The authorities acknowledge the beneficial effects of positive real rates on, inter alia, the reversal of currency substitution and on portfolio composition, and have recently increased the rates. However, they would first like to see the impact on inflation of the present tight financial policies. Much of the inflationary pressure experienced until recently emanated from an interrelated set of factors, including excess liquidity and exchange rate changes. The present policy stance addresses these factors. Once the passthrough process is completed and the impact of tight financial policies have exerted their influence on the liquidity, the inflationary momentum should subside. Additionally, considering that, at the present, economic activity is not robust and GDP growth is relatively low, any further increases in the nominal rates would not be helpful. Finally, the health of the financial system is also an important consideration at a time when the banking system is recovering from the recent shocks.

On major issues of structural reform, by far the most important and immediate concern of the authorities has been the normalization of relationships with external creditors. Efforts are being concurrently directed at stabilization. The results of the first four months of 1995/96 are encouraging enough to suggest that the authorities may have the right mix of stabilization policies. The agenda of structural reform remains crucial for restructuring the economy, improving efficiency, and increasing domestic savings. Here, I will address three of the most important items of this agenda: energy price adjustment, privatization, and the social safety net.

On energy price adjustments, the staff report refers to the substantial savings to be obtained from domestic energy price adjustments. The authorities acknowledge that the present energy policy results in waste and inefficiency, and is unsustainable. Therefore, the issue is no longer the adjustment itself, but rather its path. Two considerations are of paramount importance in determining the proper speed of adjustment. First, the extent and intensity of relative price distortions, in general, and the costly energy policy, in particular, have a long history in Iran; therefore, their rapid removal risks considerable social and economic dislocation. The entrenched and prolonged characteristics of distorted energy prices not only have major implications for the consumption and investment plans of individual economic agents, but also influence the whole technological trajectory of national output. Second, care should be exercised with regard to the possible impact of the adjustment path on the present state of the economy and on its short- to medium-term prospects.

Long and serious debate in Parliament during the discussion of the Second Five-Year Plan resolved the issue with legislation mandating that energy prices should be doubled in the first year of the Plan to aid in the recovery of production costs; with further annual adjustments continuing thereafter. There is some evidence that domestic energy consumption has declined, in part, in response to the recent doubling of energy prices. Because a major concern of the Parliament was the inflationary impact of higher domestic energy prices, it is possible that the magnitude of annual adjustment rates could be revised upward when inflation falls to its targeted level.

On privatization, during the period of First Five-Year Plan, 391 public enterprises were privatized either through direct sales or through the Tehran Stock Exchange. However, since late 1994 the pace of privatization has moderated. The reason for this has been the search for a more efficient modality for privatization. The objective is to ensure the broadest possible participation of the public at large, as well as the workers of the firms being privatized, in the ownership and management of these firms. Discussions are proceeding on proposals to create incentive schemes for participation by individual investors and private nonbank financial institutions in the privatization process. The authorities expect that this issue will be resolved shortly, and the process will then move ahead unimpeded.

On the social safety net, the authorities concur with the staff recommendation that the present system of subsidies should be replaced with a targeted and transparent social safety net. Two technical assistance missions from the Fund, and one from the World Bank, have studied this issue and provided the authorities with recommendations for the structure and organization of an efficient social safety net system. The authorities appreciate these efforts. Over the past two years, discussions have proceeded on the provision of a comprehensive social security system as well as on the safety net issues within the Government and in the Parliament. As to the former, a social security system covering all those without any coverage was put in place during the week of September 15. Many of the issues relating to the social safety net have been resolved; the remaining ones relate to the need to quantify the cost of the comprehensive safety net so as to make adequate provision in the budget, consolidation of all safety net efforts which are now dispersed throughout the economy and to the choice of social groups to be included. The latter is an important consideration; without its resolution there is the possibility of duplication of effort, which could undermine the efficiency of the proposed system.

At the present, a network of foundations exists whose objective is the provision of social services to various targeted social groups. These foundations have productive assets, whose proceeds are used for the provision of these services. These are independent organizations that receive only limited budgetary support. An effort to consolidate and unify their operations is essential so that the efficiency of the Government's own safety net targeting effort will not be undermined. This is a sensitive and time-consuming task, as part of this effort relates to the operations of these foundations on both sides of the ledger, and thus requires improved transparency of accounts. While this task is proceeding, efforts to reduce implicit subsidies are also continuing. Bread, public utility, and energy prices have been increased recently and further reduction of implicit subsidies will continue throughout the Plan period.

For the immediate future, the authorities' objectives are the timely servicing of their external obligations and further stabilization. The authorities are confident that the former will be achieved fully and completely. As to the latter, commitment to a fixed exchange rate, tight financial policies, and close monitoring of budget performance have succeeded in dampening inflation, as is reflected in the price movements in June and July. The authorities' commitment to market-oriented reforms and structural adjustment remains unwavering. While privatization efforts have moderated somewhat, this reflects an effort to find the right privatization scheme to ensure the broadest possible participation by the public in the ownership and management of privatized firms.

Finally, my authorities appreciate the opportunity to have had deeper and more frequent interchanges of ideas with the Fund staff and look forward to its continuation.

Mr. Shaalan made the following statement:

The Iranian authorities are to be commended on the substantial achievements of the major reconstruction and reform program of 1989/90-1993/94. Particularly noteworthy was the attainment of an annual average real GDP growth rate of 7 percent, substantially exceeding the growth rate of other oil-exporting developing countries over the same period. Growth was broad-based with agricultural production rising and becoming more diversified, and non-oil exports increasing at a healthy rate. The implementation of a number of important liberalization measures contributed to this positive outcome. These included liberalizing the exchange system, removing many nontariff trade barriers, freeing most domestic prices, raising utility rates, lowering income tax rates, and a beginning in public enterprise privatization.

The last three years in the reform program, however, witnessed severe pressures in Iran's balance of payments. Imports surged in 1991/92 and 1992/93, while oil exports declined, resulting in a significant widening of the current account deficit. By the end of the fiscal year 1993/94, Iran's substantial short-term deficit financing led to a ballooning of the overall BOP deficit and the accumulation of a large stock of external payments arrears. The reduction of those arrears was a major objective of the Iranian authorities in 1994/95 and they are to be commended on their remarkable success in this effort. Success on the arrears front, however, entailed a significant cost in terms of GDP growth in 1994/95. The timely servicing of external debt was accomplished by a sharp reduction in imports, which contributed to a slowdown in non-oil output growth. At the same time a reduction in oil export receipts and weak international oil prices led to a drop of 5.6 percent in the oil sector with the result that GDP growth for the year was limited to about 1.8 percent.

The tightening of financial policies in 1994/95 achieved some progress in reducing financial imbalances. Following a widening of the fiscal deficit to 6.3 percent of GDP in 1993/94, the deficit was reduced to 4.8 percent of GDP, mainly on account of a containment of quasi-fiscal foreign exchange losses. Monetary growth was also reduced compared to the previous year. Nevertheless, these tighter policies did not appear to ameliorate the high rate of inflation which was further fueled by upward price pressures resulting from the depreciation of the exchange rate.

With the 1995/96 budget, the authorities are proceeding to tighten financial policies further. A substantial expenditure reduction of 4.4 percentage points of GDP, and a small increase in revenues, is expected to bring the budget to near balance in 1995/96. Preliminary figures for the first four months of the fiscal year indicate that fiscal policy is on target. To maintain this outcome, the authorities should continue to carefully monitor expenditures and ensure the timely adoption of the revenue measures envisaged in the budget.

On the budget structure, the introduction of an excise tax on petroleum products with this year's budget is a welcome step in the authorities' plan to reduce subsidies, though it still leaves domestic petroleum prices too low. While I appreciate the authorities' concerns with regard to faster increases in petroleum product prices, as expressed by Mr. Mirakhor in his helpful statement, I believe the issue warrants further consideration. A more accelerated pace of petroleum price increases than that presently envisaged, besides improving resource allocation and enhancing growth, would strengthen government finances while, at the same time, allowing for the establishment of a transparent and well-targeted social safety net. The introduction of the value-added tax, which Mr. Mirakhor notes is on the authorities' agenda pending the completion of computerization and identification of firms to be taxed, is another important measure which would improve the budget structure further and reduce reliance on volatile oil receipts. A major feature of the budget in 1995/96 is the increased transparency in the fiscal accounts resulting from the abolition of the Foreign Exchange Obligations Account and the integration into the budget of the quasi-fiscal operations, which is to be commended. Transparency was also enhanced with the formal integration into the budget of government transfers to the commercial banks through the foreign exchange system for covering repayment of external obligations.

On monetary policy, I welcome the reduction of liquidity growth to 20 percent in 1995/96, while noting the staff concerns that available monetary instruments might not be capable of achieving this target. I note here, in particular, that while rates of return on bank deposits and rates of charge on bank facilities were increased at the start of this fiscal year, they still remained substantially negative in real terms. Given the authorities' intention to restore positive rates primarily through reducing inflation, rather than by adjusting nominal rates, I would agree with the staff advice that the Bank Markazi consider imposing direct credit controls so as to assure the attainment of the monetary growth target.

Finally, on external sector policies, the authorities' objective of generating a large current account surplus to offset the projected deficit in the capital account and improve the external reserve position will require the maintenance of the official export rate at a competitive level. Mr. Mirakhor notes that the present fixed rate will be reviewed in March 1996. I would encourage the authorities to consider, at that time, proceeding with early exchange rate unification at a market-related rate. In the meantime, firm adherence to strict financial policies will be of paramount importance, not only to sustain the present nominal exchange rate, but more generally to reduce inflation and stabilize the economy, thereby creating a favorable environment for the implementation of the needed structural reforms. I was most encouraged by the sharp deceleration in inflation in recent months, which is a reflection of the tighter monetary and fiscal policies being pursued.

To conclude, I would once again like to commend the Iranian authorities on the progress they have achieved thus far in their reform efforts and to wish them continued success in the important policy challenges on their agenda.

Mr. Clark made the following statement:

The main the staff report and the staff supplement indicate a welcomed movement by the Iranian authorities toward a reversal of the slippages in policy and the deterioration of macroeconomic performance that occurred in 1993/94 and 1994/95. Though the rate of growth of real GDP continued its steep four-year decline, and inflation surged to 35 percent, there was at the same time an improvement in gross national savings, while the general government deficit started on a downward path, and gross external reserves at the end of 1994/95 improved from 1½ to 3½ months of import cover, even though substantial but much reduced payment arrears underpinned the reserves position.

But sustained correction of deep-seated imbalances and structural rigidities is still far off. Iran has considerable untapped potential for strong growth with low inflation, and this should encourage the authorities to strive resolutely to eliminate distortionary measures in the financial and economic system. It is encouraging that they are inclined to move in this direction, and the staff have adequately pinpointed the principal areas of challenge and concern. It goes without saying, of course, that when the sanctions problem shall have been resolved, and with maintenance of the rapid progress in eliminating external arrears, the authorities would enjoy an additional degree of freedom to consolidate their efforts on the right path. I offer brief comments in three areas.

Accelerated strengthening of public finances, improvement in monetary control and reform of the exchange system are among the most urgent items on the agenda for attention. The authorities are to be commended for aiming at a sharp narrowing of the Government deficit in 1995/96, and for planning to stay on a clear deficit reduction path over the medium term, whether under the baseline or the high-growth scenario. Credibility is lent to this outlook on the revenue side by the adjustment of domestic oil prices, the shift from specific to ad valorem taxes, and the use of the more depreciated exchange rate for customs valuation purposes. Similarly, compression of expenditure in 1995/96 by 4.4 percentage points of GDP helps to reinforce confidence in the plans for fiscal consolidation. Already there is positive news that an annualized budget surplus of 2.7 percent of GDP has been achieved in the first four months of 1995/96, though this excludes outlays for quasi-fiscal foreign exchange losses. I would welcome the staff's assessment of this development against the projections for 1995/96 in both the baseline and high-growth scenarios.

More broadly, one wonders whether there is not scope for a greater effort on the revenue side, even with the measures already agreed. I note that non-oil and gas activity account for over 80 percent of GDP, while contributing just about 40 percent of Government revenues in 1995/96 and that this ratio is likely to remain the same over the medium term as revenue increases. Does the staff see any scope for increasing the relative contribution of the non-oil and gas sector to revenues beyond this level?

Regarding the exchange system, it is encouraging that the authorities aim to unify the differing official rates currently applied, and to allow the unified rate to be freely determined by market forces. The only question is whether the end of the second Five-Year Plan in the year 2000 is not too distant a target date for this. The distortions being generated from the multiple exchange rate system should not be allowed to persist longer than necessary. Accordingly, I agree with Mr. Shaalan's suggestion that the authorities consider proceeding with exchange rate unification at the time of the March 1996 review of the exchange system that is planned.

I welcome the efforts at monetary tightening earlier this year, which has brought down the net domestic assets of the banking system and helped reduce monthly inflation sharply. Further steps are needed however, as real interest rates are still negative. I am not sure if the authorities can afford the luxury of waiting to see the longer term behavior of inflation before engineering an adjustment of key interest rates in the system. In the meantime I note with interest the preparedness of the staff to support the use of administered bank-by-bank credit ceilings as an interim support to other policies for tightening monetary and credit conditions. (Is this a harbinger of further possible broad review of circumstances where direct instruments of monetary policy might be justified?)

Generally, the authorities are conscious of the urgent need for far-reaching adjustment and restructuring, and appear concerned to pursue this in a way that produces a soft landing socially and otherwise. The hard fact is that the search for a soft landing may be counter productive, as delays will increase distortions and make them even more difficult to deal with later.

I commend the staff for the very transparent way in which they made explicit the assumptions underlying the medium term scenarios. Their approach is worthy of emulation in other staff reports.

I wish the authorities well in their future endeavors.

Mr. Ismael made the following statement:

The staff report, its supplement, and the background paper have provided an interesting discussion of economic conditions in Iran. Mr. Mirakhor's statement has further clarified the picture, and is cautiously encouraging.

The progress made by the Iranian authorities in correcting the economy's imbalances in the first few months of FY 1995/96 is commendable. Nonetheless, Iran's economic framework and its performance remains fragile. This emphasizes the need for the authorities to seriously consider the structural adjustments that have been proposed by the staff. I, therefore, welcome the fact that the latest budget and the Second Five-Year Plan retain the authorities' commitment to reform the pricing system, the exchange rate, and tax collection. At the same time, we have to be realistic as well and be prepared to expect that short-term political imperatives will continue to hinder sustained implementation of the program, which would necessitate occasional policy reversals, thereby easily creating the impression that structural reform is pursued in an erratic and piecemeal fashion. That such an opposition should not be minimized is attested by the recent popular unrest that took only two weeks to spark after the increase in domestic fuel prices was introduced at the beginning of the Iranian new year last March to remove the prevailing subsidies. However, what is most important in all this is that the authorities remain committed to reform. It is, therefore, reassuring to note Mr. Mirakhor's statement of the way the authorities have planned to address three of the most important items of the structural reform agenda: energy price adjustment, privatization, and the social safety net. I can support these planned efforts.

Another major problem Iran is faced with is how to stabilize the rial at a more realistic rate against the U.S. dollar. There is no doubt in my mind that Bank Markazi had seriously attempted to do so. This was first proven by the abolishment of the official rate, which was the lowest, grossly overvalued exchange rate, and replaced by the so-called floating rate, while the export rate, now at a much depreciated rate, and the unaltered free-market rate, remained in operation.

Unfortunately, the Bank's attempts foundered as soon as news of the U.S. embargo was announced, which left the Tehran currency market very much confused. Bank Markazi has to be commended for its quick response to the collapse of the free-market rate in immediately establishing the floating rate of IR 1,750 per U.S. dollar as the new official exchange rate for essential commodities and introducing a new free-market rate of IR 3,000 per U.S. dollar for all other imports.

I am pleased to note from Mr. Mirakhor's statement that this policy change ended panic selling of the rial, restored order to the market, and slowed inflationary momentum. I am also encouraged to note that, in an effort to support the parity, reduce inflation, and stabilize expectations, coordination between monetary and fiscal policies has been strengthened through a joint daily monitoring of revenues, expenditures, and reserve money by the Central Bank and the Ministry of Finance.

Under the circumstances, I am of the opinion that the present exchange rate system should be left as it is for now. There is still the uncertainty that could arise out of the trade embargo and the United States' persistent efforts to persuade other countries to follow suit, which should not be minimized. I welcome the Iranian authorities' publicly announced commitment to keep the free-market rate in force until March 1996, at which time this rate is to be reviewed. In this connection, I am in agreement with Mr. Shaalan and Mr. Clark that the authorities consider, at that time, to proceed with early exchange rate unification at a market-related rate. The authorities should not go that far to wait until the end of the Second Five-Year Plan in March 2000 to unify the exchange rates as mandated by law.

Mr. Wei made the following statement:

The Iranian authorities are to be commended for the progress they have made in their economic adjustment over recent years. The economic performance in 1994 was impressive in many areas, including an economic growth rate of 7 percent, rapid increase of non-oil exports and improved social indicators. It is particularly worth noting that the authorities have honored their international debts, as well as having substantially reduced arrears, despite their current difficulties especially in the absence of any fresh flow of external financing. The effective implementation of the suggested measures following the previous Article IV consultations highlighted the authorities' commitment to deepening economic and structural reforms. I broadly agree with the staff on the main thrust of the report and therefore would like to concentrate my remarks on the fiscal and monetary policies.

With regard to the fiscal policy, the impressive gains in balancing the budget after accommodating the sizable exchange rate devaluations has laid a solid foundation for further improvement with fiscal accounts in the near future. As a matter of fact, as indicated in the staff supplemental paper, the General Government registered a budget surplus equivalent to 2.7 percent of the GDP on an annual basis. A steady improvement in tax administration, including a simplification of the tax system and the computerization of tax assessments, will certainly help bring in additional fiscal revenue for the government. Furthermore, the streamlining of the budgetary accounting and regulation, with the incorporation of the quasi-fiscal operations into the budget, is conducive to an improvement in fiscal management efficiency. Like others, we believe that increasing the share of budgetary resources in the GDP will certainly strengthen the stand of the fiscal policy. In this connection, the authorities' revenue-increasing measures, as indicated in Mr. Mirakhor's very comprehensive and helpful statement, are indeed welcome. The authorities are encouraged to implement their plans to convert all excise taxes to ad valorem taxes, in line with recommendations provided through Fund technical assistance.

Concerning the monetary policy, a tighter policy stance is highly warranted in light of inflationary pressure. It is encouraging to see that the monetary authorities have aimed for a reduction in growth of monetary aggregates, with a ceiling over growth designated for domestic credit expansion. The readiness of the authorities to impose additional measures in order to keep a firm control over financial pressures will help dampen inflationary momentum. On the issue of interest rates, the staff is recommending to the authorities that positive interest rates be realized in view of the importance of curbing inflation. However, the authorities are choosing the control of monetary growth over bringing down inflation. We would like to hear the staff comments on the advantages and disadvantages of the two different approaches. It is my belief that the authorities' approach is a more practical one if considering the policy objective to maintain social stability. However, I agree that interest rates should be set at an appropriate level to be consistent with the monetary policy. In the same vein, a gradual increase in the interest rates for government bonds has merit for consideration.

On the external policy, we welcome the authorities' plan to attain a full unification of the exchange rate during the SFYDP period. In this respect, the staff are encouraged to work closely with the authorities to monitor the developments on this issue. If circumstance permits, the sooner this objective is realized, the better.

On structural issues, the issue of energy price is obviously on the top of the authorities' policy agenda. In this regard it is encouraging to note that the authorities have committed to raising oil prices to the level in the international market within the SFYDP period. Although we would like to see this price adjustment process shortened if possible, we do understand the importance of the policy stance adopted by the authorities, which is well presented in Mr. Mirakhor's statement. I share the authorities' concern over a possible impact on social and economic stability if an oil price adjustment to international levels were done overnight.

In conclusion, the authorities are encouraged to persevere with their macroeconomic stabilizing efforts, and we wish the authorities every success in facing the challenges on their path of economic development in the future.

Mr. Fernández made the following statement:

Iran's First Five Year Development Plan that ended in 1994 contributed positively to improving the economic situation through the rehabilitation of many sectors and the introduction of structural reforms. Positive results have been achieved in GDP growth, in a more diversified domestic production and exports, and in social improvements. However, substantial macroeconomic and structural imbalances persist, which require the adoption of significant adjustment and stabilization measures. In this context, as noted by Mr. Mirakhor, the Iranian authorities are in broad agreement with the staff assessment, although there are differences as to the most convenient timing and intensity of the required measures.

The authorities are to be commended for their determination to regularize the external arrears that accumulated in 1992/93 and 1993/94, which jeopardized the stability of the Iranian economy, even in the context of severe constraints imposed by external sanctions, limited access to international credit, and the uncertainties of the international oil market. The authorities have been largely successful in reducing the stock of external arrears and in lengthening the maturity profile of their external obligations, which improves medium-term economic prospects under the recently adopted Second Five Year Development Plan, although the necessary import compression has implied lower growth and higher inflation in the short run.

Nevertheless, additional adjustments are warranted to enhance the scope of the new program and to reduce distortions in the economy. Not surprisingly, the staff recommends actions on all fronts--that is, in the fiscal, monetary, exchange, and structural areas. Perhaps the two most important challenges faced by the authorities are the distortions derived from the dual exchange regime and related exchange controls, and from price disruptions in the domestic energy sector. Prior experience in exchange rate unification was initially quite successful, as noted by Mr. Mirakhor, and again constitutes a key objective of the Second Five-Year Plan.

Under the first Plan, exchange unification was, to a great extent, derailed by fiscal and monetary expansion. In order to achieve success in unification under the second Plan, greater discipline will be required on both the fiscal and monetary fronts. In this context, I note that the fiscal deficit has been on a downward trend since 1993, and is currently projected to diminish to 1.8 percent of GDP for 1995, mainly as a result of significant expenditure reductions.

I am also reassured by Mr. Mirakhor's indication that the quasi-fiscal causes of the large deficits experienced in the two prior fiscal years will not recur, since the foreign exchange obligations account has been closed and its operations fully integrated into the budget. These trends, together with other measures aimed at improving budget transparency, tax system efficiency, and parliamentary limits on central bank financing of government deficits, indicate that the overall fiscal policy stance is adequate and a good basis for implementing the exchange rate unification. At the same time, however, given the inevitably greater likelihood of increased expenditure pressures over time, the authorities are well advised by the staff to consider strengthening the revenue base through more rapid increases in domestic energy prices.

Although energy prices have recently been increased very substantially, as with other important oil-producing countries, such increases have been made from a very low base. Taking into account Mr. Mirakhor's comments on the potential social and economic dislocation that could occur from an overly rapid price adjustment path, I can understand the authorities' hesitancy to move too quickly on this issue and their commitment to proceed gradually. At the same time, it is important for the authorities to take careful note of the magnitude of the implicit petroleum product subsidies, estimated at $7 billion by the staff, which, if properly targeted, could be used to substantially enhance the well being of the population. In this context, accelerating the improvement and strengthening of the social safety net, with adequate technical assistance, acquires a critical relevance. Indeed, rapid progress in these areas could allow the authorities to move more rapidly both on domestic energy prices and on unification of the exchange rate than may otherwise be the case.

Monetary policy is also on a somewhat stronger footing and, as noted by Mr. Mirakhor, in combination with the ongoing monitoring of fiscal performance, is expected to put downward pressure on inflation. Nonetheless, the staff expresses substantial concerns regarding the effectiveness of available monetary instruments to achieve the desired paths for money growth and domestic credit. In this context, I am reassured by the authorities' willingness to impose direct credit controls if these are necessary to meet the credit ceilings. Nonetheless, monetary policy needs to quickly correct the strongly negatively rates of return and rates of charge that currently prevail in the economy if inflation is indeed to be brought to heel.

As the staff notes, the resulting increase in velocity is reducing the effectiveness of monetary policy. In this context, while I understand the growth-related concern expressed by the authorities, I do not share the view that an increase in interest rates could be misinterpreted by the public as a sign of protracted inflation. I am, however, more sympathetic to the concerns expressed regarding the health of the financial system and on the strength of the regulatory and supervisory infrastructure, on which staff comments would be welcome. I would also appreciate staff comments on the feasibility of achieving positive real rates of return mainly through lower monetary growth and lower inflation, as decided by the authorities.

Iran faces many other challenges, not the least of which is the need to boost private sector activity, for which privatization is perhaps the most important structural measure that needs to be intensified. In general, one notes the authorities' commitment to this process and to other structural adjustment measures, as reflected in the Second Five-Year Plan. Such commitments to economic reform, the broad agreement with the staff regarding the main policy challenges ahead, and the progress that has already been achieved in many crucial areas are indicative of the authorities' willingness to adopt the necessary measures with which to meet the medium-term economic objectives.

Mr. Mesaki made the following statement:

First of all, it is regrettable that we have had to wait for two years since the last Article IV consultation, whatever reason there may be. This is especially so since I find this opportunity very valuable for deepening our understanding of the current situation of the Iranian economy. I believe that periodicity is an important element of effective surveillance.

It is commendable that the Iranian authorities have extricated their economy from a most serious imbalance and succeeded in reducing external arrears. Moreover, supplementary information from the staff indicates that the recent development is more favorable than expected. Nevertheless, the economy is still in the adjustment process, and many policy challenges remain.

I get the impression from the staff report that the views of authorities and the staff on economic policies differ in many aspects. This may reflect whether the change in the economic environment since the beginning of 1995/1996 is assumed to be a given. I do not want to step deeply into this issue but, in any case, the staff seems right in pointing out that policy tools are not most effectively linked with policy aims. It is useful to re-examine the allocation of policy tools from the viewpoint of making more use of market mechanisms.

As a measure to contain inflation monetary policy can be used more actively, by correcting negative real interest rates. It is hard to believe that higher interest rates may be interpreted as indicating the authorities' tolerance of higher inflation. Although I share the staff's realistic argument that direct credit control is useful, at least for the moment, even in that case the measure should be associated with higher interest rates.

Fiscal policy can contribute to growth if explicit and implicit subsidies, including those on petroleum products, are reduced, and if the saved money is allocated to improving infrastructure and building a social safety net. This process, if adopted, will lead to more efficient resource allocation, although I am not sure whether the pace of subsidy reduction advocated by the staff is actually feasible.

Securing a fairly large current account surplus will help in smoothly servicing external debt, a much-stressed policy objective. If fiscal policy alone plays a dominant role in this respect, however, growth may be depressed considerably. A unified exchange rate, at a somewhat more depreciated level, may be able to share the role. It is not surprising to see a currency depreciate externally if its domestic value declines, and it is not appropriate to use the exchange rate as a kind of subsidy. The Iranian rial was unified until recently, and re-unification should be possible once the situation improves. It is important to stand ready for this.

Generally speaking, I cannot help sympathizing, to some degree, with the Iranian authorities' tendency to stick to a seemingly-traditional policy stance under very difficult circumstances. I believe, however, that going one step further in economic adjustment, along the lines of the staff's recommendations, and making neat and clean the economy's external position will enhance the economy's credibility and bring about stable growth in the medium term.

Hoping finally for improved data reporting to the Fund, I conclude my remarks.

Mr. Abbott made the following statement:

Since our last review of the Islamic Republic of Iran two years ago, as Mr. Mesaki emphasized, there has been significant economic policy backsliding. The re-emergence of multiple exchange rates is the most obvious manifestation of this deterioration. Underlying imbalances have gone uncorrected, and in fact have been aggravated. Evaluating the true state of the economy continues to be handicapped by inadequate and unreliable statistics, a weakness we explored in detail during the last review. Official actions to suppress market responses have compromised the usefulness of technical improvements in statistical coverage.

As we piece the picture together, Iran now is engaged in a disorderly adjustment to external payments crises that has its origin in ill-advised policies immediately following the Iran-Iraq war. Inappropriate exchange rate policies then made imports artificially cheap, and short-term credit made them affordable. By the time first payments came due in 1992, Iran was running arrears. Imports collapsed as new credit became unavailable.

The year 1993 was a false dawn, as initial steps toward liberalized trade and unified exchange rates were not sustained. Underlying monetary, fiscal and external policies did not support the adjustment needed to make the more liberalized regime viable. Rather than correcting the fundamental distortions, the authorities resorted to administrative controls that have set back incipient reforms.

The authorities' request for approval of their multiple exchange rate practices provides an opportunity to amplify on this point. We would not agree with the characterization of the current exchange rate regime as provided in Appendix IV of the background paper on recent economic developments. That Appendix presents the official view that there are no exchange restrictions for imports at the official export rate of Rl 3,000 per dollar. This representation is disingenuous at best. To suppress the shortage of foreign exchange at this rate, the authorities have imposed surrender requirements for exporters, closed down exchange dealers, forced all legal import transactions through the banking system, and cracked down on import of unauthorized goods. On this latter point, the Iranian authorities acknowledged 13,000 arrests during the first three months of the new system. We believe that these measures constitute quantitative restrictions on aggregate imports at the official export rate. These are not just technical failings in the foreign exchange regime. The import clampdown has damaged industrial output and the new foreign exchange regime has curtailed growth of non-oil exports.

Data weaknesses make it extremely difficult to gauge the true extent of the economic consequence of this deterioration of the fundamentals. To illustrate, it is hard to estimate how Iran's current account position is developing. The 1993 report provided revised current account data for 1991/92, preliminary data for 1993/94, and forecasts for 1994/95 that aggregated to a deficit of $12.4 billion. The comparable figure presented in this year's report for the same time period comes to $22 billion.

On specific items, the large figure in the balance of payments accounts for transfers--which we questioned in the last review--remains unexplained. If this reflects worker remittances, it seems to be excessively large, given the experience in this country for outflows to

Iran. This figure for transfers has just been made a little smaller in the current report. Likewise, we have found it very hard to reconcile Iranian non-oil exports with trade partner data.

Similarly, in the capital accounts, it is hard to reconcile the $800 million of other capital inflows with frequent references in the report to capital flight. This is not just a problem of statistical misrepresentation; these statistical difficulties often arise as an unintended side-effect of foreign exchange controls. People who obtain foreign exchange that was diverted to the black market often need to contrive a legal explanation for their imports or bank balances. Hence, false export transactions and remittances are documented and reported to the authorities. Whatever the origin, we would expect that the current data and forecasts may be off the mark.

Data and forecasting issues aside, we agree with a number of the policy recommendations and concerns by the staff in Sections 3 and 4 of the report. A top priority should be to raise retail oil prices to realistic prices. Petroleum products now typically sell for 5 percent of their world market value. The oil industry is at risk from cheap domestic oil and the inadequate investment that results from a requirement that the National Iranian Oil Company (NIOC) surrender its revenues to the Government without provision for reinvestment.

The trade press indicates that Iranian oil exports are 150,000 to 200,000 barrels per day higher than shown in the background paper on recent economic developments. This would mean that Iran is exceeding its OPEC quota but, more importantly, given the low level of investment, it may indicate that production is being pushed to levels that will damage the long-term production prospects of the oilfields. In this regard, the diversion of scarce capital to unproductive investment and nuclear power generation is doubly wasteful. Use of flared gas or more rational reinvestment in oil production would provide far cheaper energy.

Credit policy is on a dangerous path. The background paper on recent economic developments indicates that the domestic banking system is financing public enterprise deficits equivalent to 9 percent of GDP. These credits amount to two thirds the stock of reserve money. Any shocks to the system could quickly result in inflationary impulses. Credit directed to the foundations is another potential inflationary risk given these entities' lack of accountability. A significant part of the recorded increase in credit to the private sector is probably accounted for by credits to the foundations, which are used to support uneconomic enterprises.

We continue to be concerned about the difficulty in reconciling estimates of external debt. Improvements have been made, but the debt stock cannot be reconciled with the flow data from the balance of payments except by a generous interpretation of the large errors and omissions entry. For example, official statements early this year indicated the Iran had opened letters of credit to finance $8 billion of imports. This and other reports that Iran is servicing short-term debt only on a revolving basis call into question the report that the stock of short-term external credits, excluding arrears, was only $3.5 billion as of March 1995.

Mr. Mirakhor observed that, regarding the question of data deficiencies to which Mr. Abbott had referred, there was room for improvement in the statistics of the Islamic Republic of Iran, as there was room for such improvement in all countries. That notwithstanding, it was perhaps inappropriate to condemn entirely the strong efforts that had been made by both the authorities and the staff to improve matters. Also, it needed to be borne in mind that even large industrial countries such as the United States had difficulties with their statistics from time to time, or with the quality of information that was made available. In particular, he recalled that the U.S. Central Intelligence Agency had estimated in 1990 that per capita income in the Soviet Union was about $8,900. The Fund staff had estimated the same year that per capita income was closer to $800. The data that the staff had available to it was the best that could be provided.

Mr. Abbott said that his authorities would prefer better policies across the board.

Mr. Mirakhor added that, regarding the question of expenditures for nuclear energy, a member of the U.S. National Security Council staff for Iranian affairs who had served under Presidents Ford, Carter, and Reagan had pointed out that Article IV of the Nuclear Non-Proliferation Treaty stated explicitly that the countries in compliance with the treaty would have access to peaceful nuclear technology. Iran was in compliance with that treaty. The power stations that Iran was buying from various countries would also be in compliance with the treaty. The Islamic Republic of Iran was committed to developing fully its natural gas production, and to experimenting with hydroelectric, thermal, and wind power, in addition to nuclear energy.

To stop the flaring of natural gas and to use it instead as a source of power was a useful objective, Mr. Mirakhor continued. In that respect, it needed to be borne in mind that, three years before, the Islamic Republic of Iran had submitted a project to the World Bank to reduce gas flaring. The Islamic Republic of Iran, Nigeria, and the Russian Federation were apparently the three countries that contributed to environmental deterioration by flaring gas. The United States authorities, however, had managed to stop the disbursements under that project. Perhaps if the U.S. authorities would drop their objection to that project, gas flaring could be reduced, thus helping the environment and reducing Iran's need for power from other sources at the same time.

Mr. Kiekens made the following statement:

Since Iran's last Article IV consultation the authorities have achieved significant progress in several areas. Particularly noteworthy is their success in reaching bilateral rescheduling agreements with their major creditors. The policy of import compression has improved the outlook for international reserves and external debt service. I share Mr. Mirakhor's view that the strenuous efforts of Iran's authorities to preserve their country's reputation as a reliable borrower seem be bearing fruit.

In the case of other countries that have passed through a major crisis, creditors have shown that they are capable of looking beyond the immediate rescheduling issues to examine the fundamentals. Therefore, the best way for Iran to escape from the vicious circle of debt negotiations is to pursue both macroeconomic and structural objectives in the framework of a coherent global program. The main elements of such program are outlined in the staff papers: Iran must lessen its dependence on oil export revenues, further increase domestic demand for locally produced goods, and strengthen its financial institutions to improve their ability to mobilize and channel local savings into non-oil manufacturing and services.

The stronger fiscal stance which is the key element of the program should not only correct macroeconomic imbalances but also help mobilize domestic resources. In this connection I was encouraged by reports from the staff and Mr. Mirakhor about the significant improvement of the fiscal situation from 1994 to 1995. All quasi-fiscal operations have been incorporated into the budget. Budget transparency has been increased, and tax administration improved. Iran's revenue position will become still more secure with the planned introduction of a VAT. The new, unified, well-targeted, stronger social safety net presently being designed will also alleviate pressures on the budget and help remove significant distortions in pricing.

The rehabilitation of public finances stands no chance of succeeding unless the private sector income grows rapidly. Despite the authorities' determined efforts to increase non-oil output, its growth slowed down significantly from 1993 to 1995. Faster development of the private non-oil sector has been seriously impeded by the persistence of several major distortions. These include very negative real interest rates, multiple exchange rates and artificially low domestic prices for oil products.

I share the staff's concern about the very negative real interest rates. By simply restraining credit through administrative measures and hoping that inflation will come down, the authorities seem to have chosen a longer path than necessary toward restoring positive real interest rates. I also share the staff's concern about the steady increase in velocity in response to the declining real return on deposits. In addition, I join previous speakers in encouraging the Iranian authorities to unify the exchange rates when conditions permit and, as Mr. Wei has expressed it, "the sooner the better."

I was encouraged to see that the authorities agree with the staff about the need to increase domestic prices for oil products. Though their worries that this would risk igniting a new inflation cycle are understandable, I agree with Mr. Shaalan and the staff that increasing domestic oil prices faster than planned will greatly improve resource allocation, enhance growth, and would further strengthen the public finances.

In ending, let me thank the staff for the high quality of the documents they have provided, and commend the Iranian authorities for, and I quote from the staff paper: "the progress made by Iran in strengthening its data base. This, together with enhanced transmittal of data to the Fund will facilitate effective surveillance." Nevertheless, deficiencies remain and I support the staff in urging the authorities to take further action to strengthen their statistical systems.

Mr. Fayolle made the following statement:

First of all, I would also like to commend the quality of the staff report which provides us with a balanced appraisal of the economic situation of Iran and of its policy requirements. I also thank Mr. Mirakhor for the useful information contained in his statement.

I do not want to address the fiscal issue, since I agree with the staff appraisal and the previous speakers, and I will limit myself to the following three comments:

The Iranian authorities have achieved progress in reducing some of the major financial imbalances since the last Article IV consultation in 1993. This is especially the case for external accounts: an impressive import compression has allowed to change the current account deficit into an anticipated surplus in 1994/95.

I would like to point out that the Iranian authorities are faced with a very high rate of inflation. This chair has already expressed our concern that the conduct of the monetary policy be consistent with the need to reduce inflation. Actually, since 1993, there have been additional inflationary pressures following a decrease in the level of imports and the exchange rate depreciation. Therefore, I welcome Mr. Mirakhor's description in his buff that the monetary policy seems less accommodative during the recent months with a decrease of credit to the private sector. But I am worried about the concerns expressed by the staff that the available monetary instruments might not have the capacity to achieve the government's objectives; moreover, the projected level of monetary growth for 1995/96, reflected in Table 3, gives cause for concern. And I am convinced that there is a need to induce positive interest rates on deposits--which are currently negative--in order to reduce the level of inflation and enhance domestic savings. That would allow for a more sustainable financing of investment.

Finally, there is an obvious need to continue--and maybe to accelerate--the process of structural reform. I will only mention here: the need to achieve the unification of exchange rate system, which is a source of distortions and inefficiencies. I agree with previous speakers on this topic; and the need to accelerate privatization efforts. This is very important in order to develop a diversified and competitive private sector. It could promote reaching sustained economic growth in the coming years, provided that it quickly copes with its present imbalances.

I commend the quality of the staff report, which provides a balanced appraisal of the economic situation of Iran and its policy requirements. I also thank Mr. Mirakhor for the useful information contained in his statement.

Like Mr. Kiekens, I would point out that the Iranian authorities have made progress in reducing some of the major financial imbalances since the last Article IV consultation in 1993. This is especially the case for external objectives, owing in particular to an impressive import compression, which allowed the current account deficit to turn into an unanticipated surplus in 1994/95.

The Iranian authorities are faced with a high rate of inflation. This chair has already expressed its concern that the conduct of monetary policy must be consistent with the need to reduce inflation. Since 1993, there have been additional inflationary pressures following a decrease in the level of imports and the exchange rate's depreciation. This is why I welcome Mr. Mirakhor's indication that monetary policy seems to have been less accommodative over recent months, with a decline in credit to the private sector. However, the concern expressed by the staff that the available monetary instruments might not be able to achieve the Government's objectives is worrying. I am also convinced that there is a need for positive real rates on deposits--which are currently negative--in order to reduce the level of inflation and enhance domestic savings.

Like other speakers, I see a need to continue and perhaps to accelerate the process of structural reform, including of the current dual exchange rate system. An acceleration of privatization efforts is also important, in order to develop a diversified and competitive private sector and to promote sustained economic growth in the coming years.

Mr. Al-Tuwaijri made the following statement:

I share the staff's assessment that Iran achieved important results during the First Five Year Development Plan. However, significant macroeconomic imbalances emerged and important structural issues persist.

As Mr. Mirakhor points out in his informative statement, the staff and the authorities are generally in agreement regarding the challenges facing the economy. The differences of view lie in the approach to reforms in certain areas, as well as the speed of the reform process.

Prudent fiscal policy is clearly crucial for ensuring a successful adjustment strategy. The supplement indicates that the authorities' tight fiscal stance is on track. This is indeed welcome. For the next fiscal year, the authorities will be well advised to place greater emphasis on ensuring that fiscal measures are not giving rise to undue distortions. This will entail, inter alia, an improved revenue and expenditure structure. Here, the adjustment of energy prices is a welcome step.

A tight fiscal stance is important for facilitating the conduct of monetary policy. Here again, recent developments are encouraging. I welcome Mr. Mirakhor's indication that the authorities will stand ready to impose direct credit controls, if necessary, to achieve compliance with the credit ceilings. This, of course, can only be an interim solution, pending the strengthening of indirect monetary policy instruments. Ensuring positive rates of return will require determined efforts. I note the authorities' concerns regarding further increases in nominal interest rates, and I agree that the health of the financial system is an important consideration in this regard. Careful monitoring of all relevant factors will be needed. Here, the recent slowdown in inflation is very encouraging. Positive rates of return will ultimately enhance efficiency and intermediation, and improve the health of the financial sector.

Iran's delicate external position continues to be an area requiring particular attention. The authorities are to be commended for placing the highest priority on effecting debt service on schedule. Here, I welcome the indication in the supplement to the staff paper that all remaining arrears will be cleared by December. A more determined approach to external sector liberalization, however, is needed for enhancing efficiency as well as instilling confidence. While the past few years have witnessed a rather pendular approach to exchange rate policy, one must recognize that strides have been made toward reducing distortions emanating from the exchange rate regime. Against this background, Iran is now closer and better placed to move toward a unification of the exchange rates. An early removal of exchange restrictions will also be an important element toward enhancing efficiency.

On structural reforms, important progress was made, although the agenda remains large and challenging. Clearly, many of the issues in the area of structural reforms are intertwined. A coherent and mutually consistent strategy will therefore be critical for success in this area. While the pace of privatization lost momentum, I am encouraged by the authorities' intention to form a more efficient modality for moving ahead in this area. I hope that outstanding issues will be resolved at an early date. This will also enable the establishment of an ambitious privatization agenda.

In conclusion, the Iranian authorities' have made good strides toward reducing macroeconomic imbalances and enhancing efficiency. However, the challenges ahead are numerous. A consistent package of reforms will be an important element toward providing the basis for unleashing the country's impressive economic potential. I wish the authorities success.

The staff representative from the Middle Eastern Department stated that, while, thus far in the fiscal year, fiscal developments had been more positive than expected, the quasi-fiscal losses had not been covered in government expenditure. That was an important area for achieving the targeted fiscal deficit. The staff and the central bank were a bit concerned about the magnitude of the provision in the budget for quasi-fiscal losses. The authorities were taking some additional measures to try to cover them, such as reducing government expenditure in other areas.

Mr. Mirakhor added that the quasi-fiscal operations account had now been closed, and the operations related to it had been integrated into the budget. That account was terminated in 1995/96. He understood that it was the staff's view that not all of the fiscal operations had been taken into account in the budget for the current year. If there were to be any further quasi-fiscal operations, for example, as a result of exchange losses, ways would need to be found to cover them in the budget.

The staff representative from the Middle Eastern Department stated that there were a number of fast-acting measures that could be considered to develop non-oil revenues, such as the customs tariff reform that was presently before the Majlis. Better tax administration, changing the exchange rate for customs valuation purposes to the rate actually prevailing for the imports, and changing specific excise taxes to an ad valorem basis would also serve to raise revenue quickly.

The authorities had discussed with the staff the implementation in the long term of a value-added tax, the staff representative continued. Preparations were going forward to present that to the Majlis in due course. Also in the long term, a change in the taxation of the foundations might be contemplated, so that more revenue could be realized from them.

Nevertheless, the need for increasing revenue from domestic petroleum product price increases should not be underestimated, the staff representative considered. The staff believed that it would be feasible to raise those prices over the period of the Second Five-Year Plan to the prevailing ex-refinery prices in some major refining centers. That not only would provide resources for the budget, but also could improve efficiency, increase the exportable surplus, and have beneficial environmental effects. Also, revenue from the increase in oil product prices would be important in funding, within the budget, a comprehensive social safety net, on which the Fund and the World Bank had been providing technical assistance, and which the staff believed was very necessary. Such a social safety net would, inter alia, provide respite for low-income groups that were benefiting from commodities imported at present at the official exchange rate, groups that would likely be hurt if the exchange system were unified.

Regarding what would happen to the banking system if there were to be large changes in interest rates or other structural changes, the staff believed that revenue from increased petroleum product prices might be used to restructure banks if that became necessary, the staff representative said. In that connection, the Fund had been providing technical assistance to the Central Bank in the area of bank supervision.

The authorities had clearly embarked on reducing inflation as a means of bringing interest rates to a positive real level, the staff representative concluded. In the staff's view, that needed to be accompanied by increases in the rates of return in themselves. The steady upward creep of velocity that had taken place gave evidence of the need to raise real returns, which would improve resource allocation, but mandatory allocation of credit to various sectors was still occurring.

Mr. Geethakrishnan made the following statement:

> At the outset I would like to complement the Iranian authorities on the various policy stances adopted since 1989, policy stances which have led to an average growth rate of 7 percent, diversification of domestic output and improved social indicators. These are areas where there seems to be good understanding between the authorities and the staff.

Mr. Mirakhor's statement is also very helpful in situating the policy stance against the broader perspective.

In my view the most urgent task before the Iranian authorities is the reduction of inflation which was at 35 percent in 1994-95. Considering that there is little room for maneuverability in both fiscal and exchange rate policies in the present conditions, it is the monetary policy that would need to be effectively used as the main instrument for containing inflation and stabilizing the economy. In this respect credit controls which have been suggested by the staff are of vital importance. We would caution against introducing, in haste, indirect instruments and would recommend the adoption of more direct instruments in order to enhance the efficiency of monetary policy at this stage. While the rate of return on deposits needs to be improved we concur with the authorities that increasing the interest rates at the present juncture may not be the optimal solution. Higher interest rates could fuel inflation. We would encourage the authorities to improve control and supervision of banks.

While we appreciate efforts to unify exchange rate, it has to be noted that the drastic depreciation of the currency in the last two years has had considerable adverse impact on domestic price levels. Viewed in this context measures that could lead to further depreciation of the currency merit to be examined with care and caution.

Mr. Mirakhor has explained as to how the sudden increase in the fiscal deficit is solely attributable to the Government's assumption of obligations arising out of the sizeable exchange rate devaluation. In the efforts for reducing the fiscal deficit from 4.9 percent of GDP in 1994-95 to 1.8 percent in 1995-96 revenue enhancing measures are to be the major factors. I would like to emphasize the need for focusing even more on this area.

While the authorities are to be commended for lowering expenditure from 31 percent of GDP in the earlier year to 26 percent in 1995-96 while at the same time increasing capital expenditure; this also underlines the limited scope for further contraction on the expenditure side without adversely impinging on the allocations for social safety net measures so vital for protecting the low-income groups.

One last point before I close. In Iran the savings ratio is quite high at 30 percent, with private savings at nearly 27 percent. This indicates the confidence of the private sector in the future of the Iranian economy. But the point remains that such high savings ratio should in the normal course have enabled achievement of a much higher growth path. Obviously there is considerable scope for improving the incremental capital output ratio. It will be useful to analyze the trends in the incremental capital output ratio and see what changes need to be brought about for securing an improvement in this area.

We wish the authorities success in all their endeavors.

Mr. Saito made the following statement:

I wish to commend the Iranian authorities for the significant progress made during the program of reconstruction and economic reform in the context of the First Five Year Development Plan. The implementation of the plan resulted in an average GDP growth of 7 percent, greater diversification of the agricultural production, and a significant expansion of non-oil exports. Notwithstanding the latter, macroeconomic imbalances reappeared during the second half of the plan period and some structural issues remained still unresolved, which makes the medium term more challenging and complicated.

I agree with the staff that in order to improve the effectiveness of policy implementation, the authorities should make an appropriate use of policy instruments by directing them to those task to which they are more effective. In this regard, monetary policy, supported by a strong fiscal package should be directed to restore macroeconomic balance, structural reforms should aim at increasing productivity and transparency and a well-targeted social safety net directed at protecting the low-income groups.

Since I am in broad agreement with the staff appraisal, I will limit my remarks to a few issues for emphasis.

On the macroeconomic side, I am concerned about the resurgence of inflation in 1994/95 and early 1995/96. In this connection I share the view of the staff that a stronger stabilization program, complemented by far-reaching structural reforms, is required. In this regard, I welcome the authorities actions to implement tight fiscal and credit policies during the first part of fiscal year 1995/96. The information contained in Mr. Mirakhor's illustrative statement as well as in the staff's supplementary information paper are convincing that the Iranian authorities are adhering rigorously to their program.

On the external sector, I welcome the decision of the authorities to normalize relations with foreign creditors, reducing sharply the arrears accumulated during the period 1992-1994. Like other Directors, I encourage the authorities to continue this process of normalization and to complete the regularization of external payment arrears. In this context, it is reassuring to know, as noted by Mr. Mirakhor in his statement, that Iran has serviced all new external obligation maturing in 1994/95 without delay. Regarding Iran's foreign exchange rate policy, as the experience of other countries (including my own during the 1980s) shows, the use of the exchange rate policy as an instrument to support low-income groups is inefficient and can prove to be very costly. Thus, I agree with the need to unify the exchange rate and exhort the authorities to eliminate the surrender requirements as soon as the enabling circumstances are in place.

In relation to the medium and long term, the decision to implement a Second Five Year Development Plan starting in 1995/1996 is welcomed. I am also pleased with the elements incorporated in the plan: namely the resumption of reforms initiated during the first plan; an improvement of the fiscal sector balance, including a more adequate approach to the petroleum price policies; an appropriate management of the monetary instruments aimed at a reduction of the broad monetary growth according to the inflationary target; and the unification of the official exchange rates.

Finally, I share the view that a crucial element of the reform process is the elimination of distortions, particularly, in the exchange rate system, domestic oil product market, and the banking system. In this connection, in order to ameliorate the effects of these corrections on the poor sectors of the population, it is critical to design and implement a well-targeted social safety net program, which should be an integral part of the reform process.

With these remarks, I wish the Iranian authorities success in their difficult endeavors.

Mr. A. R. Ismael made the following statement:

We are encouraged by the generally positive developments in the Iranian economy, over the past two years, as indicated in the staff report and Mr. Mirakhor's informative statement. The strong determination of the authorities to implement the measures envisaged in their plan have helped to reduce significantly fiscal imbalances, and improve the external account. We commend the authorities for these achievements, as well as for the remarkable progress made regarding the regularization of external arrears.

Overall, we are in broad agreement with the staff appraisal and with the recommendation that in view of the existing macroeconomic imbalances, the authorities should formulate and implement a strong package of mutually reinforcing stabilization and structural reforms. In the fiscal area, while expenditure-reducing measures, especially of subsidies should be given attention, there appears to be room for additional revenue-raising measures as well as broadening of the tax base. In this respect, we are very much encouraged by the indication in Mr. Mirakhor's statement that his authorities plan to convert all excise taxes to ad valorem taxes and to introduce soon a value-added tax. Like others, we also encourage the authorities to adopt a market-related exchange rate for customs valuation.

As regards monetary policy, we welcome the authorities' intention to strictly control domestic credit. We have noted the wide range of instruments envisaged to ensure that the credit ceilings are met, and we agree with the staff that the Bank of Markazi should consider imposing direct credit controls, if necessary.

On the issue of interest rates, we have noted the recommendations of the staff for further increases in the nominal rates so as to make the rates positive in real terms. However, in view of the weak economic activity, the difficulties of the financial system, and the set of interrelated factors that have caused inflation to increase, as noted by Mr. Mirakhor, we would agree that it might be more prudent to see the impact on inflation of the wide range of measures that have been recently taken, before deciding on any further action. In this regard, the indication in the staff supplement of a deceleration of inflation from 7 percent a month in April-May to nil in June-July is very encouraging. I wonder if these latest developments have caused the staff to adjust their inflation forecast for 1995/96, and also their recommendations regarding interest rate policy.

In the external sector, we welcome the sharp reduction in external arrears, and the objective of a surplus in the current account balance. On the exchange rate issue, we would join others in encouraging the Iranian authorities to consider unification of the exchange rate as soon as conditions permit. In the meantime, and in support of the present exchange rate policy, tight fiscal and monetary policies should be maintained.

On structural reforms while noting the important progress made, we urge the authorities to continue their efforts toward privatization and to take steps to remove relative price distortions.

Mr. Mozhin made the following statement:

I shall be brief. It seems to me that the proper balance between administrative and market-based economic management has yet to be found by the Iranian authorities. On the one hand, Iran restored the practice of multiple exchange rates, slowed down the pace of privatization and continues to rely on such methods as "moral suasion" in macro-economic management (including in ensuring commercial banks' compliance with established credit ceilings, as indicated in Mr. Mirakhor's helpful statement). On the other hand, the country has recently achieved considerable progress in reducing inflation through tight fiscal and credit policies, and has regularized the bulk of its external payments' arrears and resumed normal relations with most of its creditors.

I note from an update to the staff paper (SM/95/233 Supplement 1, 09/28/95) that in the four months since end-March an annualized surplus equivalent to 2.7 percent of GDP was registered in the accounts of the General Government. Moreover, consumer prices in Iran remained unchanged over June-July, while earlier in April-May the monthly rate of increase was 7 percent. This remarkable progress in achieving price stability suddenly rendered positive the real rates of return on bank deposits, which remained negative in Iran for a long time. Combined with a relatively large surplus in the current account of the balance of payments and an increase in the central bank's external reserves to about 4.8 months of imports, these recent developments create a favorable environment for implementing a number of difficult policy measures in the structural area that have been planned by the Iranian authorities in the framework of the Second Five-Year Development Plan. Therefore, the Iranian authorities are encouraged to consider an earlier than planned unification of the exchange rates, implementation of further adjustments of domestic energy prices closer to the world market levels, and adoption of a socially acceptable privatization strategy.

As I agree with the staff on their main policy recommendations, I would like to conclude on this note and wish the Iranian authorities continued success.

Mr. Schlitzer made the following statement:

I wish to associate myself with other speakers in congratulating the staff for two excellent papers and in commending the Iranian authorities for embarking upon a serious program of reconstruction and reform, as well as for their commitment to meeting their external obligations and normalizing relations with creditors.

As the staff papers and Mr. Mirakhor's useful statement indicate, recent economic developments in Iran are encouraging in many respects. However, a number of distortions and rigidities remain in the economy, which make future developments highly uncertain. At this stage of the discussion, I will only add a few remarks.

First, on the adequacy of the statistical information provided to the Fund for the purpose of surveillance. The staff assessment in this regard indicates that the statistical information provided to the mission was sufficient to achieve a "realistic" description of current as well as future economic developments in the Iranian economy. However, notwithstanding the progress made so far in the provision of statistics, serious deficiencies remain, especially as concerns the area of external financing and that of bank financing of the public budget. Hence, I would like to encourage the Iranian authorities to make every effort to improve the adequacy of the official statistics.

Second, on fiscal policy. I agree with the staff that a number of critical factors, on both the expenditure and the revenue side, might give rise to serious slippages. In this connection, I note that there is a significant difference between the authorities estimated fiscal deficit for 1995/96, equal to 0.1 percent of GDP, and that of the staff, equal to 1.8 percent of GDP in the baseline scenario. I am also somewhat confused as how to interpret the new information circulated in the Supplement. Does the positive performance registered in the first four months of the fiscal year 1995/1996 imply a change in the staff projections, as well as in the authorities' projections? Is there now a larger consensus on the size of the 1995/96 fiscal deficit between the staff and authorities? I would appreciate some clarifications by the staff on these points.

Third, on monetary policy. Here, the main problem is related to the effectiveness of the central bank control on credit to banks, which is hampered by the low rate of return on government bonds. I can go along with the staff suggestion that the imposition of direct controls might prove useful for the time being. It should be clear, however, that these can represent only a temporary device, and that the authorities should aim at improving the effectiveness of the indirect instruments of monetary policy.

A related problem is that of the very low nominal interest rates and associated negative real rates. In this regard, I agree with the authorities that a positive real interest rate should be accomplished primarily through the reduction of inflation. However, I can hardly understand their view that large increases might be misinterpreted by the market, bringing about a rise in inflationary expectations.

Finally, I would like to encourage the authorities to maintain and possibly speed up the pace of structural reforms, especially in the fields of public enterprise privatization and the social safety net, and to specify a clear timetable for the removal of the remaining restrictions on foreign exchange.

With these remarks, I wish the Iranian authorities every success in their future endeavors.

Mr. Shields made the following statement:

I share others' concerns about developments over the last couple of years. It is good to see the external arrears position improved substantially, but some of the methods taken to achieve this have been draconian, in particular what has been done on the exchange rate front. That amounts essentially to rationing, and has had considerable implications for resource allocation, with some medium- as well as short-term costs. I share others' desire for the authorities to move quickly in the direction of achieving an exchange rate unification at market-related rates as soon as possible.

While some progress has been made on the fiscal side, the authorities need to look much harder at revenue-raising measures, including by moving domestic energy prices more toward the levels in other countries in similar situations. General revenue-raising measures are also needed. Better social safety nets will be needed to deal with the consequences of some of the other actions.

With respect to monetary policy, there has been support from various quarters for direct credit controls. I am not particularly attracted by that, but even if that does happen, there still seems to be a need to pursue the rest of monetary policy in at least some semblance of a market-related fashion, which requires the equivalent of positive real interest rates. Otherwise, the prospects for positive growth in the short term will be disappointing. In fact, I am not sure whether the outturn for non-oil exports will be as positive as the staff projects.

Many structural issues remain to be addressed. I would single out the financial sector, and in particular, the need for better banking supervision, especially in light of the high rate of inflation and what might happen if positive real interest rates materialize. Banks must have adequate capital, and prudential standards must be observed.

The staff report notes the prospects for large and rapidly increasing inflows of foreign direct investment, which have been at a low level--if not negligible--until this year. I wonder whether that is rather optimistic. Mr. Abbott expressed concerns about the quality of the data, and in particular about the total for external debt--$23 billion in the staff report. I would have thought that it would be higher than that.

Some speakers have noted that it has been a full two years since the last Article IV consultation discussion with the Islamic Republic of Iran. I regret the considerable delay in bringing the Article IV consultation to the Board for consideration. The gap between consultations should not be unduly long.

Mr. Dlamini made the following statement:

Following the successful implementation of the first five year development plan that ended in 1993/94, the Iranian economy has been experiencing more intensified economic and financial imbalances which have been exacerbated by weak international oil prices and an unfavorable external environment arising from sanctions. Besides, the bunching of external debt obligations have exerted further pressure on the balance of payments. Thus, with the emergence of external payment arrears it is not surprising that the authorities have reoriented their policies in order to rapidly regularize relations with their creditors. The authorities deserve to be commended for their determination to unwind these arrears, albeit at the cost of a substantial compression of imports that would restrain medium-term growth.

Nevertheless, I am encouraged that this resolve has led to the conclusion of negotiations to reschedule Iran's debts with its major creditors. With the strict adherence to their stabilization program, the country has accumulated a comfortable level of reserves that should make it possible for the authorities to meet the rescheduled debt obligations in a timely manner.

I am in broad agreement with the staff appraisal and I will limit my remarks to two issues. First, while accepting the staff recommendation that the current stabilization and structural policies, with the emphasis on further fiscal consolidation, need to be reinforced, I am less concerned about the risk of slippages in budget implementation. I note that, apart from the revenue strengthening measures already taken and those that could be implemented administratively without undue delays, the authorities have in place quarterly reviews which could be a powerful tool for effective monitoring of budgetary developments. As a matter of fact, in his very helpful buff statement, Mr. Mirakhor has indicated that such monitoring is carried out jointly by the Central Bank and the Ministry of Finance on a daily basis. These reviews should enable the authorities to take necessary corrective action whenever adverse developments emerge. Besides, I have also learnt from Mr. Mirakhor's buff that Parliament has barred any recourse to deficit financing through the Central Bank. All this should significantly minimize the risk of serious fiscal slippages.

Second, I also share the staff advice that the authorities should put in place a more transparent social safety net system that is well targeted at the most vulnerable groups. To that end, I am encouraged that both the Bank and the Fund have offered technical assistance for the development of a more efficient delivery system which the authorities have found to be useful. However, caution should be exercised to avoid sudden withdrawal of current and entrenched subsidies that could provoke unnecessary social and economic dislocations. In the meantime, the authorities should be encouraged to continue removing the implicit subsidies.

With these brief remarks, I wish the Iranian authorities well with the economic management.

Mr. Keller made the following statement:

I broadly agree with the staff analysis and policy advice.

We acknowledge the substantial efforts undertaken by the Iranian authorities toward economic stabilization under difficult circumstances, and their encouraging results. The focus on the normalization of relations with external creditors with a view to reestablish a strong debt service record is particularly welcome. This effort will be proving helpful for Iran to improve its international financial standing.

However, being well aware that this economy is not operating under normal conditions, the staff report recalls this fact when describing numerous distortions in the economy, and Mr. Abbott has given us an exhaustive list. In this sense, the staff report could also be read as an assessment of some of the consequences of the given situation. Indeed, external pressures are taking a heavy toll in several respects and sometimes require counteracting policies from the authorities which they might otherwise not endorse. But it is regrettable that it is again the population which is carrying the full burden.

We note that some staff recommendations take into account the special circumstances, for example when commenting on second-best solutions or more gradual policy approaches than usual in key areas, such as energy pricing or example mandatory credit allocation. The staff recommends that only the scope of mandatory credit allocation be reduced "in order to lay the foundation of a more market-oriented banking system". This appears in contrast to our discussion on this issue last Friday with regard to Ukraine. It would be interesting to know from the staff to what degree the circumstances in the case of Iran do allow for apparently greater Fund tolerance with regard to deviations from optimal policies without impinging on the principle of even-handed treatment of Fund members.

One last remark concerning Table 55 on the last page of the background paper on recent economic developments: this table reflects the caveats of debt consolidation procedures outside the Paris Club, which in this case was to the detriment of Switzerland, while favoring large countries.

The staff representative from the Middle Eastern Department stated that, in order to raise productivity, the authorities had undertaken some expenditures to improve education. Secondary education enrollment had risen, which was cause for optimism. Structural reforms and changes in relative prices--including petroleum product prices and banks' rates of return and rates of charge--should also raise productivity.

The staff had projected a fiscal deficit for 1995/96 of 1.8 percent of GDP, compared with a somewhat lower estimate by the authorities, the staff representative commented. The difference was explained largely by the expenditures related to provisioning for foreign exchange losses; the staff believed that the outlays for foreign exchange losses would be higher than what had been put in the budget. Another difference--of the order of Rls 900 billion--was the accounting for the measures that remained to be taken on import tax increases.

The staff's projections of foreign direct investment reflected the discussions with the authorities, the staff representative explained. A number of investment projects were under way, including a large joint venture buyback oil project. The authorities had also put out for tender 12 other areas for oil exploration on a buyback basis. In making the projections, there was a counterpart entry on imports that corresponded to the amount of foreign direct investment. If that entry were made either larger or smaller, the amount for imports would be adjusted accordingly.

There were often press reports from Tehran stating that the stock of debt was somewhat larger than the staff's estimate, the staff representative concluded. The authorities periodically prepared a summary table with three elements: the stock of debt--or the principal--the interest due on the stock of debt, and debt contracted but not yet disbursed. When those three elements were added together, a much larger figure resulted--about $30 billion. The figure on disbursed debt was the figure that had been included in the staff report.

Mr. Mirakhor stated that the authorities considered that the international financial markets were unlikely to represent a level playing field for Iran for some time to come. For that reason, they would have to rely on the mobilization of domestic resources. The authorities were also anxious to remove price distortions, particularly in terms of implicit and explicit subsidies. They were operating on the premise that, should inflation fall, there would be greater scope for moving faster on the adjustment of energy prices. The authorities had requested a 400 percent price increase from the parliament, but the parliament was concerned that that would add to the inflationary momentum, and that the time was not yet ripe for it. When inflation pressures were reduced, the authorities would reconsider energy price increases. In that connection, as Mr. Ismael had pointed out, it needed to be borne in mind that the last doubling of domestic energy prices had caused considerable concern among the population, especially as it had taken place at a time of existing high inflation.

That notwithstanding, the authorities were aware of the potential for raising revenues by increasing the prices of petroleum products, Mr. Mirakhor continued. Anywhere from $5 billion to $8 billion a year could be raised by adjusting the price of energy and reducing direct subsidies. However, the ground would have to be prepared well for that; but the authorities intended to move in that direction. It was now just a question of time.

There had not been a considerable difference of opinion between the staff and the authorities, Mr. Mirakhor emphasized. The final objective of the staff policy recommendations converged with those of the authorities, in fact.

The Iranian authorities were very sensitive to the Board's advice, and he would convey faithfully to them the key points that had been made in the discussion, Mr. Mirakhor concluded. The policy actions that the authorities had taken since the preceding Article IV consultation bore witness to the usefulness of the Fund's advice and the fact that that advice had been fully taken into account.

The Acting Chairman made the following summing up:

> Executive Directors were in broad agreement with the staff appraisal. They observed that the policies implemented during the First Five-Year Development Plan had led to a number of positive achievements, including high growth, larger and more diversified agricultural output, rapid growth of non-oil exports, and improved social indicators. Noting the importance of servicing external debt in a timely manner, Directors welcomed the steps taken by the authorities to regularize arrears and their commitment to service debt on time. However, Directors expressed concern that serious financial imbalances remained and that structural reforms were being pursued in a piecemeal fashion. A number of Directors emphasized that the reduction of inflation was the most urgent task of the Iranian authorities.
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> Directors emphasized the importance of further strengthening fiscal and credit policies and accelerating structural reforms. In particular, they noted that the key element in any fiscal program should be to strengthen the revenue base, including by bringing domestic oil product prices to international levels quickly, even though the political and social difficulties involved were recognized. Directors emphasized that non-oil revenue sources needed to be broadened and the tax system overhauled over the medium term. They also considered that there was a need to implement a well-targeted and comprehensive social

safety net within the budget, in part so that the exchange system was no longer relied on to provide implicit subsidies.

Directors considered that further tightening of monetary policy was needed. They stressed the importance of achieving and maintaining positive real rates of return so as to reverse the steady climb of velocity and encourage intermediation. Directors agreed that reliance on mandatory credit allocation should be reduced, and prudential supervision of banks and nonbank intermediates strengthened, in order to facilitate a more market-oriented banking system. However, pending the further development of indirect monetary policy instruments, they recognized that the use of bank-by-bank credit ceilings could be useful.

Directors recommended that the authorities pursue an exchange rate policy that would respond quickly to market conditions, and called for early action to unify the exchange rates. In that regard, Directors took note of the authorities' intention, as reported in Mr. Mirakhor's statement, to review the adequacy of the export exchange rate by March of 1996, and hoped that the authorities would seize the opportunity to unify the rates at that time, and to specify a timetable for the early removal of exchange controls.

Directors commended the authorities' determination to regularize external arrears and service rescheduled and other external debt without incurring further arrears. This underscored the importance of an early strengthening of macroeconomic policies in view of Iran's difficult external environment and the obligations coming due over the next few years.

Directors emphasized the need for strengthening structural policies to reinforce the stabilization effort. In addition to early further action to raise domestic energy prices, they particularly encouraged the authorities to develop a new plan for continuing privatization.

Directors welcomed the improved provision of information, but noted that deficiencies in areas of the capital account of the balance of payments and economic classification of government spending remained. They advised further actions to remove these deficiencies.

Some Directors expressed their disappointment at the delay in the conclusion of the 1995 Article IV consultation with Iran owing to scheduling difficulties, but welcomed plans for close cooperation between Iranian officials and Fund staff through periodic visits.

The next Article IV consultation will be held on the standard 12-month cycle.

4. EXECUTIVE DIRECTOR

At the informal meeting on the Joint Bank/Fund Note on Multilateral Debt held on October 2, 1995, the Managing Director bade farewell to Mr. Al-Jasser on the completion of his service as Executive Director for Saudi Arabia.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/95/95 (9/29/95) and EBM/95/96 (10/2/95).

5. SIERRA LEONE - EXCHANGE RESTRICTION - EXTENSION OF APPROVAL

The retention by Sierra Leone of the exchange restriction evidenced by certain external payments arrears is approved until the next Article IV consultation with Sierra Leone or December 31, 1995, whichever is earlier (EBD/95/120; and Sup. 1, 9/27/95).

Decision No. 11085-(95/96), adopted
September 29, 1995

6. OFFICE SPACE - PHASE III - FITOUT BUDGET - PART ONE

1. Appropriations for the construction of Part One of the Phase III Fitout work associated with the base construction of the Phase III addition to the headquarters building and associated design services and project operations, as described in EBAP/95/77 (9/26/95), are approved in the total amount of $11,800,000.

2. No commitment will be made that causes the total budget of $11,800,000 for Part One of the Phase III Fitout to be exceeded without prior approval by the Executive Board.

Adopted September 29, 1995

7. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/95/81 (9/29/95) is approved.

APPROVAL: April 9, 1997

REINHARD H. MUNZBERG
Secretary