

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

MASTER FILES
ROOM C-525

0404

October 25, 1995

Approval: 11/1/95

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 94/94

10:00 a.m., October 21, 1994

Contents

Attendance	Page 1
1. Saudi Arabia - 1994 Article IV Consultation	Page 3
2. St. Vincent and the Grenadines - 1994 Article IV Consultation	Page 50
Decision Taken Since Previous Board Meeting	
3. Executive Board Travel	Page 61

Executive Board Attendance

P. R. Narvekar, Acting Chairman
A. D. Ouattara, Deputy Managing Director

Executive Directors

M. Al-Jasser

H. Evans
K. P. Geethakrishnan

D. Kaeser

K. Lissakers

H. Mesaki
A. Mirakhor

G. A. Posthumus

A. S. Shaalan
D. E. Smee

Zhang M.
A. G. Zoccali

Alternate Executive Directors

A. A. Al-Tuwaijri
M. Sirat
E. Srejber

S. Arifin, Temporary

R. N. A. Ally, Temporary
A. V. Mozhin
J. Jonáš, Temporary
N. Coumbis
J. B. Wire, Temporary
A. Galicia, Temporary

M. Daïri
J. O. Aderibigbe, Temporary
O. Havrylyshyn
Y.-M. T. Koissy
E. Wagenhoefer

H. Petana, Temporary

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

Also Present

IBRD: M. E. Tadros, Middle East and North Africa Regional Office. External Relations Department: S. J. Anjaria, Director; A. M. Abushadi, C. Hellemaa. Legal Department: J. K. Oh. Middle Eastern Department: P. Chabrier, Director; S. H. Hitti, Deputy Director; T. Enger, S. N. Erbas, Z. Iqbal, M. D. Knight, A. Mazarei, B. Mukhopadhyay, S. E. Williams. Policy Development and Review Department: J. T. Boorman, Director; C. F. Adams, M. Allen, C. Puckahtikom, J. P. Pujol, S. K. Wajid. Secretary's Department: R. S. Franklin, K. S. Friedman. Statistics Department: P. L. Joyce. Treasurer's Department: K. Udovicki. Western Hemisphere Department: C. M. Loser, Deputy Director; A. S. Linde, J. Thornton, E. S. Williams, G. Yadav. Office of the Managing Director: S. Sugisaki, Special Advisor; M. A. El-Erian, J. Prust. Advisors to Executive Directors: J. M. Abbott, M. A. Ahmed, R. F. Cippa, S. K. Fayyad, T. K. Gaspard, G. Y. Glazkov, Y.-H. Lee, M. F. Melhem, R. Rainford. Assistants to Executive Directors: S. E. Al-Huseini, T. Berrihun, J. W. Dagustun, G. Z. El-Masry, S. S. Farid, R. Ferrillo, A. Guennewich, R. Glennerster, H. Golriz, M. A. Hammoudi, O. A. Himani, G. H. Huisman, T. Kanada, A. M. Koulizade, T.-M. Kudiwu, K. J. Langdon, G. A. Sanchez, V. Trivedi, A. Viirg, Wang X.

1. SAUDI ARABIA - 1994 ARTICLE IV CONSULTATION

Executive Directors considered the staff report for the 1994 Article IV consultation with Saudi Arabia (SM/94/249, 9/27/94). They also had before them a statistical appendix (SM/94/250, 9/28/94).

The Director of the Middle Eastern Department said that he had received the World Bank's revised social and demographic indicators, which would be included in a corrected report to be issued soon. The size of the population at the end of 1992 had now been estimated at 16.8 million. However, those changes would not modify the staff appraisal.

Mr. Al-Jasser made the following statement:

In line with my authorities' long-standing objective of diversifying the economic base, Saudi Arabia's economy has undergone a remarkable transformation over the past two decades. A modern economic infrastructure has been built and a large stock of human capital has been developed, laying the foundations for sustainable private sector growth. Indeed, value added by the private sector has increased from SRls 10 billion in 1973 to SRls 165 billion in 1993. Moreover, non-oil exports have expanded substantially from \$26 million to \$3800 million. Significant progress has also been made in broadening and deepening the financial market.

This transformation has been greatly facilitated by a commitment to a market-based economy with a liberal exchange and trade system, as well as prudent macroeconomic policies. In this connection, during the 1970s and early 1980s, substantial foreign assets were accumulated in order to build a cushion to help smooth out government finances as oil revenues fluctuated.

These reserves proved invaluable during the decade of the 1980s as they allowed for an orderly adjustment in the face of the drastic fall in oil prices. The thrust of the adjustment was predicated on a policy of sustained fiscal restraint. As a result, expenditures in nominal terms in 1989 were cut to almost half their level in 1981 and the external deficit was contained (Chart 1). ^{1/} At the same time, private sector activity continued to expand in a noninflationary environment, although at a more moderate rate.

Unfortunately, this orderly adjustment process was interrupted in 1990 by the Gulf War and its aftermath. Besides disrupting private and public investment, this crisis has led to strong pressures on the budget and the balance of payments. Even

^{1/} See Annex.

now, three years after the end of the Gulf War, the fiscal and the balance of payments accounts continue to be affected by decisions and commitments made during that period.

This interruption notwithstanding, my authorities moved quickly and decisively to put the adjustment process back on track. Expenditure reduction resumed, and by 1993 expenditures were 18 percent lower than their 1990-91 average level. As a result, the fiscal deficit was reduced from an average of 17 percent of GDP in 1990-91 to 10 percent of GDP in 1993. This was achieved despite the unanticipated sharp decline in oil prices, particularly in the latter part of 1993. What is noteworthy is that in spite of the substantial cuts in government expenditures over the past two years, private sector activity continued to expand albeit at a somewhat slower pace. This development provides further evidence of the weakening linkage between public expenditures and private sector economic activity. This is a clear indication of the increased maturity of the private sector. Such development should also greatly facilitate fiscal management over the medium term.

The reduction in oil prices in 1993 notwithstanding, my authorities have renewed their resolve to adjust the economy further; the fiscal deficit was budgeted to decline by 3 percentage points of GDP in 1994 in spite of a budgeted fall in oil revenues by some 21 percent. This major consolidation effort is to be achieved primarily through a 20 percent cut in expenditures. Although recognizing that a reduction of such magnitude is an ambitious undertaking, my authorities view it as an essential step to eliminate inefficiencies, concentrate spending on priorities, and set the stage for achieving further expenditure cuts in the future. In this connection, subsidies are to be reduced by some 34 percent in line with the vigilant efforts to encourage an efficient and self-reliant private sector. Expenditures on supplies and services are also to be reduced substantially. The Government has been renegotiating a number of contracts with suppliers in order to achieve a reduction in costs by an average of 20 percent through postponing or eliminating the less essential components of these projects. As noted in the staff report, these negotiations are fully consistent with the legal framework of all government contracts.

Preliminary data for the first half of 1994, which I have just received, clearly indicate that the adjustment is well on track. Expenditures in the first half of the year amounted to SRls 72.6 billion--33 percent less than in the same period of 1993--compared to a budgeted figure of SRls 152.6 billion for the whole year. Revenues amounted to SRls 54.6 billion in the first half of the year compared to a budgeted figure of SRls 120 billion for the whole year. Owing to higher average oil prices, it is

expected that revenues will improve in the second half of the fiscal year. Average oil prices in the third quarter were about 13 percent higher than in the first half. On the external side, data for the first six months indicate a better than expected picture. The current account deficit for the first half of the year amounted to \$7.3 billion, compared with a staff projection of \$16.8 billion for the whole year. This development along with an improved outlook for oil prices in the second half of the year bodes well for the external sector. In the meantime, investments by the private sector have accelerated, and there are strong indications of a pickup in private sector activity while inflation remained very low at less than 1 percent on an annual basis.

Despite the sizable adjustment effort, my authorities are cognizant of the need for further fiscal consolidation over the medium term. Indeed, as noted in the staff report, they stressed that, irrespective of oil price developments, the expenditure-reduction and rationalization measures initiated in 1994 would be continued in the context of the Sixth Development Plan, 1995-99. This should help restructure the budget with a view to reducing implicit and explicit subsidies and enhancing non-oil revenues.

The fiscal consolidation efforts will continue to be supported by a prudent monetary policy aimed at maintaining low inflation and nominal exchange rate stability, vis-à-vis the dollar. My authorities and the staff agree that a stable SR1/dollar exchange rate has served the economy well and will continue to do so. In addition, the progress made in fostering financial deepening has further enhanced the banking sector, and bank capital has increased considerably over the past year. Increased trading in mutual funds has deepened the secondary market in government paper. Moreover, in order to enhance the efficiency of resource allocation through the financial system, the specialized credit institutions are no longer receiving transfers from the budget. In fact, these institutions' claims on the nonbank domestic sector have been declining, as shown in Table 43 of the statistical appendix.

My authorities will also continue to attach high priority to supporting a self-reliant private sector through further reduction of the Government's involvement in the economy. It should be noted, however, that the Saudi Arabian economy is predominantly a market-based one with only a few activities in government hands. This latter aspect was due to historical and developmental imperatives. Nevertheless, the economy is maturing enough to allow the Government to embark on a privatization program in the context of the Sixth Development Plan. Such privatization should also have positive implications for the fiscal accounts. Public enterprises under consideration include the telephone company and the national airline, Saudia. A reduction in the Government's

equity share of the Saudi Arabian Basic Industries Corporation (SABIC) from its current level of 70 percent over the next five years is also under consideration.

On international issues, Saudi Arabia is fully aware of its systemic responsibilities as the largest oil producer in the world and will continue to be a reliable and effective participant in the international arena.

Its oil policy will continue to aim at fostering stability and predictability in the oil market. In this regard, the negative impact of discriminatory taxation of petroleum products on the stability of the oil market should not be underestimated. The rising global demand for oil will necessitate large investments in capacity building which might not materialize if excessive taxes on oil products continued to be levied by the major consuming countries.

On trade issues, Saudi Arabia remains fully committed to an open exchange and trade system. We have already applied to join the General Agreement on Tariffs and Trade (GATT), and the process of accession is well on its way. Moreover, we strongly believe that unhindered trade and capital movement are essential for global growth and prosperity. In this regard, it would only be fair if Saudi Arabia's trading partners accorded its exports the same kind of free access that it grants their exports.

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 more concessional than that provided by other donors as it consists largely of untied grants and highly concessional loans.

Finally, I wish to express my authorities' deep appreciation for the positive environment in which the Article IV consultation has been held. They attach particular importance to the views of the staff, management, and the Executive Board regarding the policy orientation of the Saudi Arabian economy.

Mr. Shaalan made the following statement:

At last year's Board discussion on Saudi Arabia's Article IV consultation report, the Executive Board pointed to the emerging fiscal and external imbalances, and called on the authorities to take medium-term corrective measures. The paper before us clearly attests to the positive response of the authorities, who have intensified their efforts in a comprehensive manner to redress the imbalances in these twin and closely related areas. The authorities clearly recognize and attach considerable importance

to the thrust of needed policy reforms in the period ahead. These policy reforms are focused on the budget--addressing both the magnitude of the deficit and its sustainability, as well as introducing specific measures aimed at diversifying the revenue base in order to address the changing economic environment in the country. The measures also include far-reaching cuts in government expenditures.

In last year's discussions, I noted that the fiscal deficit target of 3 percent of GDP for 1993 was ambitious when compared to 17 percent and 9 percent in the preceding two years. As it turned out, the deficit reached about 10 percent of GDP, a level not much changed from the previous year. Going beyond this aggregate number, however, some encouraging developments in 1993 were evident. Although the expenditure outturn fell short of their overambitious target, expenditures nevertheless declined by some 11 percent from the previous year's level, in spite of the growth in nondiscretionary outlays. All other expenditures were cut back substantially. Thus, the deficit overrun was basically caused by the unexpected decline in both oil and non-oil revenues, which together declined by some 16 percent from their budgeted level. Faced with this situation, the authorities have forcefully begun, in the current year, to address the budgetary problem. For 1994 an austere budget was promulgated effecting a 20 percent cut in expenditures. A reduction of the deficit by some 3 percent from the previous year's outturn was targeted. In addition, during the year, when the authorities anticipated certain increases in nondiscretionary outlays, they reacted by pruning discretionary expenditures further, despite an improvement in oil prices. As a result, the budget deficit is now projected at 5 percent, about one half the level of the previous year. This policy stance is a welcome change reflecting the adaptability of policy to changing conditions. Not only is this policy to be continued in subsequent years but, more important, the authorities are also intent on widening sources of government revenues to reduce the dependency of the budget on volatile oil prices. This is another significant change in the authorities' policy stance. Preliminary data provided by Mr. Al-Jasser for the first half of the current year provide grounds for optimism regarding the attainability of the targeted deficit reduction.

This takes me to the medium-term scenario that the staff outlines in broad terms in the report. The staff projects that, based on unchanged policies, the deficit ratio would remain unchanged over the medium term and the closely related external accounts would weaken further. I believe that these conclusions should be tempered by the following important considerations. First, when the authorities faced a similar budgetary problem in the mid-1980s, occasioned by a much sharper drop in oil revenues than is the case today, their policy response was swift and

decisive. Expenditures were cut sharply. The second and more important factor is the authorities' dramatic shift in policy this time around. They have clearly stated that every possible area of revenue generation or expenditure cuts would be scrutinized carefully to reduce the overdependence on oil revenues. I believe these two considerations augur well for the medium-term outlook.

On oil policy, Saudi Arabia's policy has been guided by two main considerations: to maintain adequate supplies to satisfy the rising global demand, and to moderate fluctuations in oil prices. To this end, the authorities have undertaken sizable exploration investments which are scheduled to raise production capacity by about 17 percent to 10.5 mbd by the end of this year. To accommodate rising world demand while maintaining relative price stability, it is estimated that investments of some \$100 billion would be required within the next two decades. These objectives would be difficult to attain if discriminatory taxes continue to be levied on oil products by major oil importing countries. These oil levies may appear to be an easy way to redress fiscal imbalances, but it is questionable that they are the most efficient means to effect budgetary improvements. I would echo the Saudi authorities' contention that such taxes could have an adverse impact on global economic growth.

On structural adjustment measures, the authorities' recognition of the need to proceed further in this area is reflected in the new Sixth Development Plan, 1995-99, which embodies a set of policies and objectives centered around promoting private sector-led growth in the context of a market-based economy, and including sharply reduced expenditures on implicit and explicit subsidies. I note, in particular, the reduction of subsidies associated with wheat production. Moreover, subsidized public goods and services will be priced to cover at least the cost of production.

On the issue of economic integration within the Cooperation Council for the Arab States of the Gulf (GCC), reflecting on recent consultation reports of GCC member countries, it appears that in some instances policy decisions in individual countries are constrained by the need for coordination among members. Certain important decisions that need to be taken, particularly in the areas of fiscal, monetary, and trade policy, are awaiting effective collective GCC-wide consideration. I would, therefore, encourage GCC members to actively pursue the suggestion offered by the staff to assist them in the coordination of economic policy.

As regards Saudi Arabia's record of foreign assistance, although there has understandably been a decline from the high levels of the recent past, such assistance in 1993 continued to be well in excess of the UN target and more than double that of OECD

countries. Moreover, Saudi Arabia's aid is largely untied and carries a very high grant element.

Looking ahead, and with the benefit of having led missions to this country for well over a decade, I am most encouraged by the resolve of the Saudi Arabian authorities to address the medium-term outlook. There has been a clear recognition by the authorities that the fiscal and external balances must be restored. This recognition was followed by action that covered a wide spectrum of measures that have already been introduced or are under serious consideration. I wish the authorities every success in the challenging period ahead.

Ms. Srejber made the following statement:

I am in broad agreement with the staff appraisal and, thus, I would like to concentrate my comments on what both the authorities and the staff consider to be the main problem, namely, the budgetary imbalance and the associated external current account deficit.

The staff projection for the medium term shows a rather depressing development with the budgetary deficit stuck at about 5 percent of GDP and the external current account deficit gradually rising from 13 percent to about 16 percent of GDP, if current policies continue--and that includes the authorities' tough actions to tackle the fiscal deficit by cutting expenditures in the 1993 and 1994 budgets! Of course, in the short run, Saudi Arabia has no problem in financing these twin deficits, but a further rise in the domestic debt, already judged to be at 70 percent of GDP in 1994, after a fast rise from only 15 percent of GDP in 1988, together with a further drawdown of net official foreign assets, which have decreased from \$78 billion in 1988 to a projected \$60 billion in 1994, would, as the staff rightly points out, have serious consequences for the credibility of the authorities' policies and thus, for the stability of the economy and the sustainability of the exchange rate.

The pressure against the riyal in late 1993 was a clear warning bell, although the bell was not ringing so loud at that time, and the authorities were able to calm the markets relatively easily. In this area, the experience in my own country of how market sentiment can change quickly and dramatically could be a warning.

But what should be done to address the twin deficits? I have no illusions about being able to come up with new or better ideas than the staff and the authorities, but there are some points I would like to highlight.

Let me start with stressing the need to restructure the budget. Looking first at the expenditures, the need for a change in its priorities away from nonproductive expenditure and subsidies is certainly called for. Explicit subsidies, of which the main part is different agricultural subsidies, accounted for 7 percent of current expenditure in 1993 and 5 percent in 1994. The downscaling of these subsidies is welcome as one suspects that the subsidies have contributed to keeping the agricultural sector at an artificially high level. The sector accounted in 1992 for 9 percent of GDP and 10 percent of employment.

The largest part--51 percent in 1994--of the current expenditure is, however, spent on the wage bill. The nominal amounts spent on wages have increased, although their share of the current expenditure seems quite stable over the years. Looking at Table 33 in the statistical appendix, one can see that community and social services employs an increasing share of workers--28 percent in 1983 and over 41 percent in 1994. Furthermore, Table 35 shows that about 35 percent of budget expenditure is spent on defense and security. Perhaps here one has room for increasing effectiveness and savings.

Looking at the revenues, one is struck by the dramatic decrease in investment income and by the heavy dependance on the volatile oil revenues, budgeted at 70 percent of total revenues in 1994. From the budgetary developments data given in Table 7 of the statistical appendix, I note that the revenue side has become increasingly dependent on the oil sector, with oil revenues rising in importance from 58 percent of total revenues in 1988 to 75 percent in 1993. One could even, with eye-econometrics, detect a possible relationship between income tax and oil revenue. Thus, the staff's advice on additional revenue mobilization to raise durably non-oil revenues and improve revenue stability seems well founded.

Furthermore, the basic data on Saudi Arabia in the staff report also seems to show a trend of increasing importance of the oil sector in the total GDP, contrasting with the private sector's decreasing pace and manufacturing, to which high priority is given in the attempts to diversify the productive base, very slowly increasing its share of GDP from 13.3 percent in 1988 to 14.6 percent in 1992.

Of course, one could look at Saudi Arabia's increasing dependence on oil as regional specialization. However, as acknowledged by the authorities and as already noted during the previous discussions on Saudi Arabia, the country's development strategy for the medium term should rest on the development of a diversified economic base with the private sector acting as the engine of growth. Efficient private sector growth would also, in

its turn, provide employment opportunities for the fast-growing population. In this light, the poor growth performance for the private sector is worrisome and calls for an analysis of the possible structural impediments to a successful diversification.

The high population growth, 3.4 percent in 1993, leads me to another important point in creating a positive environment for development--education! The primary school enrollment, with a total figure of only 76 percent and even lower for girls, is clearly not in line with a sustainable development strategy. Add to that an illiteracy rate of as much as 38 percent for those aged 15 and over, and I begin to wonder whether the work force really has the necessary skills to make the successful diversification into manufacturing possible. Going back to the budget expenditures, I wonder whether the manpower development expenditure--18 percent of total expenditure--also covers basic education or only specialized training.

Mr. Mirakhor made the following statement:

The staff deserves to be commended for a balanced and forthright report for the 1994 Article IV consultation with Saudi Arabia. The report contains a comprehensive overview of economic developments in 1993 and 1994, the policy options facing the authorities in the near term, and the important challenges that lie ahead. As I concur with the staff appraisal I will limit my comments to three areas: fiscal consolidation, private sector issues, and the regional approach to certain policy issues.

The year 1993 was a difficult one for Saudi Arabia. The authorities' hitherto impressive record of steadfastness in adhering to policy reform and sustained fiscal restraint was driven off course. Despite efforts to rein in budgetary expenditures, an unanticipated weakening in oil and non-oil revenues caused the fiscal deficit target to be missed by a wide margin. This was unfortunate as the resulting budgetary stance had a number of adverse consequences for domestic debt, the non-oil sector of the economy, and the external position.

The developments on the macroeconomic front in 1993, and the related pressures on the riyal have not, however, diminished the authorities' determination to tackle the root cause of the economy's macroeconomic imbalances. Indeed, if anything, the experience of 1993 has, by heightening the urgency for early and decisive action, strengthened their resolve to address more forcefully the fiscal issue. This determination is most vividly illustrated by the authorities' ambitious--but achievable--budget for 1994, which seeks to recapture the momentum of adjustment by securing a major reduction in the fiscal deficit. Mr. Al-Jasser says that, based on preliminary data for the first half of 1994,

the adjustment path in the fiscal and external areas is well on track. This is a welcome and reassuring development and strengthens the hope that the slippage in macroeconomic policies in 1993 can be quickly reversed and the economy returned to a more stable growth path.

However, far more important than the authorities' determination to tackle the immediate fiscal problem in 1994 is their recognition that a lasting solution to the process of fiscal consolidation--in an environment of uncertain oil price movements and the need to increase essential capital and maintenance outlays--cannot be found unless further expenditure restraint is matched by a commensurate and determined effort to increase non-oil revenues. The authorities' unequivocal assertion that "no aspect of revenue enhancement would be excluded from consideration" constitutes a major shift in their policy stance and is an encouraging development. We strongly support this stand; the opportunity presented by the launch of the Sixth Development Plan to implement their revised strategy should be seized. Determined actions to broaden the domestic non-oil revenue base are desirable not only from a fiscal point of view but also from the standpoint of ensuring the stability of the economy, lending credibility to the commitment to a stable exchange rate, and fostering efficiency gains in the private sector.

The authorities expect the growth of non-oil GDP in the period ahead to be increasingly driven by a growing and vibrant private sector. As Mr. Al-Jasser points out, recent years have seen encouraging signs of a lessening of the dependence of the private sector on fiscal stimulus and budget support. This trend toward greater self-reliance and a maturing of the private sector can be accelerated through the implementation of policies that allow more freedom for the operation of market forces. The decision by the authorities to enhance the process of privatizing public enterprises in the electricity, water, telecommunications, and airline industry is an important adjunct to this strategy. If privatization is to be successful and yield durable efficiency gains, it would be important to ensure that the planned strengthening in the structure of the budget and the associated move toward a more market-based approach to pricing of utilities precede the implementation of the authorities' privatization agenda.

The staff is correct in underlining the need for a regional approach to issues such as non-oil income and subsidies. For one thing, the regional approach can reduce domestic political inertia to the need for proper functioning of the price mechanism. Therefore, the staff's suggestion that an "exchange of views" take place regarding alternative economic strategies, and possible

collective action in areas where there are shared problems is most welcome. I have, however, two comments in this regard. First, the regional context should be broadened to include oil producers in the region, in addition to GCC members who also have similar problems. Moreover, proximity and contiguity make it imperative that these other countries be included in "the exchange of views" in order to ensure that possible solutions to common problems will not be undermined by distortionary factors--for example, illicit cross-border trade. Second, although the modalities of the "exchange of views" are not spelled out in the staff report, it may be useful, in the first instance, to place the staff's proposal within the rubric of technical assistance. The systemic impact of increased efficiency of resource use in the region is a clear justification for undertaking such a project.

We join the staff and other Directors in commending the Saudi Arabian authorities for continuing their generous and high-quality economic assistance under difficult circumstances and wish them success in their adjustment efforts.

Ms. Lissakers made the following statement:

Developments since the late 1980s have left Saudi Arabia with structurally weakened fiscal and current account positions. Of necessity, it is going to take some time to restore a better financial balance. The narrowness of the country's economic base limits the authorities' room for maneuver, but Saudi Arabia's vast internal and external wealth gives it the latitude to take a deliberate approach toward the necessary adjustment. An adjustment program is under way and progress has been made on fiscal adjustment over the past 18 months. Nevertheless, the message that emerges from the staff report is that a faster and more forceful fiscal adjustment is needed to assure the long-term health of the economy.

Saudi Arabia's high and rising internal debt, its eroding net foreign asset position, and its exposure to volatile oil earnings are reason enough to support the staff's basic assessment. Nevertheless, I found the analytic presentation in the staff report unclear as to what one should draw about how much adjustment has been undertaken and how much more is needed.

The expectation in the staff report is that in 1994 the budget deficit will drop from 10 percent of GDP to 5 percent of GDP. But on the external side, the current account deficit will rise from 12 percent of GDP to 14 percent of GDP. I am sure that dwindling net foreign income and rising internal debt service make a difference. However, as the Government is the heavy borrower in the economy and the major beneficiary of swings in oil revenues, I would have expected a closer correspondence between trends in the

budget balance and the external balance. One year might be a fluke, but the projections for 1994-1998 show the budget deficit being held to 4-5 percent of GDP, while the current account deficit creeps up to 15 percent and 16 percent of GDP.

If this is the likely situation, what could we expect if fiscal consolidation were pushed to the point of a balanced budget? Would the current account still be in double-digit deficit? Or conversely, if we took the view that Saudi Arabia probably should not be running a substantial current account deficit when the world demand for oil is high, what fiscal position do we think would be consistent with the current account balance?

From conversations with the staff, I have the impression that the medium-term projections are a composite of extrapolations based on assumptions of unchanged policies, and considerable guesswork about fiscal data and budgetary tendencies. This seems to have resulted in some mixing of apples and oranges, which detracts from the quality of the overall analysis.

Projections based on unchanged policies are useful for demonstrating the need for adjustment. However, in this case, significant policy adjustments have been made over the past year, and the staff report says the authorities are evaluating several further steps. It would have been useful to have had the budget and current account implications of these measures drawn out more clearly. I was particularly puzzled by the projections for the service account. The staff's projections show a secular rise in the service balance from a high base, despite the fact that service payments are one component of the current account that ought to be directly affected by a more disciplined fiscal policy.

This said, however, inadequate data availability really is a problem, as indicated on p. 17 and p. 19 of the staff report. I would hope data improvements and a fuller dialogue with the authorities might lead to a more robust analysis in next year's consultations.

Leaving aside these analytical issues, the financial figures alone support a persuasive case for the need for further fiscal consolidation. One of the medium-term developments that Mr. Al-Jasser did not mention in his statement was the buildup of internal debt. Internal debt rose from 15 percent of GDP in 1993 to 63 percent of GDP in 1998, and on current policies is expected to rise to 77 percent of GDP in 1998. Debt service is absorbing a correspondingly larger share of the budget. Interest payments, which were under 4 percent of the budget four years ago, are at 11 percent now, and headed for 13 percent. At the same time, the government wage bill has expanded and now absorbs 48 percent of

total expenditures. Secular tendencies such as these are thus making the expenditure side of the Saudi Arabian budget much less flexible than it was in the 1980s. On the revenue side, the rundown of foreign assets has reduced an important source of non-oil budgetary income. Oil revenues, however, remain volatile. In terms of keeping its own finances on even keel, it is clear that additional budget consolidation is needed.

With the budget deficit now being financed from domestic sources, some financial strains are already emerging. As the Government can readily tap the cash flow of autonomous government institutions as well as the banking system, it has been able to place its paper without difficulty. But the flip side of this is that savings accumulated in the autonomous government institutions are no longer available to rebuild foreign assets or to provide indirect financing to the private sector. In effect, government borrowing has pushed the private nonbank sector to borrow more abroad and to rely more heavily on the banks. As monetary policy is nonaccommodative, the banks have had to run down their net foreign assets to meet private credit demands.

The authorities indicate that they do not plan to undertake official balance of payments borrowing. They will confine their own borrowing to the internal market, and seek to achieve a current account balance that can be financed by autonomous private capital flows. While this policy has some conceptual appeal, in practice, it will be very hard to tell how much private borrowing is autonomous and how much is induced. Credit and savings flows through government entities are simply too large and too pre-emptive to allow residual private flows to be viewed as autonomous. Rather than guiding policy on the basis of a subjective estimate of autonomous capital flows, I believe that it would be better to have a specific objective for the budget balance, or an objective for some measure of the current account.

We can support fully the staff's specific recommendations regarding areas where the budget could be strengthened. As the problem is structural, the emphasis should be on measures that can endure rather than just across-the-board cutbacks. This will require a reprioritization of spending and new sources of non-oil revenue.

I raised a question in the U.K. discussion about the public availability of the statistical appendix. I noticed no reference in the transmittal note to the public availability. I wanted to ask the staff for clarification on this point.

Mr. Mesaki made the following statement:

First of all, regarding Saudi Arabia's systemic role, I would like to commend the authorities for their effective contribution, as the largest oil producer, to stability in the global oil market.

Let me now turn to the recent economic situation. There was remarkable economic progress in 1992 as a result of adjustment efforts after the end of the regional crisis. Unfortunately, despite the adjustment momentum, there was no economic improvement in 1993 because of the lower oil prices. Although oil prices recovered somewhat in 1994, the economic situation remains difficult. In particular, the deterioration of the external current account is worrisome.

With respect to the medium-term economic outlook, internal and external imbalances are expected to expand, and domestic debt outstanding is increasing. There are serious concerns about the overall economy from both the short- and medium-term perspectives.

As the staff report clearly states, an economic structure that relies excessively on volatile oil revenue is not sustainable. Under these conditions, it is crucial to intensify economic adjustment efforts, and embark on policy reorientation in order to redress the internal and external imbalances resulting from structural factors. It is all the more important to set priorities with regard to the development of the non-oil sector. To this end, the authorities should accelerate privatization and encourage foreign investment. I welcome the authorities' attaching a high priority to supporting private sector-led growth.

Although I endorse the staff appraisal, I wish to comment on a few areas.

The main focus of attention should be fiscal consolidation. From a short-term perspective, it is necessary to put in place expenditure-containment measures in order to reduce the fiscal deficit. I support the staff's recommendation to reduce unproductive spending and follow a prudent wage policy. In this regard, I welcome the authorities' intensification of fiscal adjustment policy in 1994 through widespread cuts in expenditure. It is also important to strengthen expenditure management through monitoring, in order to avoid expenditure overruns. Regarding revenue measures, the authorities are encouraged to enhance the revenue base of the non-oil sector. In this connection, I welcome the fact that the Development Plan, which will begin in 1995, will include fiscal strengthening measures. As the fiscal position will remain fragile over the medium term, it is important to

establish a comprehensive fiscal policy, including the rebuilding of the non-oil revenue base as soon as possible.

In the context of tight fiscal policy, monetary policy has a large role to play. Fiscal consolidation needs to be accompanied by prudent monetary policy aimed at low inflation and the stability of the exchange rate, thereby ensuring necessary credit expansion to the non-oil private sector. From the viewpoint of enhancing credit expansion to the private sector, the establishment of a secondary market of government paper is desirable, as the staff points out.

Finally, as pointed out at the previous board discussions, priority should be given to improving the coverage and correctness of economic and financial statistics, including such items as statistics on external debt.

Mr. Zhang made the following statement:

At the outset, we commend the Saudi authorities for their unwavering efforts to recapture the adjustment momentum by strengthening fiscal discipline and broadening structural reforms in recent years. In particular, despite the substantial drop in oil exports, aggregate GDP growth remains positive, and inflation has been subdued.

As the staff points out, as with other countries in the region, there is ample room for the authorities to restrain expenditures. Much work needs to be done to strengthen non-oil revenues, and improve the efficiency of resource allocation. Apparently, the internal and external imbalances remain severely harmful to the overall long-term objectives--namely self-sustaining growth--and thus call for the authorities' immediate attention in intensifying their efforts to address the issue. In this respect, I am encouraged by the authorities' recognition of the severity of these imbalances. With these general remarks, I would now like to focus on some specific policy issues.

On the fiscal side, we are particularly impressed by the authorities' policy reorientation toward intensifying budget austerity not only through widespread cuts in overall spending, including subsidy cuts, but also through increases in non-oil revenues. For many years, a restrained budgetary policy has relied mainly on cutting discretionary spending, which has not always been very effective in achieving budgetary requirements. In this regard, an urgent task is to make prompt headway in reducing the implicit and explicit subsidies. This would not only fortify revenues, but also rationalize the price structure and twisted resource allocation. In this respect, I am pleased to

learn from Mr. Al-Jasser's very comprehensive and helpful statement that "subsidies are to be reduced by some 34 percent." It cannot be denied that this measure might result in a somewhat upward general price level as a result of the large cut in subsidies. Therefore, a cautious and gradual approach might be necessary. Meanwhile, I also welcome and encourage the authorities' determination to redouble their efforts to generate larger non-oil revenues through the preferential policies granted to the private sector.

With respect to financing the budget deficit, I welcome the authorities' policy intention not to resort to external borrowing rather than domestic financing, in view of the weakening external position and the exchange rate target. However, it seems to me that as the public debt is currently estimated to rise to 77 percent of GDP by 1998--a relatively high level--more effort should be made to diversify the financing instruments. We are somewhat concerned about the likely impact of domestic financing on credit expansion. Could the staff shed some light on this issue?

It is commendable that a prudent monetary policy has been continuously maintained against the backdrop of a weak fiscal position, and an adverse balance of payments development. As a result, price stability has been achieved albeit through substantial subsidies, which have kept nominal prices at a low level. Nevertheless, the overall objectives of monetary policy must be maintained in order to secure a sound domestic financial system, and to safeguard a free and flexible exchange rate policy. We encourage the authorities to further strengthen the functions of the central bank by deepening and widening both the capital and foreign exchange markets, with particular emphasis on facilitating the desired credit expansion to the private sector.

On the external sector, we remain concerned about the projected increase in the current account deficit--persisting at 16 percent of GDP during 1995-98. To reverse this worsening trend, the authorities are expecting a desirable level of private capital inflows to finance the deficit, in addition to an anticipated improvement of the fiscal situation. However, in view of their intention not to resort to balance of payments borrowing, and in view of a steady decline in private capital inflows during 1994-98 as predicted by the staff, we urge the authorities to make a greater effort in improving their fiscal position and exploring non-oil sector exportation. Otherwise, the resulting balance of payments would call for a further drain on official reserves.

The authorities' firm commitment to maintaining the free exchange rate and foreign trade regimes has greatly facilitated

macroeconomic management; thus, we encourage them to persevere with these policies.

We highly commend the authorities' generous attitude in providing financial assistance to developing countries, in spite of their own current budget constraints, and would ask Mr. Al-Jasser to convey this chair's best wishes to the authorities in their future endeavors.

Mr. Sirat made the following statement:

At the outset, let me commend the staff for both a very clear and relatively short paper on the situation of the economy of Saudi Arabia. By and large, I fully share the staff's appraisal, and therefore can be relatively brief.

The existence of sizable twin fiscal and current account deficits is certainly not something new. Obviously, the geo-strategic context can only have worsened the situation.

The determination of the authorities to tackle these issues is certainly undoubted. The adjustment implemented by the authorities during the last two years is impressive, as recalled in the statement of Mr. Al-Jasser. In conjunction with recent increases in oil prices, such measures should certainly help alleviate any concern about the financial situation of the economy.

As recognized by the authorities, there is certainly no room for complacency, in view of, first, the past increase in and current level of the public debt and, second, the remaining balance of payment disequilibria, as illustrated by the rather bleak balance of payments projection included in the report (Table 2).

The medium-term strategy seems rather clear cut: reduce the fiscal deficit; foster private capital inflows; and diversify the economy so as to provide enough jobs for a young and rapidly increasing population. In addition, while understanding the specificity of the Saudi Arabian economy, like Mr. Shaalan and others, I would support the staff's suggestion of an enhancement of the regional economic integration in many areas, including fiscal policy. In that context, I will be interested to hear the staff's response to Mr. Mirakhor's two suggestions.

In particular, it is noteworthy that there seems to be an ongoing privatization process in many countries of the region, and I would, therefore, encourage the authorities to rapidly begin the implementation of the privatization operations that they are now considering.

Indeed, such privatization operations can have a threefold positive impact: they would certainly enhance the overall economic situation by improving the competitiveness of the economy; they would imply an increase in foreign direct investment, thus facilitating the balance of payments financing; and they would naturally entail a positive fiscal impact both directly--through the sales receipts--and indirectly--through the necessary increase in utility tariffs--and therefore, the reductions in subsidies.

I do not know whether the authorities already have a clear idea about the use of privatization receipts. I would certainly advocate that they be used to reduce the existing public debt, which would allow for a reduction of interest payments.

As I implicitly mentioned, this privatization process should go hand in hand with an increase in non-oil revenues through increases in utility prices. Such price increases, for instance for water and electricity, would in addition have a positive effect on their consumption levels.

The authorities' recent stance in favor of a further liberalization of the economy, encompassing privatizations and increases in non-oil revenues, is very much welcome on its own economic merits, independent of its direct impact on the current financial imbalances. Needless to say, the recent increases in oil prices, which would benefit fiscal and external balances, should not lead to a postponement of such measures, even if such increases would allow for a financial adjustment based solely on further expenditure cuts.

Conversely, some further reduction in expenditures, including unproductive expenditures, should not be altogether ignored in the future, following the ambitious 1994 budget, as underlined in Mrs. Srejber's statement.

Finally, I join Mr. Shaalan and others in commending the authorities for the level of foreign assistance they grant and, like Mrs. Lissakers and others, I fully support the need for better and more timely data to be provided to the staff, so as to allow them to give more timely and informed policy advice.

Mr. Evans made the following statement:

First of all, let me welcome the staff paper and the recognition in it of Saudi Arabia's interrelationships with other states in the region. I agree with a great many of the statements that have been made so far. In Ms. Srejber's statement, the rather telling final paragraph mentioned the low level of girls' education in Saudi Arabia. Although perhaps not so relevant for

the short term, I think that is a point that is certainly important for the longer term.

Let me start by commending the authorities on their determined response to the financial difficulties at the end of last year. I agree with Ms. Lissakers about the need for more discipline in the budget, a theme which we expressed a year ago.

I welcome the cuts in agricultural subsidies announced last year, but in tackling problems of expenditure, it seems to me that the authorities will need to reduce other forms of current spending, and not just project expenditure. I welcome the authorities' recognition of the need to continue with a thorough review of public expenditure--"expenditure rationalization as well as reduction."

As an example, I note that provisional figures for 1994 show a further increase in the wage bill, while project expenditure has been cut by 30 percent. I believe that, in view of the importance of maintaining and improving infrastructure, as laid out in the Sixth Development Plan, there is scope for seeing more cuts in current spending and less on capital expenditure next year.

One of the concerns is about the reported arrears in government payments. As the staff paper suggests, it may be that much of this has arisen in the context of the current renegotiation of many government contracts. In that case, they will presumably be settled fairly soon. But I note that delays in payments cannot be a substitute for genuine expenditure cuts.

I very much welcome the authorities' stated intention to look at all options for revenue enhancement. As Mr. Mirakhor says, this is a very positive development over the past 12 months. The staff or Mr. Al-Jasser might wish to comment further on whether more revenue could be obtained from raising utility tariffs--as Mr. Sirat said, some of these are very low--user fees, or perhaps a more general sales tax. Clearly, more revenue from trade taxes would not be a good idea. I agree with the staff that revenue-raising efforts will come much more easily in a regional context, whether that is a formal or an informal agreement.

I commend the authorities on their pursuit of a tight monetary policy and commitment to exchange rate stability. I agree with the staff that the reduction of the budget deficit should be accompanied by a switch to greater reliance on nonbank financing.

To come to the question which Ms. Lissakers and others have raised, the current account deficit on present policies appears likely to increase from its present level, reaching 16 percent of

GDP in 1998. Capital inflows on this scale do not look very likely, or are probably not the best basis for planning policy. Ms. Lissakers raised the interesting question of what the fiscal objective should be, and whether there should be an additional or, indeed, overriding objective for the current account. It is easier, and perhaps preferable, to have an objective for fiscal policy, partly because that is much more under the control of governments, but also because we have a better idea of where we want it to end up. I take it that the import of the staff paper is that the staff would like to see a leveling off, and then a reduction, in that income ratio, which would imply something close to balance in a few years' time.

The question then is what would happen to the current account under those circumstances. It is always difficult to know what an appropriate target for the current account ought to be. After all, some of the most successful economies, judged by capital inflows, run a substantial current account deficit. It is hard to specify what that target for the current account ought to be, particularly in the case of Saudi Arabia.

Some of you may recall the Lawson thesis from some years ago. Very crudely stated, it was that the current account did not matter. However, that is a misleading way of putting it. In fact, what he said was that if government policies were sound, by which he meant sensible macro policies and micro policies, and in particular if the government had its own fiscal affairs in order, then a current account deficit basically reflected the position of the private sector, which would either finance it itself or the necessary adjustment would be set in train without any necessary action on the part of the government. That, of course, might involve some other changes. As I said, my preference would be for a clearer objective in terms of fiscal policy and then to see what happens once that had been achieved. I would be interested in the staff's comments on this.

Briefly, on privatization, I encourage the authorities to proceed with their plans to privatize utility companies and Saudi Air and to reduce their holding in SABIC. The reductions of subsidies, which are also planned, and the accompanying price liberalization will help pave the way for such privatization. I echo the staff's statement on statistics that, despite some improvements over the past year, it is desirable both for the authorities themselves, and others interested, to improve the quality and coverage of most economic data.

We encourage the Saudi Arabian authorities in their move to play a wider role in the region and in the international community. The United Kingdom supports Saudi Arabia's GATT

application and welcomes the recent decision by the GCC to end the secondary and tertiary aspects of the Arab boycott.

Ms. Lissakers, elaborating on her statement, said that she had not been advocating a current account target per se, but had been concerned about the divergent paths projected for the budget deficit and the current account deficit. Because the staff had treated the current account as a source of external imbalance, a question had arisen about the fiscal policy that would be necessary to reduce substantially the current account imbalance, in the context of the 45 percent budget deficit projected for the succeeding several years, and the widening current account deficit in the balance of payments.

Mr. Jonáš made the following statement on behalf of Mr. Kiekens:

Even the tactful language of the staff report makes it clear that the Saudi Arabian authorities must vigorously address their present economic imbalances. If they do not, various minor problems--like the pressure on the exchange rate that appeared in late 1993 and the subsequent widening of interest rate differentials--are likely to become much more serious. Although the comfortable level of foreign reserves gives the authorities some time to design their strategies, it is clear that any hesitation will be costly.

The authorities are to be commended for recognizing the seriousness of the situation and not excluding ex ante any potentially useful measures, especially for redressing the fiscal imbalance. The data in Mr. Al-Jasser's statement show that their efforts to reduce unsustainable fiscal and external imbalances have already produced tangible results.

The staff clearly identifies the areas on which future fiscal efforts should focus, and I fully agree with their recommendations. I would like to stress that the authorities cannot afford the luxury of continuing to link the pace of budget-deficit reduction to movements in oil prices; but it is clear that this linkage can hardly be eliminated while oil revenues continue to account for about three fourths of total revenues, a ratio that is expected to remain generally unchanged despite the authorities' stated intention to "restructure the budget with a view...to enhancing non-oil revenue." By enhancing, do they mean only a slight increase in absolute terms, which will leave the ratio of oil receipts to GDP unchanged?

Another source of concern is the possibility that Saudi Arabia's fiscal measures will be constrained by regional commitments and considerations. The staff proposes that Saudi Arabia's measures to enhance non-oil revenue should be taken in unison with other GCC members. But does this not involve a

risk that the adjustment effort will be reduced to the lowest common denominator? Is the situation in the other states--in terms of the extent and nature of the fiscal problems and the willingness of the authorities to deal with them--commensurate with the situation in Saudi Arabia? In any case, I would appreciate it if the staff could give us more information about the form and extent of fiscal measures considered by the authorities.

I welcome the authorities' intention to cut back explicit and implicit subsidies. However, this Board traditionally questions the wisdom of capital spending cuts, as these can lead to a deterioration of public infrastructure and a slowdown of economic growth. I note that the authorities are planning to cut capital spending not just in relative but even in absolute terms. I wonder whether the cuts represent savings obtained from the planned privatizations, or are just one more way of trying to reduce the fiscal imbalances. If the latter is true, I would urge the authorities to consider possible ways of achieving their deficit-reduction targets that are less harmful for long-term economic growth.

Turning briefly to monetary policy, the change in the composition of commercial banks' assets is another signal of the risk attached to a prolongation of unsustainable fiscal and external imbalances. Even if the secondary market for government paper develops as planned, this will do nothing to prevent a crowding out of the private sector in the credit markets that would undermine the dynamics of its future growth, a point that reinforces the arguments already mentioned about the need to improve the fiscal balance. On a somewhat different issue, I note that the authorities are encouraging commercial banks to participate more actively in the capital of domestic firms, but wish to discourage them from participation in excessively risky ventures. As assets held by banks in the form of equity are usually considered to be risky, I wonder whether there is not a certain inconsistency in the authorities' approach.

I would like to express my authorities' appreciation of the generous foreign assistance that the Saudi Arabian government provides, and for its efforts to stabilize oil prices.

Mr. Coumbis made the following statement:

Despite the adjustment measures implemented in 1993, adverse developments in oil markets have prevented the realization of a favorable outcome. Even though a substantial reduction in public expenditure was achieved, the 18 percent decrease in budgetary oil revenues contributed to an increase in the budget deficit, already at a high level, following the 1990/91 crisis. Reflecting the

contraction of the oil sector and the tightening of government expenses, economic activity exhibited only modest growth in 1993. Following a fall in net capital inflows, resulting from the speculative pressure on the exchange rate, the overall balance of payments deficit increased even further, despite the decline of the current account deficit.

I am in broad agreement with the staff's appraisal and, therefore, will restrict my statement to comments on the budget and external deficits, which are the major points of concern presently faced by the country.

The events last year have demonstrated how dependent the fiscal sector and overall economy are upon the oil sector. It is reassuring that in 1994 the authorities have responded to these events by intensifying their efforts toward budget tightening and reduction of the external deficit. This major consolidation effort, which, according to Mr. Al-Jasser, will involve a 20 percent cut in expenditures, especially concerning subsidies and expenditures on supplies and services, certainly deserves to be praised. However, according to the staff's projections, the measures taken might not be enough to allow for a sustained reduction of structural imbalances. Even though the budgetary imbalances are expected to decline considerably in 1994, projections show that the budget and external current account deficits will remain large and unsustainable, putting the stabilization of the economy at risk over the medium term, unless the necessary policy measures are taken to control them. Such deficits would either raise external debt substantially and/or require an extensive drawdown of foreign currency reserves. In view of interest payments, increased debt would impose additional constraints on the budget. A large budget deficit would intensify the pressures on exchange rate markets, and its financing--from domestic banks--would contribute to the crowding out of private investment. This is particularly serious in view of the economy's great need for productive private investment. The diversification of the productive base of the economy requires a substantial amount of new investments, which, in view of the restrained fiscal stance, have to rely primarily on private sector initiative.

The sustained improvement of budgetary accounts requires not only additional expenditure cuts, but also the addressing of the underlying structural weaknesses identified in the staff report, and the enhancement of non-oil revenues. As was already mentioned, the dependence on volatile oil revenues has to be tackled with the increased participation of the private sector in economic activity. In this context, the decision to privatize some public enterprises can be considered a step in the right direction. With respect to the other weaknesses, consisting of explicit or implicit subsidies, the authorities' commitment to

restructuring the budget with a view to reducing those subsidies is encouraging. In view of the present strong exchange rate position, the country can afford to implement these structural reform measures, together with the necessary prioritization of public expenditure, within the context of the new Development Plan, provided that these measures are targeted, have a specific timetable, and are front-loaded. In this context, I would like to ask the staff or Mr. Al-Jasser if they could provide us with some information concerning the stage of preparation of the above-mentioned plan. It seems that the most important structural measures that the authorities are planning to implement are connected with the Sixth Development Plan.

In addition, the current financing of the deficit directly through the banking system may contribute to either restricting credit to the private sector, or risking the asset position of commercial banks. By drawing down their foreign assets as a means of financing domestic lending--and with the buildup of foreign currency deposits--the net positive currency position of commercial banks has been falling. Therefore, further drawdowns to finance private activity would unbalance commercial banks' asset position. In this context, I agree with the staff that the establishment of an active secondary market for government paper would facilitate the desired credit expansion to the private sector.

Concerning international trade, the present policy of maintaining a stable and competitive exchange rate vis-à-vis the main commercial partners, minimizing the exchange risks, is an important step to promote trade. The following step should be the dismantling or reduction of barriers to trade, either within a regional framework or within a wider one. Because progress on economic integration among the members of the GCC has remained slow, the fact that Saudi Arabia has initiated the process of accession to the GATT and is expected to become a contracting party in about a year, is encouraging.

I welcome the fact that the authorities are planning to maintain their program of providing assistance to developing countries, which consists of grants and highly concessional loans.

Mrs. Wagenhoefer made the following statement:

Since the last Article IV consultations, the Saudi Arabian authorities have undertaken commendable steps to intensify adjustment efforts. In view of the existing internal and external imbalances, however, further substantial fiscal consolidation is crucial to avoid adverse consequences for the stability of the economy in the near future. The staff has developed, in detail, what should be done to achieve a sustainable situation in the

medium term. I fully support its recommendations and would like to restrict my comments to a few points.

Recent fiscal developments in Saudi Arabia have been considerably influenced by the aftermath of the regional crisis in 1990-91 and the sharp decline in oil prices afterwards. Earlier hesitation in adopting and implementing the necessary corrective measures in a changed economic environment may also have contributed to the widening of the twin deficit.

Even if the current recovery in oil prices continues, the key to sustainable economic development lies in accelerating fiscal consolidation, in the further diversification of production and-- as noted by Mr. Al-Jasser--in particular, in supporting a self-reliant private sector through further reduction of the Government's involvement in the economy.

The achievements of this year are encouraging. Widespread cuts in discretionary expenditures have helped to reduce the budget deficit substantially. Nevertheless, as indicated by the staff, under current policies and following the world economic outlook oil price projections, the budgetary deficit and the external current account deficit would remain large over the medium term. Therefore, to achieve the authorities' long-standing objectives of maintaining exchange rate stability, and promoting self-sustained growth and employment, a further deepening and broadening of adjustment efforts is essential.

In this connection, we welcome the authorities' intention to further strengthen adjustment policies, as envisaged in the Sixth Development Plan. This proposed strategy, which, besides expenditure cuts, now includes the mobilization of non-oil revenues and cutbacks in subsidies, is indeed an important qualitative change in the authorities' position. In view of the background of existing imbalances, the volatility of oil revenues, and the need to increase capital expenditure and maintenance outlays, I would like to encourage the authorities to implement the plan vigorously, and, if possible, to accelerate the pace of adjustment. The outlays for the wage bill, which remain unchanged relative to GDP until 1998, might indicate scope for additional adjustment measures. I would appreciate it if the staff would comment.

Further actions are also needed to diversify the productive base. A key element of this issue is the promotion of an efficient private sector. In this connection, I fully agree with Mr. Al-Jasser that the Saudi Arabian economy is mature enough to allow the Government to embark on a privatization program. Therefore, I welcome the intended privatization of several public enterprises. These measures should be accompanied by appropriate

structural measures, in order to allow for an efficient resource allocation. I fully share the mission's emphasis that it is important that utility rates and related prices should be market based and that prices of publicly supplied goods and services should be reviewed. The recent reduction of subsidies marks a welcome step in this direction, but more has to be done. The studies seeking rationalization for the overall system of subsidies and utility rates, which are actually being undertaken, will, it is to be hoped, produce beneficial results.

Let me finish by welcoming, once again, Saudi Arabia's contributions to stability and predictability in the global oil market and also their commitment to providing assistance to developing countries.

The Director of the Middle Eastern Department said that, with respect to the apparent inconsistency between the current account deficit and the fiscal deficit, it was helpful to remember that a current account deficit had to be financed through the capital account. The capital account showed that unspecified financing had increased from \$6 billion to \$15 billion over the four-year period. If the imputed interest payments arising from that financing were included, the current account deficit would worsen by \$0.5 billion in 1994, and by \$2.5 billion in 1995. Also, the growing role of the private sector affected the current account deficit substantially, but was relatively less important in affecting the budget deficit. That was another reason why the twin deficits had diverged.

The staff had preferred targeting fiscal account adjustment rather than external current account adjustment because fiscal policy had been a central issue in Saudi Arabia, which had a direct impact on the import level and size of the current account deficit, and because a fiscal policy deviation was easy to ascertain and to correct through fiscal policy actions, the Director continued. The Saudi Arabian authorities should move quickly to restore budget balance, and perhaps even achieve a modest budget surplus, in the staff's view.

The relative weights to be given to public expenditure restraint as opposed to non-oil revenue mobilization, in achieving a budget balance, could be debated, the Director commented. Public expenditures could be restrained in a number of ways, such as the elimination of nonproductive expenditures and of various subsidies, such as on wheat. The staff had discussed with the authorities the importance of prioritization of expenditure, but there were constraints on reducing public expenditure because a large part of it was nondiscretionary. For instance, it would have been difficult to reduce the wage bill and the interest payments. Also, the staff would not recommend cutting some important expenditures, such as on maintenance that would adversely affect economic efficiency. A substantial cut in capital expenditure, especially in the large electrification and energy generation program, would also have an adverse impact on private sector development.

Adjustments in domestic energy prices would be one way to mobilize additional non-oil revenues, the Director continued. A modest excise tax on gasoline--which was currently sold for eight cents per liter--could generate substantial government revenues. Rescinding the 30 percent reduction in the electricity tariff that had taken place in 1992 could provide about SRls 4 billion directly to the electricity company, and indirectly to the budget. Other possibilities would include a general sales tax, excise taxes on durable and nondurable goods, taxes on wages and salaries, import duties, and an extension of the corporate income tax. However, some of those measures would have to be discussed with other GCC partners. In that context, it was encouraging to note that in those member countries substantial proposals for non-oil revenue generation were being considered by the authorities and/or parliaments.

The Saudi Arabian authorities had decided to privatize some public corporations, and prime candidates were the utility companies, Saudia, and the Saudi Arabian Basic Industries Corporation, the Director commented. The privatization would bring in substantial revenues. The staff had recommended to the authorities that the bulk of the proceeds from the sale of government assets be allocated to the reduction of public debt--rather than to new expenditure--which would benefit both the budget and the balance of payments. To support the intention to accelerate privatization, the authorities would need to take decisions on sequencing and priorities, input and output prices in the privatized companies, and the allocation of subsidized credit, so that market-based price signals could be provided on which sound investment decisions would be made. A number of issues would need to be dealt with in the development of the capital market, including the transparency of transactions and the type of restrictions on the ownership of the newly privatized industries by foreign investors, besides residents of the GCC.

The staff had discussed informally with the GCC issues pertaining to the GCC itself and those related to technical assistance, the Director of the Middle Eastern Department commented. The GCC Secretariat had requested that the staff investigate how to improve tax coordination and the harmonization of procedures for providing fiscal statistics within the GCC. The staff had also discussed such issues as the common external tariffs and the coordination of exchange rate policy, and the relations between the GCC and other important trading blocs such as the European Union. The discussions had included issues such as market access to petrochemicals, developments in the area of the Generalized System of Preferences (GSP), and a possible free trade arrangement between the GCC and the European Union.

Ms. Lissakers said that she had been surprised by the limited prospects for reducing the public sector wage bill, in view of the fairly standard policy prescription available in that regard. She wondered whether the Saudi Arabian wage bill was less flexible than others. She also wondered why personal income tax was not considered a viable option for raising revenue. Furthermore, in a situation of a rising current account deficit, marginal increases in the oil price, together with budget stringency, would

have implied a very large financing requirement for the private sector, which seemed out of line with the size of the private sector in Saudi Arabia. Also, Mr. Al-Jasser had mentioned that the staff was aiming for a budget surplus--although that had not been reflected in the staff report. The projections and policy objectives in the outlook were somewhat vague; perhaps the staff could be more precise about the magnitude of the projected budget surplus.

Ms. Srejber said that, like Ms. Lissakers, she could not understand why wage adjustment was more difficult in Saudi Arabia than in other countries. Also, she wanted to know the level of manpower development expenditures, in particular, how much had been allocated for basic education and training.

The Director of the Middle Eastern Department said that a tax on wages and salaries could be similar to a personal income tax. With virtually no salary increases for a number of years, there had been considerable wage restraint in Saudi Arabia. Rather than forcefully constricting the wage bill, the staff had considered it preferable to recommend the introduction of measures to mobilize non-oil revenues. However, it was up to the authorities to decide what was more practical.

Ms. Lissakers said that, although she agreed with the need for sustainable non-oil-related tax revenue measures, there were two considerations pertaining to the wage bill: first, to hold down salaries, and second, to reduce the size of the public sector work force. The Director of the Middle Eastern Department had maintained that there was no scope for reducing the work force.

The Director of the Middle Eastern Department said that there would be some scope to reduce the work force in the public sector through the scheduled privatization of public entities. Otherwise, the best that could be hoped for was a freeze on the size of the civil service; as the economy grew, the civil service wage bill as a proportion of the budget would decline. The best way to achieve a durable improvement in the structure of the budget would be to keep the nominal wage bill under control, bring about a substantive tax reform, reduce subsidies, and rationalize the pricing of energy products and other highly subsidized services and commodities.

Mr. Evans said that he shared Directors' concerns about the public sector wage bill. A week ago, the U.K. Treasury--an efficient institution by any standard--had announced cuts of 25 percent in its senior staff. There was scope for increasing efficiency in any public sector, and any civil service. The scope for improving efficiency ought to be examined.

The Director of the Middle Eastern Department agreed that the scope for efficiency improvements in the civil service was considerable. However, before recommending a particular measure, it was necessary to ascertain whether it would be applicable in a given context. For example, although Directors had argued for substantial changes in the tax system, tax administration needed to be strengthened in order to ensure compliance and

collection. Also, a substantial wage cut or a reduction in the size of the civil service would not help the authorities at the current time, when they wanted to elicit support for revenue mobilization. At the same time, the authorities could do well to restrain wages and shift some staff from less productive activities to the new tasks.

Mr. Al-Jasser remarked that, beginning in 1981, Saudi Arabia had made a serious attempt to freeze nominal wages. There had been a freeze on hiring in almost all government departments, except in education and health, which were two critical sectors in the human capital development of the country. With the Gulf crisis in 1990, the number of military personnel had increased.

The staff representative from the Middle Eastern Department said that he wished to comment on the consistency of the forecast budget deficit and the related current account deficit. The apparent divergent movements reflected the structural transformation of the economy; the Government was beginning to play a smaller role, while the private sector was expanding rapidly. As a result, the private sector's import demand and the volume of other international transactions were not directly affected by what was happening in the budgetary sphere.

The apparent divergence of the budget deficit and the current account deficit could be explained by three factors, the staff representative continued. First, an accurate estimate of rising interest payments could not be incorporated in the budget because no decision had been made, so far, about specific ways of financing the budget deficit--that is, through domestic or foreign borrowing. The authorities appeared to have decided against an increase in external borrowing. Second, net outflows of private transfers and payments of interest and profits, which had been increasing with the expansion in the size of the private sector, had tended to increase the current account deficit, but not the budget deficit. Third, differential rates of transfer of oil earnings to the budget had been a significant factor. While total oil receipts appeared in the current account of the balance of payments, only part of those earnings transferred to the Government was recorded in the budget. Hence, budget deficits and external current account deficits would not necessarily move in the same direction.

The staff had analyzed what would happen to the current account deficit if the budget deficit were eliminated, the staff representative commented. The outcome depended on whether the budget deficit was eliminated through an increase in revenues, or a reduction in government expenditures. However, in view of the authorities' targets of having net foreign assets unchanged with no external borrowing, the external current account deficit needed to be consistent with autonomous capital inflows of the private sector. That had implied that a balanced budget--and perhaps a small budget surplus toward the latter part of the projection period--would be required to achieve a current account deficit that could be fully financed by autonomous capital inflows.

The encouragement of increased bank participation in the equity of private firms, while leaving the banks to decide the risk of such participation, had been the result of a change in the overall economic growth strategy, the staff representative explained. The authorities had been pushing for increased privatization and market-based, self-sustaining growth, which required that financial institutions provide autonomous financing for private sector growth. In that context, banks had been moving gradually toward a universal banking system, by not only providing short-term credit but also long-term finance, as well as equity participation. Two factors had contributed to that development. First, there had been a need to diversify banks' portfolios, which had led the banks to consider the viability of equity participation, apart from long-term credit. Second, a number of private firms had opted for equity rather than debt participation. Under such circumstances, the banks either had to withdraw from the market, or generate a mechanism for equity participation.

Over the years, the proliferation of mutual funds had expanded and deepened the financial markets, and the banks had actively participated in the development of those mutual funds for private sector investment, the staff representative from the Middle Eastern Department commented. Part of the money in the mutual funds had come from the banks' own resources. Although mutual funds carried greater risks, the returns had been higher. The authorities had expected the banks to be more careful in lending operations, although the supervisory authority had provided sufficient instruments to protect against any risks. For example, the Saudi Arabian Monetary Agency (SAMA) required that mutual funds provide the banks with information about their holdings. Furthermore, SAMA's credit information system protected banks from risky ventures. In addition, the increasing complexity of the banking system and the development of derivatives had required the banks to be more deeply concerned about protecting their investments. In that context, a closer relationship with the investors had been established to ensure that the banks had some influence on how their resources were being used. That was why the banks had been increasingly involved in private sector participation in equity and capital generation, a development that the staff had welcomed. Over time, however, a need for increased supervision might emerge.

Ms. Lissakers said that, under the financial system described by the staff representative, risk was concentrated in a relatively small number of private sector institutions, through a web of intermediary instruments. She would disagree fundamentally with the staff's assessment that such concentration strengthened either the financial intermediary system, or the business sector in Saudi Arabia. In view of the substantial individual and corporate savings in the economy that could provide equity capital--independent of the commercial banks--she wondered why it would not be feasible to encourage the development of an autonomous capital market.

The staff representative from the Middle Eastern Department, agreeing with Ms. Lissakers, said that the process of diversification of the capital

market--which would facilitate the evolution of new institutions to ensure that commercial banks did not acquire a disproportionate share of risk--was already under way. However, the rapid increase in foreign direct investment would tend to diminish the role of the banks as primary providers of equity capital. Banks would act as secondary providers, in addition to being suppliers of skills and advice.

Mr. Al-Jasser said that the concentration of risk in the financial system in Saudi Arabia was not excessive. The stock market had deepened tremendously. According to the latest statistics, between 1992 and 1993, the number of shares traded and their value had increased by 71 percent and 26 percent, respectively; and between September 1993 and September 1994, the number of shares traded and their value had increased by 220 percent and 63 percent, respectively.

The network of banks and their branches had served as a kind of electronic trading floor, in view of the impracticality of stock exchanges in so large a country, Mr. Al-Jasser continued. The Saudi Arabian Monetary Agency and the Ministry of Finance had been concerned that, if the banks that were entrusted with intermediation were to take substantial equity positions, they might be lured to take advantage of insider information. The authorities were interested in leaving equities predominantly in private nonbank hands. Therefore, in order to avoid concentration, commercial banks, which had been allowed to participate in the equity of corporations, had been permitted to take only limited risks under strict prudential guidelines. If the 12 banks in Saudi Arabia had been allowed greater freedom in corporate affairs, undesirable interlocking directorates and institutional arrangements between the private corporations and the commercial banks might have developed.

Ms. Lissakers observed that, according to the staff, there was still uncertainty about the level of foreign participation in the privatized industries--which was always an issue in privatization programs. However, in view of the relatively small size of the Saudi Arabian economy and the small number of financial intermediaries in Saudi Arabia, it would be particularly important that foreign investors have access to the shares of privatized industries, in order to avoid the concentration of risk in a few institutions. The Board should recommend opening the country to foreign investment.

The Director of the Middle Eastern Department said that, at the previous ministerial meeting of the GCC, the Finance Ministers had reached an agreement under which a GCC entity could hold shares in all GCC corporations, except in banks and insurance companies. The authorities had been aware of the need to avoid excessive concentration, and some measures had already been taken in that regard.

Mr. Al-Jasser, responding to Ms. Lissakers, said that Saudi Arabia had made a determined effort to encourage foreign participation in its development strategy. The Saudi Arabian Basic Industries Corporation--the

holding company for all petrochemical industries--was the most important corporation in the country. The Government had persistently sought and obtained foreign participation, as a result of which all SABIC companies had foreign partners. Similarly, there was wide foreign participation in the banking sector, including the Saudi American Bank, the Saudi British Bank, the Saudi Dutch Bank, and other banks with Pakistani, Iranian, and French connections. Saudi Arabia had been cognizant of the role of foreign partners in its effort to develop a vibrant banking system, and a healthy private sector.

The staff representative from the Policy Development and Review Department said that the statistical appendix of the report was subject to the policy on publication decided by the Board on July 11. There was no reference to publication in the covering memorandum, because it had been pointed out by an Executive Director that the captions concerning publication in the covering memoranda for Directors could cause some official recipients of background papers on recent economic developments to be less careful in handling those documents. Therefore, it had been suggested, as indicated in the note referred to by the Chairman earlier that, in future, the captions would not be needed in such memoranda.

Mr. Al-Jasser said that the publication policy gave an Executive Director and the member concerned the right to accept or reject publication. He had objected to the publication policy from the beginning. The rights of those not wishing to allow publication should be protected. Any captions on the documents of members that had opted not to publish would prejudice their choice and rights. The original format--without a caption--was the correct approach to publication. He hoped that the matter could be taken up in another meeting.

Ms. Lissakers said that she had raised the issue not to question the right of any member regarding publication, but to clarify the procedure in the current transition phase. Her office had received many inquiries about the availability of information on various countries, as there had been an awareness about changes in the Fund's disclosure policy. She wanted to know when a document was publicly available, so that she could respond appropriately to requests for information.

Mr. Al-Jasser said that the publication issue involved differences of interpretation of a policy adopted by the Board, a discussion of which would detract from the current surveillance discussion.

Mr. Coumbis said that it appeared that all the proposed structural measures were connected with the Sixth Development Plan of Saudi Arabia. He wondered at what stage of preparation was that development plan.

The staff representative from the Middle Eastern Department replied that the implementation of the five-year Sixth Development Plan had been scheduled to begin in 1995, but he was not aware of its stage of preparation.

Mr. Posthumus made the following statement:

I welcome the authorities' firm policy stance. In particular, the expected reduction of the budget deficit by one half this year is a respectable achievement, although Mr. Al-Jasser apparently is not yet sure whether this will indeed happen. At the same time, I note that, although part of the twin deficit problem has to do with the aftermath of the Gulf crisis, underlying structural features in the economy and the budgetary system still make it difficult to substantially reduce the height of the "twin towers." The current account deficit is expected to remain rather high in the medium term; and the outcome could be even more worrisome if oil exports from the Russian Federation and Iraq increase in the coming years.

In the light of these structural problems in Saudi Arabia's economy, the staff appraisal could, in my view, have been much more explicit and forward looking in its policy advice, instead of merely reflecting and supporting the authorities' ideas. Let me mention three specific issues.

First, I wonder whether the authorities have set any concrete budgetary goals, quantitative or qualitative, in preparing the budget for the next year. In earlier years, they have mentioned a target of 3 percent of GDP. In view of the volatility of oil revenues, I would recommend considering the possibility of using budget norms, such as balancing the budget over the medium term, or setting explicit ceilings for government expenditures.

Second, the authorities' indication of their willingness to consider increasing non-oil revenues--which is perhaps a new code word for taxes--is indeed welcome. The Board has made this point for many years. However, increasing non-oil revenues does not automatically lead to reduced dependency on the oil sector, or on oil market developments. I have the feeling that for revenue-stability purposes, diversifying taxes will be only partially successful. Another issue in this respect is the staff's advice to coordinate non-oil revenue measures with other GCC members. I do not see the logic of that coordination. I tend to agree with Mr. Jonáš that this approach might lead to a delay, or postponement of needed policy measures.

Third, like Ms. Srejber, I was struck by the enormous public wage bill. Apparently it is difficult to reduce public wages or the number of civil servants despite economic difficulties. The phenomenon of higher wages has occurred in 1993, and is likely to happen in 1994 as well.

Finally, I think Mr. Al-Jasser could publish the whole Article IV consultation report in this specific situation, because it is harmless.

Mr. Koissy made the following statement:

We join previous speakers in commending the Saudi Arabian authorities for intensifying the thrust of their adjustment efforts in the face of continued exogenous shocks. As the staff report points out, the authorities have courageously implemented large cuts in outlays in 1994, and as a result, the fiscal deficit is projected to decrease to about half its level in 1993. This is a very encouraging development and attests to the authorities' determined efforts to address the budgetary imbalances. However, to consolidate this fiscal gain, additional measures will be required to address the underlying structural fiscal deficit generated by volatile oil prices, and rising public debt. Although additional measures to reduce and rationalize expenditures will be required, relatively more attention will need to be given to revenue-increasing measures. The Government's revenue base needs to be broadened and made less dependent on oil revenue. We are therefore pleased that the authorities are well aware of these issues, and that they intend to take the appropriate steps to address them. The Director of the Middle Eastern Department has mentioned several possible new sources of revenue, and we would encourage the authorities to give them full consideration.

On monetary policy, we welcome the prudent stance that has enabled inflation to be kept low, and the exchange rate stable. However, we share the concerns of the staff regarding the risks associated with the large drawdown of foreign assets by banks to finance domestic lending, which had led to a substantial reduction in the ratio of banks' foreign assets to total deposits. This drawdown could have destabilizing effects, and underscores the need for further fiscal adjustment, as well as the deepening of financial intermediation. On the latter, the introduction of a secondary market for treasury bills, as suggested by the staff, would certainly be appropriate.

I would like to commend the Saudi Arabian authorities for their generous external financial assistance, which has benefited many countries in my constituency, and for their contribution to oil price stability. Despite its budgetary and external payments problems, Saudi Arabia has continued to maintain a generous level of foreign assistance, which is highly appreciated.

Mr. Zoccali made the following statement:

Mr. Al-Jasser's statement clearly underscores the authorities' awareness of the current and future challenges faced by the economy, namely the medium-term problem of rapid internal and external public debt accumulation that could crowd out private business activity and undermine external viability, and the long-term issue of insufficient diversification of the productive base and inefficient resource allocation arising from distortive subsidies. In view of the authorities' established track record of prudent policies, we feel reassured by their firm commitment to budgetary consolidation, and their decision not to rely exclusively on discretionary expenditure cuts to bring this about. In this regard, I share the thrust of previous remarks on the twin deficits and, in particular, on the desirability of more specific medium-term objectives for budgetary consolidation and on the framework, noted by Mr. Evans, for assessing developments in the external current account.

Saudi Arabia's recent economic developments reveal the vulnerability of a fiscal structure that combines ambitious programs of government spending with a tax system that relies mainly on oil-related tax revenue. This was made evident during 1993, when the sizable fall in international oil prices contributed to a considerable increase in the fiscal deficit, to 10 percent of GDP from an originally planned level of less than 3 percent of GDP, which, in turn, impacted negatively on the already sizable stock of domestic public debt, the growth of non-oil GDP, and net official reserves.

As the budgetary and the associated external current account deficits in the medium term are projected to remain large under current policies and the world economic outlook for oil prices, we agree that one of the biggest challenges is to cut and rationalize expenditure, including subsidies, and to substantially raise non-oil revenues.

We endorse the orientation of monetary policy geared toward maintaining confidence in the domestic financial system and a stable exchange rate, which has served the country well. Nonetheless, the size of the future budgetary deficit financing requirement could not only unbalance commercial banks' asset positions, and further reduce their stock of foreign assets and that of the AGIs, but more important, curtail credit expansion to the private sector, contrary to the stated objective of encouraging its expansion, efficiency, and self-reliance. In addition, it could give rise to undesirable expectations about the exchange rate, as experienced in 1993 with the widening of the spread between domestic and international interest rates. Consequently, we share the emphasis in the staff appraisal on

further fiscal adjustment and deepening of financial and capital markets, particularly through the creation of an active secondary market for government bonds.

In a context of unchanged domestic savings and declining gross fixed capital formation in 1993, the external current account deficit fell, despite the larger than envisaged fiscal imbalance. Although sustainable in the short and medium term, in view of the sizable stock of official reserves, the current account deficit of over 12 percent of GDP and 32 percent of total exports is sufficiently large so as to merit close attention, particularly if reserves continue to be drawn down at a rapid pace.

On the structural front, we commend the authorities for their commitment to international oil price stability and the promotion of transparency in this crucial commodity market. The restructuring of the national oil company to increase sectoral efficiency and the decision to embark on a privatization program in the context of the Sixth Development Plan are welcome developments. Nevertheless, more economywide restructuring is needed for a sustainable process of private sector-led economic growth. Despite the downscaling of explicit subsidies on agriculture production, they remain high, distracting resources from more productive uses, and exacerbating the fiscal imbalance. Similarly, artificially low prices of public utilities could lead to a substantial accumulation of state enterprise debt, and to further demands on the budget at the moment of their eventual privatization. Some quantification by the staff of total nonguaranteed debt of state enterprises would be welcome. The reform strategy should thus include the rationalization and reduction of remaining distortive subsidies, the adoption of market-based pricing of public utilities, the acceleration of the privatization drive, and the completion of accession to the GATT.

In closing, I join previous speakers in acknowledging Saudi Arabia's record of foreign economic assistance even in times of fiscal tightness, and in wishing the authorities success in their future endeavors.

Mr. Aderibigbe made the following statement:

The Saudi Arabian authorities should be commended for their strong commitment to prudent financial policies and adherence to structural reforms that have helped establish a low inflation and stable exchange rate environment, while maintaining the official external reserve assets at a comfortable level. Progress in economic diversification and the expansion of private sector activity has also been encouraging.

However, like many other OPEC member countries, the vulnerability of the Saudi Arabian economy to the uncertainties of world oil market developments was evident in 1993 when oil prices weakened, repeating the experience of the mid-1980s. Attributable largely to this unfavorable development, real output growth decelerated to less than 1 percent in 1993 from 2.2 percent in 1992, while the budgetary and external current account deficits widened. Despite the strengthening of adjustment efforts by the Saudi Arabian authorities and the anticipated improvement in 1994, as reflected in Mr Al-Jasser's statement, the financial imbalances are expected to remain substantial over the medium term. The need for stronger adjustment efforts that would address the problem of financial imbalances and facilitate economic diversification away from overdependence on the oil sector has therefore been underlined.

In particular, we are encouraged that the authorities are cognizant of the difficult tasks of eliminating the current imbalances, and promoting sustainable economic growth and allocative efficiency in a stable price environment. In this regard, we welcome the orientation of the authorities' adjustment policies in a medium-term context. The fiscal consolidation program is aimed at stemming the growth in the stock of public debt and freeing resources for private sector development. Monetary policy continues to focus on ensuring low inflation performance and exchange rate stability, while structural reforms are designed to guarantee efficiency of the economy through a liberalized market mechanism.

We are in general agreement with the thrust of these policies and would encourage the authorities to continue with the implementation of the financial policies while accelerating the pace of structural reform, particularly the privatization process. The adoption of additional measures should be considered if necessary.

I have two questions before concluding my general remarks:

I observe that investments in treasury securities are predominantly by the autonomous government institutions and commercial banks. Could the staff explain why these instruments offer little appeal to private investors?

My second question is not completely new. I wonder whether the authorities have assessed the systemic risks entailed in involving commercial banks in direct equity participation in nonfinancial sector enterprises, and whether necessary consideration has been given to minimizing such risks.

The rest of my comments will be very brief and will focus on two issues.

First, I commend Saudi Arabia's policy of ensuring international oil price moderation and stable and predictable oil supply flows. It is important that the major oil importing countries should show maximum cooperation with oil exporting countries by modifying their discriminatory tax policies on petroleum products, such that these policies would not serve as disincentives to increased investments for production capacity building that would facilitate uninterrupted future supply flows.

Second, the quality and size of Saudi Arabia's external development assistance to developing countries are commendable and worthy of emulation by other donors. Despite the constraints imposed by the fiscal consolidation program, we are encouraged by the authorities' commitment to maintaining Saudi Arabia's program of providing substantial financial assistance to developing countries on concessional terms.

Mr. Smee made the following statement:

As I broadly agree with the staff appraisal, I can be brief in my remarks. As the staff suggests, Saudi Arabia faces an unsustainable position, resulting from political instability in the region, together with generally weaker and volatile oil prices.

Saudi Arabia must get onto a more stable and sustainable course. As the authorities recognize, they can no longer afford as many subsidies as in the past. Like others, I welcome the authorities' plans to further consolidate the fiscal position through both raising non-oil revenue and cutting back government expenditures.

The greatest challenge for the authorities is to develop dynamism in the private sector, in order for it to be the engine of growth in the economy and of revenue growth.

Although the Government can control public sector expenditures, it does not have the same degree of influence over revenues, or employment, which depend largely on factors abroad--oil prices--and on the private sector in Saudi Arabia.

Like Ms. Lissakers and Mr. Evans, I wonder why we cannot reduce employment in the government sector. When Mr. Al-Jasser said that wages in the government sector today are at about the same level as they were in 1981, he must have meant that real wages had remained constant. However, the wage bill had increased from SRls 56.3 billion five years ago to SRls 92.9 billion in

1992. If wage compensation per worker had remained constant over time, the number of employees in the government sector must have increased to reach such a large wage bill. It was not clear where that growth in employment had taken place, and it was not understandable why it was not possible to get rid of some of those workers. There must be some ways to increase the efficiency of government by reducing employment.

Although it had been stated that the private sector had been acquiring a larger share of the economy, data in Table 18 shows only a modest growth in wage compensation in the private sector, which had constituted only about two thirds of the size of government compensation compared to the level in 1988, when it had been higher than in the government sector. Furthermore, during the period 1988-93, the share of the government sector in consumption and gross fixed capital formation had increased. It was therefore not clear how the private sector had been growing, if both consumption and capital formation had been small in relative terms.

I agree with Mr. Mirakhor that the trend toward greater self-reliance and maturity of the private sector could be accelerated through the implementation of policies that allow more freedom for the operation of market forces. In this regard, I note that the authorities are embarking on their Sixth Development Plan. In my mind, however, development plans are dangerous. Although it is good to have goals and a strategy for reaching them, the private sector flowers best with an encouraging, enabling framework that seldom changes. It may be useful to clarify what this development plan is, and why we need it.

As regards taxes on oil in consuming countries, whether motivated by energy conservation or government revenue considerations, the important question is not whether such taxes might lead to a lack of investment in capacity building. Rather, the question is, at what price will this investment take place? What does it take to balance global demand and supply in energy? If the tax wedge between the producer and the consumer price remains, as demand continues to rise the price will have to rise, which will give the necessary inducement for investment to take place.

The consuming countries are afraid to reduce the taxes, not only because of the impact on their budget deficits, but also because of energy conservation considerations. It was not at all clear what would happen to prices and energy demand if taxes were abolished. Whether the removal of the taxes would lead to investment in capacity building, including in Saudi Arabia, was equally unclear. To me, it is a question of the price at which this investment will take place.

Mr. Mozhin made the following statement:

During the past year, Saudi Arabia has made further progress in reducing its financial balances and addressing other consequences of the regional crisis. The authorities' efforts to cut discretionary expenditures proved successful, monetary policy has maintained its prudent stance, and successive steps have been taken to stimulate further the development of private sector activities. Despite these and other positive economic developments, and because the economy remains vulnerable to external shocks, there are still important areas where improvements are clearly needed--particularly in the fiscal and structural areas. As I share the concerns of other Directors, I will limit myself to several brief remarks.

The fiscal position remains the main concern of the Saudi Arabian authorities and the staff. We are encouraged by the authorities' intention to reduce the fiscal deficit in 1994, and by the measures that the authorities are planning to take in this regard, as outlined in Mr. Al-Jasser's statement. However, the shortfall in oil revenues in 1993, as a result of a sharp drop in oil prices, caused some slippages in the fiscal area, and the budget target was not achieved. Under these circumstances, the Saudi Arabian authorities once again have demonstrated an ability to control the reduction in expenditures, as current expenditures have been reduced by 5 percent of GDP in 1993. The projection of a reduction in the budget deficit, from 10 percent of GDP in 1993 to 5 percent in 1994, is encouraging. I welcome the authorities' intention not only to curtail expenditures but also to enhance their revenue mobilization efforts, by taking actions aimed at increasing non-oil revenues, finding the appropriate pricing policies, and reducing subsidies--in other words, in pursuing diversification of the tax revenue base in order to make the economy less dependent on volatile oil revenues and to build additional budgetary savings. These are clearly steps in the right direction.

In this regard, the objective of developing a more sophisticated and diversified private sector is crucial. The authorities' actions aimed at the further development of the private sector would not only help to reduce the fiscal deficit and to diversify the productive and export base, but also would provide a basis for further liberalization of the economy. The authorities' intention to promote a self-sustaining growth of output and employment in the private sector, and recent indications of a strengthening of private sector activity--as mentioned in Mr. Al-Jasser' statement--are encouraging. However, the projected rate of private sector growth--1.5 percent for 1994--too moderate, and I would appreciate the staff's comments on this issue.

The medium-term outlook remains constrained, as there are major uncertainties in the world oil markets. I note that the projections in the staff report are based on the assumption of unchanged oil exports by Russia, and unchanged oil market access by Iraq. In commending the authorities for their efforts in maintaining the stability and predictability of the oil markets, I would like to encourage them to continue prudent policies in the medium-term perspective.

Finally, I welcome the fact that, despite budgetary pressures, the Saudi Arabian authorities have maintained their important role in providing financial assistance to developing countries.

The Director of the Middle Eastern Department said that the predicted budgetary outturn for 1994 would be realized. In view of the figures for the first half of 1994, and with the oil price increase in the third quarter, achievement of the revenue target could be expected. With the exception of one item--the share of Saudi Arabia in the cost of recent deployment of military forces in the region--expenditure would be within the limit envisaged in the budget.

Cooperation in policy matters among GCC members was necessary to ensure that measures taken by individual countries would not lead to trade diversion or excessive capital movements in other member countries, the Director commented. It was advisable to take measures in unison, particularly in the area of income taxation. Because the GCC countries aimed at a common external tariff, no individual country could establish a totally independent tariff, at least for the time being. There were a number of taxes and prices that needed to be set at the regional level, but that did not mean that countries were completely forbidden to take some policy measures on their own, including with respect to taxes.

The secondary financial market had consisted largely of treasury bills and the Saudi Arabian Government's development bonds, the Director concluded. That market was not active and had not developed as desired for several reasons: only two market participants; a lack of information and of transparency; the unequal treatment of holdings of treasury paper by foreign and domestic banks with respect to income taxation; and limited discounting facilities, with only 75 percent of treasury bill holdings and 25 percent of government bond holdings by individual banks available for discounting. During the consultation, the staff had made several recommendations to the authorities for remedying the situation, including the formation of domestic bond dealerships, the provision of more information to the secondary market participants, and the devising of some means for participants to take possession of securities. The staff had stressed that the authorities should address the issue of unequal tax treatment not only among primary bond holders, but also secondary holders. Furthermore, the staff believed that the authorities could probably increase the amount of securities that they would be prepared to repurchase.

The staff representative from the Middle Eastern Department said that increases in the government wage bill had been the result of wage adjustments that compensated for the rising cost of living--amounting to about 3 percent per annum over the previous few years. Furthermore, figures in Table 18 of the background paper on recent economic developments had related to a broader concept of the government sector, and had covered activities that were not strictly within the purview of the budget itself. Activities associated with high-cost jobs had expanded very rapidly, thereby increasing the wage bill.

The relatively low private sector growth in 1994 of 1.5 percent could be explained by the private sector's continued dependence on the government sector, despite gains made in reducing that dependence, the staff representative commented. A substantial reduction in the government budget would have an impact on domestic demand in the economy, and, therefore, on private sector growth. The authorities had expected an initial slowdown in growth, but were confident that it would pick up later on.

On the basis of available information, the nonguaranteed debt of the public enterprises was about \$2.1 billion, the staff representative commented.

Manpower development expenditures had covered basic education as well as specialized training, the staff representative from the Middle Eastern Department added.

Mr. Smee said that, considering the background paper on recent economic developments and the staff representative's statement about wage adjustments owing to cost of living increases, it appeared that wages in Saudi Arabia had not been allowed to rise in real terms. Even if allowance were made for an annual increase of 3 percent, as the staff representative had mentioned, the total wage bill would not have reached the recorded level of SR1s 93 billion. Therefore, it appeared that substantial growth in employment had contributed to the increase in the wage bill.

The staff representative had said that Table 18 of the staff report had used a wider definition of government than that pertaining to the budget, Mr. Smee continued. What were those other institutions outside the scope of the budget, which had been treated as producers of government services only? Where had most of the increases in employment taken place? Perhaps Mr. Al-Jasser could respond to his questions about the data on the private sector given in Table 17, as well as the issue of the Sixth Development Plan.

Mr. Shaalan observed that Mr. Al-Jasser had referred to nominal, not real, wages. Merit increases and promotions, which might be substantial, would need to be taken into account in analyzing wage increases.

Mr. Zoccali said that he was concerned that artificially low administered prices might give rise to additional internal debt, with an impact on the budget later on, when privatization began.

The staff representative from the Middle Eastern Department explained that Table 18 had used the national accounts definition of government services, which was broader in scope than the definition used in the budget. The broader definition included the municipalities, local governments, and other activities of a government nature that were not part of the budget itself. Some productive activities had also been included in that broader concept.

The losses of the public utilities--mainly of the electricity companies--had been covered through subsidies from the budget, and therefore did not generate domestic debt per se, the staff representative from the Middle Eastern Department explained. Other debt had arisen as a result of the mobilization of capital and expansion of capacity of utilities, but not from subsidizing below-cost pricing of some activities.

Mr. Sirat commented that even if part of the expenditures on salaries related to the extrabudgetary sector--municipalities, local authorities, and public enterprises--the wage increases must have had some impact on the budget, through transfers and subsidies.

The staff representative from the Middle Eastern Department replied that any wage increase would have some budgetary implications. The budget used a narrower concept of government than that used in Table 18. All budgetary outcomes should be reflected in Table 18, although some items covered in that table might not be directly reflected in the budget.

Mr. Al-Jasser thanked the Directors for their constructive comments, and for their interest in the policy developments of the Saudi Arabian economy. There had been a clear agreement between the Fund and the authorities about the policy imperatives facing the Saudi Arabian economy, which had been reflected in the staff report.

It was necessary to emphasize the seriousness with which the authorities had regarded fiscal consolidation, Mr. Al-Jasser continued. Fiscal performance during the first six months of the current fiscal year had further demonstrated that seriousness, which had been evident in the adjustment process in Saudi Arabia in recent years.

The Saudi Arabian economy would continue to be based on oil, and there should be no illusion that it would be otherwise in the coming decade, Mr. Al-Jasser commented. The vagaries of the oil market had adversely affected the development of the Saudi Arabian economy. Therefore, the authorities had made a determined effort to control budgetary expenditures, which, in nominal terms, had been reduced to half the levels of 1981/82. However, that did not imply that no further policy action was required, or that the authorities would raise spending. Rather, it was necessary to

maintain a proper perspective, in order to safeguard the economic progress achieved so far.

The Saudi Arabian economy was still undergoing substantial transformation, and Saudi Arabia was essentially a developing country, Mr. Al-Jasser commented. Available data showed that primary school enrollment had risen to 77 percent of the school-age population in 1992, compared with 24 percent about 25 years ago. Similarly, female enrollment in education had risen from only 11 percent 25 years ago to 72 percent in 1992.

Immunization for measles--an important factor in reducing infant mortality--had risen from 46 percent of the population in 1980-85 to 90 percent by 1992, which was much higher than the average of 81.8 percent for the Middle East and North Africa regions, Mr. Al-Jasser continued. During the same period, DTP immunization had risen from 50 percent to 94 percent of the population. A quarter of a century ago, there had been about one physician for every 7,400 people, whereas there was one for every 698 at present. Infant mortality had declined substantially from 148 per 1000 to 28 per 1,000. Over the preceding quarter century, life expectancy had risen from 48 years to 69 years.

Student enrollment in Saudi Arabia, which had been about half a million in the mid-1970s, had reached more than 3 million, in government educational institutions alone, Mr. Al-Jasser continued. That had amounted to an annual growth in enrollment of 9.5 percent, compared with the population growth of 4 percent per year. Great efforts had been made in developing human capital, and passing the benefits of better human capital along to the rest of the economy. The improvements in social indicators in Saudi Arabia represented an achievement.

The role of the private sector had acquired remarkable prominence, Mr. Al-Jasser commented. Although the contribution of the private sector to output growth and non-oil exports had increased substantially during the preceding 20 years, the Government was still striving to do more, as demonstrated by the budget for 1994, and the decisions on privatization; the Government wished to reorient the economy more toward the private sector during the Sixth Development Plan period.

Development plans in Saudi Arabia had been intended as guidelines, and not as rigid norms to be followed by each enterprise, Mr. Al-Jasser commented. The broad guidelines of the most recent Development Plan, which continued to emphasize the role of the private sector and the development of human capital, had already been approved by the cabinet. The Plan also emphasized rationalization of government expenditures--which would have implications for non-oil revenues--and subsidies. The Plan dealt with privatization much more explicitly than before. The details of privatization, and its implications for the budget and government institutions, would be reflected in the budget for 1995. The Government

would be steadfast in its policy of fiscal consolidation, rationalization of government services, and giving a larger role to the private sector.

The authorities' commitment to adjustment had been demonstrated by the fact that budgetary spending in 1994 had been targeted to decline by 33 percent in comparison with the level of 1990/91, Mr. Al-Jasser said. In the meantime, revenues had declined by 24 percent, basically owing to the fall in oil prices. In that regard, the authorities were serious about pursuing revenue diversification. Oil, however, would continue to be a major source of revenue for some time to come.

Saudi Arabia was returning to the level of spending of 1989--the peak of the adjustment process in the 1980s--Mr. Al-Jasser remarked. Although the authorities had been optimistic that the favorable trends of 1989 would continue, the Gulf crisis had interrupted the adjustment process. The country had regained some of the lost ground, and was determined to launch a more intensified effort to bring about the necessary adjustments in the economy.

Direct wage compensation in the budget related to education, health, and mobilization of military personnel during the crisis, Mr. Al-Jasser noted. In Table 18, government wage compensation had included incidental costs related to the Gulf crisis in 1990, 1991, and 1992. The reconciliation of national accounts data with budgetary data deserved further attention.

In an economy like that of Saudi Arabia, the volume of external transactions for imports and exports was substantial, Mr. Al-Jasser observed. Therefore, any attempt at current account targeting might imply some restrictions, which were not contemplated in Saudi Arabia. The Government's primary focus was on fiscal adjustment, but that did not mean that fiscal policy was the only influence on the current account. The rapid growth in and influence of the private sector had been reflected in the external current account outcome. At present, fiscal policy and the other structural policies in the real sector would influence the current account.

In oil-based economies, the term "non-oil revenues" had always been used, because oil was such a significant aspect, Mr. Al-Jasser commented. A number of non-oil revenue measures were under discussion, but not a personal income tax, because other revenue measures might be more promising and realistic.

The authorities had not intended to restrict the banks' role in the economy, Mr. Al-Jasser commented. A primary reason for the regulations on the involvement of commercial banks in the equity of corporations was the need for prudential supervision, in order to promote a healthy financial sector.

Distortions caused by domestic taxes on oil in importing countries had a direct bearing on investment plans and on the availability of resources in oil producing countries, Mr. Al-Jasser concluded.

The Acting Chairman made the following summing up:

Executive Directors endorsed the thrust of the staff appraisal. Directors noted that the authorities' attempts to restore the strong adjustment momentum of the late 1980s through substantial budgetary expenditure cuts had been frustrated in 1993 by the decline in oil prices. The budgetary and external current account deficits remained high, domestic public debt rose in recent years to nearly two thirds of GDP, growth of non-oil GDP slowed, official net foreign assets fell further, and the exchange rate came under pressure during late 1993. However, inflation remained low.

Directors welcomed the significant strengthening of the authorities' efforts to reduce the budget deficit and improve the external balance in 1994 through further cuts in government expenditures. Nonetheless, Directors noted that with unchanged policies, the medium-term budgetary outlook would be somewhat fragile. Budgetary and external current account deficits would remain high for a number of years to come. Financing of these deficits would become increasingly difficult. For the authorities to succeed in limiting domestic bank borrowing and avoiding external borrowing for balance of payments purposes, additional measures to strengthen the budget structurally and to bring about a lasting reduction in the deficit, as well as in the ratio of government debt to GDP, is essential. In particular, a reduction in unproductive expenditures, along with a rationalization of public sector priorities, and a careful review of the possibilities of reducing the public sector wage bill, would be needed, as would measures to raise non-oil revenues. Budgetary adjustment was particularly necessary because of the volatility of oil revenues and the need to increase capital outlays and enhancement of private sector activity with a view to establishing a strong foundation for self-sustaining growth and providing employment opportunities for the growing population. In this context, the need to protect expenditures in education was stressed. An early intensification of fiscal adjustment was of the essence, as it would provide a signal to the market that would support exchange rate stability and boost confidence and, therefore, growth prospects. Many Directors urged the authorities to adopt explicit budget targets in a medium-term context.

Directors welcomed the authorities' intentions to build upon the measures taken in 1994 through the adoption, as a part of the Sixth Development Plan, of further cutbacks in implicit and explicit subsidies and of measures to mobilize non-oil revenues.

They stressed that utility rates and prices of publicly supplied goods and services should be adjusted quickly so as to reflect market conditions. AS the other Cooperation Council of the Arab States of the Gulf members were presently confronted with structural adjustment requirements similar to those in Saudi Arabia, and in light of the commitments under the GCC umbrella, Directors recommended that consideration be given to adopting non-oil revenue enhancement measures as well as subsidy reductions in coordination with other GCC members.

Directors agreed that a tightened fiscal stance should continue to be supported by prudent monetary policies and that the reduction in the budget deficit should be associated with a further shift toward nonbank financing of such deficits. For this purpose, Directors called for the development of an active secondary market in government paper and for an early elimination of subsidized credit through the specialized credit institutions.

Directors fully endorsed the authorities' plans to initiate privatization of public enterprises and to encourage private sector activity, and also emphasized the need to attract foreign investment in various sectors. The possible risks of bank participation in nonbank private sector equity were stressed by some Directors.

Directors commended the authorities for the continued maintenance, despite persistent financial pressures on account of the regional crisis and lower oil prices, of an exchange and trade system free of restrictions, and a sizable economic assistance program to developing countries. Directors further noted Saudi Arabia's continued contribution to stability in the global oil market. They also welcomed Saudi Arabia's decision to seek accession to the GATT.

Directors noted the recent progress in the provision of data. However, in view of the size and importance of the Saudi Arabian economy in the global context, and the importance of facilitating and enhancing analysis of economic developments, there was a need for the provision on an ongoing and timely basis of more detailed and current information to the Fund on developments in the economy.

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

2. ST. VINCENT AND THE GRENADINES - 1994 ARTICLE IV CONSULTATION

Executive Directors considered the staff report for the 1994 Article IV consultation with St. Vincent and the Grenadines (SM/94/258, 9/30/94; and Cor. 1, 10/19/94). They also had before them a background paper on recent economic developments in St. Vincent and the Grenadines (SM/94/254, 10/12/94; and Cor. 1, 10/19/94).

Mr. Smee made the following statement:

My Vincentian authorities thank the staff for the spirit in which the Article IV consultation was conducted, and for the useful advice and suggestions offered during the process. My authorities are in general agreement with the overall thrust of the report that the staff has prepared.

For some time now, the uncertain outlook for banana production and exports has been the principal dark shadow looming over the medium-term economic prospects for St. Vincent and the Grenadines and other members of the Windward Islands group. This was a central point of concern when the Executive Board discussed the last Article IV consultation report on St. Vincent and the Grenadines in October 1992. Since then, some widely expressed fears have been realized. A combination of adverse weather conditions and changes in the regime for the marketing of bananas in the European Union have led to a drastic decline in the banana industry. From a level of 76,000 tons in 1992, export volume is expected to fall to 45,000 tons in 1994, a decline of 41.0 percent; and reflecting both the fall in volume as well as a fall in prices, export earnings of US\$36.6 million in 1992 will drop to US\$19.4 million in 1994, a reduction of 47.0 percent. This downturn was linked to a 10 percent reduction by end-1993 in the acreage under banana cultivation, and to an 11.0 percent fall in 1993 in agricultural output.

Owing principally to the impact of these developments, the small island economy of St. Vincent and the Grenadines experienced a sharp decline in real growth from an average annual rate of nearly 6.0 percent during 1988-92 to an estimated average of 1/2 of 1 percent in 1993 and 1994, yielding a sluggish 1/2 of 1 percent growth in real GDP per capita in these latter two years.

As would be expected, the declining performance of the banana industry also impacted unfavorably on the external position. The external current account deficit averaged about 14 percent of GDP during 1989 to 1992. The deficit was balanced each year, except in 1991, by inflows of private capital and concessionary loans. The current account deficit deteriorated sharply to an estimated 17.5 percent of GDP in 1993 and a projected 32.7 percent of GDP in 1994. This unsustainable widening of the current account deficit

has led to an overall balance of payments deficit in these latter two years, financed in large measure by a running down of St. Vincent and the Grenadines' imputed reserves at the Eastern Caribbean Central Bank (ECCB).

My authorities are aware of the policy challenges posed by these developments. Their medium-term objective is to restore real GDP growth to 3 percent in 1995 and 1996, increasing thereafter to 5 percent in 1998, accompanied by an elimination of the external current account deficit by 1999, and with the overall external position in balance. They aim to bring this about by means of a well-articulated five-pronged strategy, while keeping inflation low, in line with Eastern Caribbean norms and St. Vincent and the Grenadine's principal trading partners. First, they are committed to maintaining and, where possible, strengthening the prudent fiscal policies for which they have been commended in the past. Second, they are embarking urgently upon a program to increase productivity and competitiveness in the banana industry. Third, they will promote diversification and development of non-banana agriculture. Fourth, they will be pursuing considerable expansion of the tourism sector, and promoting growth in manufacturing. Fifth, they will strengthen the incentive framework to enhance efficiency in the economy and to encourage domestic and foreign private investment.

In the area of fiscal policy the authorities are determined to maintain the high level of public sector savings achieved in past years, and indeed to increase it into the medium term. Accordingly, the authorities view positively the recommendation of the staff that the public sector current surplus be strengthened steadily over the next five years from a projected 7 percent of GDP in 1994 to 10 percent of GDP in 1999. This would help the authorities avoid major use of domestic financing to support their public investment program. Indeed, with external grants having declined from 6 1/2 percent of GDP in 1988-89 to 1 percent of GDP in 1993, they hope that domestic public sector savings can be supplemented by concessionary loan financing to improve infrastructure without increasing external debt service unduly.

The authorities aim to maintain a strong fiscal stance while reducing customs tariffs, corporation tax, and the highest marginal tax rates on personal income. As detailed in the staff report, other tax measures have been or are being introduced to offset some of the resulting revenue losses. At the same time, while improving outlays for the social sectors, strict control will be maintained on current expenditure, with the authorities remaining especially committed to the objective of keeping public sector wage adjustments within the rate of inflation.

With respect to policies relating to the production and export of bananas, the authorities believe that the adjustment

response to the developments affecting the sector should aim at applying focused and well-conceived measures to improve productivity and competitiveness in the industry. Accordingly, measures are now being pursued to encourage marginal producers to move into other areas of activity, to replant suitable banana lands along more efficient lines, and to substantially improve yields per acre. The authorities expect that, on the basis of these policies, St. Vincent and the Grenadines will be able to restore the performance of the banana industry over the next four years to the point where it will be able to meet its quota of 82,000 tons to the European Union market in 1998. The St. Vincentian Government is also seeking, jointly with other Windward Islands banana exporters, to restructure the traditional arrangements for shipping and distributing the fruit, with a view to receiving a larger share of the proceeds for the domestic economy.

The authorities recognize that it will not be easy achieving further significant diversification of non-banana agriculture, which at present largely comprises a range of root crops for domestic and regional markets. Nevertheless, this remains an important objective. Alternative areas of agricultural production offering attractive income opportunities will have to be targeted, particularly through the identification and development of export marketing outlets supported by adequate infrastructure and viable transportation arrangements. The authorities are encouraged by the fact that a start has already been made along these lines with the production of fruits and flowers for the North American market.

The authorities are placing the greatest emphasis on the tourism sector in their search for economic opportunities outside the banana industry. To this end, as outlined in the staff report, they have succeeded in attracting private sector investment for a number of major tourism-related projects. A major yacht repair and rental facility is soon to be completed on St. Vincent Island, and some 500 new hotel rooms, along with villas, apartment complexes, and yachting berths are to come on stream during 1994 to 1996 on Union Island and Canouan in the Grenadines. These projects will relieve the pressure of demand on the limited capacity of the country's tourism plant, especially the up-market facilities in the Grenadines. They will provide the basis for the number of stay-over visitors to rise from an estimated 53,000 in 1994 to a projected 77,000 in 1999 and for tourism receipts to increase from an estimated US\$33 million in 1994 to a projected US\$67 million in 1999.

Supporting all these projected developments will be the continuing effort of the authorities to strengthen the incentive framework. In addition to the tax reform measures already mentioned, price controls have been eliminated except for a small

number of products or product groups, company legislation has been modernized, alien landholding regulations are being revised to remove obstacles to the acquisition of domestic assets by foreigners, import licensing procedures have been simplified, and further reduction of import licensing requirements is being considered. The exchange market has been further liberalized with the removal, in common with other Eastern Caribbean Central Bank member countries, of the 1 percent tax on foreign exchange purchases. St. Vincent and the Grenadines is prepared to review, with partner countries in the region, the ECCB-imposed minimum interest rate on savings deposits.

My authorities look forward to continued close cooperation with the Fund and to benefiting further in the future from its technical resources and the expertise of its staff.

Mr. Ally made the following statement on behalf of Mr. Kafka:

St. Vincent and the Grenadines is a small island agricultural economy which, until last year, had maintained average real growth rates in excess of 5 percent during 1989-92. Although preferential banana market arrangements and access to concessional financing for infrastructure expansion have been beneficial, considerable credit is due to sound economic and financial management by the authorities.

Real GDP growth is expected to rise marginally from 1.4 percent in 1993 to 1.6 percent in 1994. The medium-term outlook is more promising, having regard to the start-up of new tourism facilities by the end of 1994. Inflation continues to fall in line with the easing of import prices and an appreciation of the Eastern Caribbean dollar vis-à-vis the European countries, and the maintenance of a tight fiscal position.

We note that St. Vincent is part of the Organization of Eastern Caribbean States (OECS) monetary and fixed exchange rate system that has withstood two oil shocks, two world recessions, and a series of natural disasters over the past 25 years. The exchange rate anchor has served the economy well, as noted in the staff report. However, the recent appreciation in the real exchange rate will put increasing emphasis on maintaining international competitiveness. In this connection, structural reforms in company legislation, in the tax regime and tax administration, and in import duties and import licensing have been essential elements in the cost structure of doing business. Wage levels will also need to be monitored carefully.

Public sector savings have averaged over 7 percent of GDP since 1989 which, with additional support from concessional donor assistance, have made possible substantial expenditure on capital

investment without having a deleterious impact on debt servicing. However, with the recent narrowing of the savings balance of the public sector and lower concessional flows, it will be necessary to reprioritize capital investment to manageable levels.

With respect to the investments of the National Insurance Scheme, we would suggest that although diversification of the investment portfolio would be beneficial, prudential criteria should be developed to minimize undue risk to the value of the Scheme.

The period ahead is a critical one for the economy. Although the threat perceived in the change in the preferential arrangements for bananas, with the creation of the single EU market, had been acknowledged for some time, there is clearly more urgency now to do something constructive about: either diversifying the economic structure, thereby reducing reliance on bananas; or, improving the cost structure of banana production in St. Vincent and the Grenadines, or, indeed, both.

The efforts to improve banana productivity are long overdue. Although there are various elements in the cost structure of banana production, the targeting of yield per acre to at least match those of competitors is a necessary step. Also, the goal of reducing shipping and distribution costs may improve returns to producers, but more important, should be seen as achieving lower costs overall. Could the staff say whether the steps being taken have a reasonable chance of bringing the cost of production to the level of competitors' cost before the current EU arrangement expires, or could the efforts be more usefully expended elsewhere?

As has been noted in previous Board discussions, diversification of the economic base will not be achieved easily. The market for traditional non-banana exports to the rest of the CARICOM region has suffered by continuing recession in those countries, which it is to be hoped will be revived in the near future. The staff report notes the continuing efforts to develop nonagricultural activity; however, there have already been unfortunate casualties in the enclave sector. With regard to incentives for private sector development, we were somewhat surprised by the statement on page 3 of the staff report that the Government had guaranteed the external debt of the private sector with regard to the Ottley Hall project. What is the risk of this guarantee being invoked when one considers the circumstances that might have made such a guarantee necessary in the first place?

Excluding the government guarantee referred to previously, it is noted that the external debt is being undertaken on increasingly commercial terms, and is an issue that needs to be

monitored, although debt service is not yet considered to be onerous.

With regard to what seems to be a costly airport development project, we would suggest that the scope and feasibility of such a project should be carefully considered. Air transport facilities among the small island countries of the Eastern Caribbean could be more cost effective if the regional or cooperative approach was intensified.

We would be less concerned with the dramatic widening of the current account deficit on the balance of payments as long as it is being financed by direct private investment.

In closing, as we said earlier, the period ahead is a critical one, and we trust that the authorities will maintain their prudential approach in adapting to the new environment.

Ms. Petana made the following statement:

We sympathize with the situation the St. Vincent and the Grenadines authorities are now facing, as it closely mirrors the situations of many other small and primarily agricultural economies, heavily dependent on a few export commodities and markets, and subject to natural disasters and shifts in international terms of trade. As we are in broad agreement with the staff's assessment, and the authorities' proposed five-pronged strategy described in Mr Smee's helpful statement, I will be brief in my comments.

Since the last consultation, there has been some success in broadening the export base. I would caution, however, that just as there is attention to improving the quality of the banana industry aside from increasing output, this approach should also be taken to nurture growth in the niche markets for these few commodities. I am a bit concerned, however, that in insisting on diversification, particularly in the agriculture sector, sometimes we tend to overlook the constraints in markets, infrastructure, transport arrangements, research, land terrain, and soil quality, which combined can be fairly prohibitive. No less prohibitive is the impact of migration on human capital and the implications for diversification of these island economies, as this can constrain the pace of diversification or prevent it from taking place on a sustainable scale. In this respect the progress made by the authorities is to be commended.

I also note that in the papers there was limited information on the private sector, although its contribution to the current revitalization of the tourism sector, and no doubt the manufacturing sector, is certainly laudable. Expansion of these

sectors will be important for future growth. In view of the progress made on the land issue, as well as the other initiatives being taken to promote both domestic and foreign investment, I wonder whether the staff could comment on the scope for private sector involvement in some of the activities or enterprises under the Government.

The authorities' commitment to fiscal policies will be critical in the medium term. We are encouraged that the authorities fully realize the importance of expenditure restraint, and particularly wage restraint, in preserving longer-term external competitiveness. However, although no new general wage increases were awarded in 1994 by the Central Government, the increasing wage bill relative to current revenues is a matter of concern. In this regard, the outcome of the discussions on a new wage contract for implementation in 1995/1996, particularly at a time of slow economic growth, increased investment spending, and ongoing reforms of the tax regime, may undermine their efforts to maintain tight fiscal policy. However, in view of their pursuit of fiscal discipline and sound financial management policies generally over recent years, we are confident that they will continue to exhibit such prudence.

We note the intentions of the authorities to adjust public utility rates to meet the investment needs of enterprises. In this regard, the overall current surplus position of a number of state enterprises, particularly the Water and Sewerage Authority and the Electricity Authority, from tariff adjustments is commendable, in view of the difficulty usually encountered in such small open communities for a user-pay approach, although I suspect that the profitability of these enterprises also lies with efficient management practices. We wish the authorities well in this trying period.

Mr. Havrylyshyn said that the St. Vincent and the Grenadines' economy was dependent on volatile banana exports, the volume of which was largely determined by weather conditions and quota arrangements. Because the unfavorable effects of quota arrangements were likely to continue, diversification of agricultural exports, upgrading of the quality of exported bananas, and development of the tourist potential were crucial to the country's future development. Although the Government intended to provide the supporting infrastructural investment, the leading role in the transition process would be played by the private sector. However, in order for the Government to achieve that goal without impairing price stability, it would be necessary to retain current expenditures by granting only modest central government wage increases, reducing tax exemptions, and lowering tax rates. It appeared that the Government was firmly committed to pursuing such a policy.

While inflation had declined from 7 percent in 1990 to about 3 percent in 1994, bank lending rates had remained at about 11-12 percent, Mr. Havrylyshyn remarked. In view of the 4 percent decline in inflation rates and unchanged lending rates, real interest rates had risen substantially. Because of the 4 percent statutory floor on savings deposit interest rates, some banks were unwilling to accept savings deposits. He was aware that the staff had recommended abolishing the floor on savings deposit rates. He wondered whether some measures were being contemplated to deal with high lending rates, which were having a disincentive effect on investment.

The staff had mentioned that there were difficulties in raising the needed financing for the international airport project, Mr. Havrylyshyn concluded. However, it was not clear whether the difficulties involved complexities of raising the needed financing in a relatively small economy, or whether the difficulties were associated with the economics of the airport project itself. The staff might wish to comment about the feasibility of the proposed airport. On a related matter, he wondered whether the projections of tourism revenue in the staff report were based on the assumption that a new airport would not be built.

Mr. Wire made the following statement:

We agree with the staff appraisal, which itself appears to broadly endorse the Government's overall development strategy. Fiscal policy needs to be tightened, with special emphasis given to new revenue measures and wage restraint.

Heightened domestic and regional efforts are needed to boost the efficiency and competitiveness of the banana industry. The economic base must be diversified, not only through selective public investment, but also through efforts to stimulate private investment and private sector activity by reducing government controls and regulations.

We also agree with the cautions that the staff expresses with regard to commercial debt and private sector guarantees.

Finally, the widespread statistical deficiencies noted in the report ought to be rectified as soon as possible.

The staff representative from the Western Hemisphere Department said that it was unlikely that Vincentian banana farmers would be competitive with Latin American producers under the new European Union banana arrangement. Available information had indicated that average productivity in Latin America ranged from 16 to 25 tons per acre, and in St. Vincent, between 6 and 8 tons per acre. The authorities were striving to raise productivity to about 10 tons per acre. Attempts to reduce costs further by renegotiating port and discharge rates might not help much, because the gap between Vincentian and Latin American productivity levels was so large.

The Ottley Hall project, for which the Vincentian authorities had guaranteed a loan, was a joint venture between a foreign company and the Government, in which the latter held 45 percent of the equity, the staff representative explained. The project required large imports of capital equipment, spurring the suppliers to demand a sovereign guarantee for them. Notwithstanding the financial risks involved and the possibility of creating a precedent, the authorities had provided the guarantee, as it had been considered crucial to boost tourism development. However, they had made it clear that they were unlikely to enter into similar arrangements in the future.

The private sector had dominated productive activities in St. Vincent, the staff representative explained. Apart from the few state enterprises, the largest of which--the dairy and the distillery--were currently up for privatization, the Government's role was confined to infrastructure development. The agriculture and tourism sectors were entirely in the hands of the private sector--except for the government involvement in the Ottley Hall project.

The feasibility study on the airport project had been issued recently, the staff representative continued. The Government was still in the early stages of examining that report, and exploring options. Since the issuance of the feasibility study, the Government had obtained further information that suggested that an international airport could be constructed at an alternative site at a substantially lower cost--approximately \$75 million, in comparison with the estimate of \$150-250 million given in the feasibility study. The Government had recognized that raising even \$75 million was going to be a major task. The authorities had not yet started to discuss the financial arrangements.

Because loans were given largely to farmers whose incomes were volatile, bank lending had been risky, and the risk element built into the lending rates had been relatively high, the staff representative commented. Several foreign-owned banks could also be accused of collusion to keep lending rates high. Notwithstanding substantial reductions in deposit rates over the years, lending rates had remained unchanged. The authorities had tried to circumvent that by promoting the National Commercial Bank, which had helped to exert downward pressure on lending rates. However, the minimum lending rate remained at about 11 percent.

Mr. Smee thanked his colleagues for their useful comments on the Vincentian economy. The banana and tourism sectors of St. Vincent and the Grenadines were undergoing considerable change. The banana sector had suffered from drought, the uncertainty related to the new EU regulations, and a lack of competitiveness. Attempts were being made to enhance competitiveness in order to take advantage of the export quota of 82,000 tons, over the period when the EU regime was to be in force. Although only about half of that quota was being utilized at present, the unutilized part was not transferable to a future year. In view of the anticipated increase in price and planned improvement in competitiveness,

the banana sector was likely to perform better over the succeeding three years, but the long-term viability of the sector depended on the EU policy regime in the next century.

Notwithstanding the considerable efforts of the authorities to diversify agriculture and manufacturing, the tourism sector had the greatest prospects for development, Mr. Smee commented. A great deal of investment was already taking place in tourism infrastructure. Although undesirable, a sovereign guarantee might have been unavoidable in the case of the Ottley Hall project, in view of the circumstances of a small island state and the importance of that large project to the economy. He would convey to the Vincentian authorities the Board's concerns that the guarantee should not become a precedent, and that the Government must not underwrite private sector investments.

St. Vincent's airport was small, and could accommodate only smaller aircraft from other islands in the Caribbean, Mr. Smee explained. The authorities had believed that in order to fully develop tourism, it would be necessary to upgrade air transport facilities at some point. The comparison of the cost of the airport--even at the conservative estimate of \$75 million--with the island's GNP of about \$250 million revealed the high infrastructure costs facing small states. Although the costs of building an airport would be about \$70 million anywhere in the world, to undertake such a project in an economy that was generating an income of only \$250 million was quite difficult. In that sense, the airport project would remain a dream unless the economics underlying it were improved.

There should be more competition in the financial sector in the region as a whole, Mr. Smee concluded. More benefits would accrue from developing the wider regional market than in enhancing competition on particular islands, the prospects for which were limited. The Eastern Caribbean Central Bank was attempting to introduce more competition through an integration and development of capital markets of the countries of the region.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal. They observed that for a number of years St. Vincent had enjoyed high rates of growth, reasonable price stability, and balance of payments surpluses. While inflation remained low, economic growth had slowed over the past two years owing to the sharp decline in banana production and exports related to poor weather conditions and the uncertainties surrounding the banana regime in the European Union.

Directors observed that the planned expansion of public sector investment in infrastructure and the downward trend in external grants pointed to the need for an increase in public sector savings in the next several years. To meet this objective,

it was important to contain the growth of current expenditure, particularly through wage restraint, and to strengthen revenue performance through a reduction in tax exemptions and corrective adjustments in public utility tariffs. Directors cautioned the authorities to be very careful about the long-term financial and economic viability of the major airport project that was being considered.

Directors were of the view that the measures being taken to improve quality and increase efficiency in the banana industry, along with the effects of investments currently under way in the tourism sector, should help strengthen the economy. They emphasized that maintaining export competitiveness in the framework of a sound macroeconomic environment was critical for the success of economic diversification and employment creation over the medium term. They considered that the fixed exchange rate peg between the EC dollar and the U.S. dollar had served St. Vincent well, but stressed that under this arrangement, the achievement of a satisfactory degree of export competitiveness depended on a tight fiscal stance and a wage policy consistent with low inflation. Directors also urged the authorities to remove the statutory floor on savings deposit interest rates in order to improve the efficiency of financial intermediation. Directors cautioned the authorities to refrain from further private sector debt guarantees. Finally, the authorities were encouraged to give greater emphasis to the improvement of economic and financial information and statistics to facilitate policymaking.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/94/93 (10/19/94) and EBM/94/94 (10/21/94).

3. EXECUTIVE BOARD TRAVEL

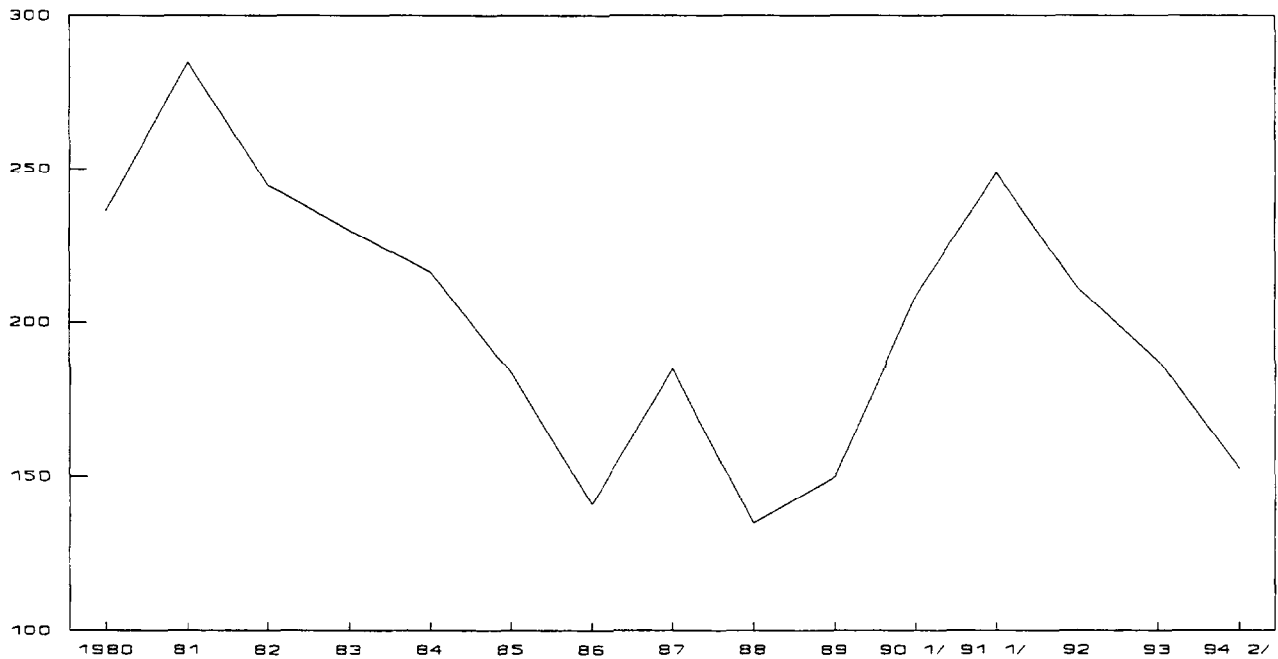
Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAM/94/168 (10/19/94) is approved.

APPROVAL: November 1, 1995

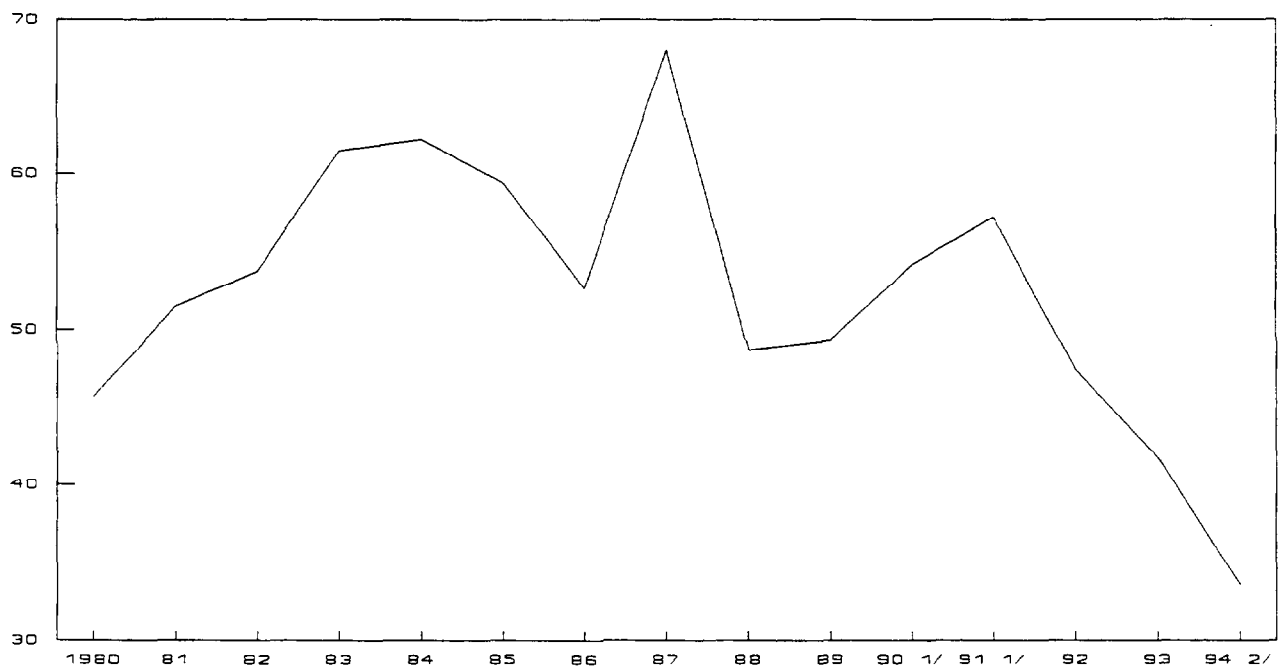
LEO VAN HOUTVEN
Secretary

ANNEX

CHART 1
TOTAL GOVERNMENT EXPENDITURE
(in billions of Saudi Arabian Riyals)



(in percent of nominal GDP)



1/ Prorated expenditure figures with respect to GDP.

2/ Budgeted expenditure for 1994. 1994 GDP is staff estimate.