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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/35

3:00 p.m., March 2, 1987

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	P. E. Archibong, Temporary
	Song G., Temporary
C. H. Dallara	M. Lundsager, Temporary
	E. L. Walker, Temporary
	G. Seyler, Temporary
A. Donoso	
M. Finaish	S. K. Fayyad, Temporary
	B. Goos
	Hon C.-W., Temporary
	J. R. N. Almeida, Temporary
	M. Foot
	R. Fox, Temporary
	M. A. Kyhlberg, Temporary
	D. McCormack
	D. Saha, Temporary
	I. A. Al-Assaf
	L. Filardo
	S. de Forges
	G. Pineau, Temporary
	J. de Beaufort Wijnholds
	I. Sliper, Temporary
G. Salehkhou	O. Kabbaj
	V. K. Malhotra, Temporary
K. Yamazaki	
	F. Di Mauro, Temporary

L. Van Houtven, Secretary
J. K. Bungay, Assistant

Also Present

IBRD: T. King, Europe, Middle East, and North Africa Regional Office; R. H. Nooter, Eastern and Southern Africa Regional Office. African Department: A. D. Ouattara, Director; D. T. S. Ballali, J. M. Jimenez. Exchange and Trade Relations Department: J. T. Boorman, S. Kanesa-Thasan, M. K. Rodlauer. Legal Department: A. O. Liuksila, J. M. Ogoola, J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; S. H. Hitti, S. Kawar, P. H. Mathieu, M. F. Melhem, K. Nashashibi, B. R. H. S. Rajcoomar, C. Sassanpour, B. K. Short. Treasurer's Department: T. Leddy, Deputy Treasurer; J. E. Blalock, J. C. Corr, J. A. Gons, R. L. Velutini. Western Hemisphere Department: M. Caiola, L. A. Cardemil, E. Decarli, V. J. Fernandez, J. Ferrân, M. E. Hardy, S. C. de Sosa. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: M. B. Chatah, S. M. Hassan, K. Murakami, A. Ouanes, I. Puro. Assistants to Executive Directors: A. R. Al-Abdullatif, O. S.-M. Bethel, H. S. Binay, O. Isleifsson, K.-H. Kleine, T. Morita, R. Msadek, J. A. K. Munthali, A. H. Mustafa, L. M. Piantini, S. Rebecchini, C. A. Salinas, H. van der Burg, D. A. Woodward, I. Zaidi.

1. VENEZUELA - 1986 MIDYEAR ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 midyear Article IV consultation with Venezuela (SM/87/22, 1/21/87).

Mrs. Filardo made the following statement:

My authorities are very appreciative of the staff report and the way in which economic policy discussions were held on the occasion of the midyear Article IV consultation. They enjoyed the open nature of this consultation and wish to express their satisfaction to the staff for the professional work performed. In general, they agree with the staff's view that the external sector disequilibrium was larger than expected and that there was urgent need to implement a comprehensive, sound economic package progressively to reduce it. To this end, the Government announced new measures in December 1986 that are now being implemented. The Article IV consultation report of July 1986 was distributed to the creditor commercial banks, as a compromise, under the enhanced surveillance agreement. The authorities remain committed to continuing this approach and give their assurances that the new report will also be distributed. In the remainder of my statement, I will first refer to the recession period that Venezuela experienced for more than seven years; discuss the oil shock and developments in 1986; and finally comment on the outline on economic policies for 1987.

Like other Latin American countries, Venezuela still suffers from the global recession of the early 1980s. The combination of steep declines in both the volume and price of its exports and sharp rises in real interest rates pushed Venezuela's external balance into deep deficit. The overwhelming dependence on oil as a source of government revenue and foreign exchange and the small base of diversification make the country particularly vulnerable to fluctuations in the global demand for oil and, hence, to its price. Therefore, when capital inflows from commercial banks were most needed, the debt crisis erupted in 1982-83, and Venezuela was caught up in the process of renegotiating the public sector's foreign debt.

When the new Government took office in February 1984, Venezuela's economy had declined for seven consecutive years and was experiencing serious internal and external imbalances that were aggravated by the burden of its foreign debt. Notwithstanding the country's recession, the authorities decided to intensify the austerity measures adopted by the former Administration. This led to a significant improvement in public finances and the external sector. The public sector deficit--nearly 15 percent of GDP in 1982/83--turned into a surplus of 5 percent of GDP both in 1984 and 1985. 1/ The current account improved substantially recording a surplus of $5.4 billion in 1984 and $3.1 billion in 1985, and international reserves reached $15.5 billion. Unfortunately, this successful adjustment was made at the expense of growth and increasing unemployment: GDP in real terms declined again by 1.4 percent in 1984 and leveled off in 1985, while unemployment rose from 7.1 percent in 1982 to 12.1 percent in 1985.

Given the country's overwhelming dependence on oil exports, the limited diversification of its economic base, and the successful adjustment made, the authorities were ready to start implementing comprehensive economic policies and structural reforms aimed at reactivating the economy toward more sustainable growth. With regard to macroeconomic policies, the authorities bestowed on fiscal policy the primary role of strengthening the growth of the economy through the implementation of the Triennial Plan of Public Investment and the intensification of the ongoing process of closing and reconverting public industries, with a view to increasing productivity and improving the allocation of resources. To this end, the nonfinancial public sector enterprises, which had accumulated a deficit of Bs 6,519 million when the new Government took office, has shown a surplus of about Bs 20,760 million in the past three years, mainly becuase the reorganization, closing, and expenditure reduction of some state-owned enterprises. On structural reforms, in 1984-85 the Government initiated a program of technical assistance with the World Bank in various fields, namely, the electricity sector, capital markets, and energy conservation. My authorities have seriously taken the recommendations of the reports on electricity and capital markets into account for implementation. The energy conservation report has still not been completed.

When the economy was ready to take off, after seven years of stagnation, the oil shock at the beginning of 1986 forced the Government to reconsider the economic strategy that was to have been pursued during that year. The first question was whether the shock was transitory or of a more permanent nature, given the uncertainties surrounding the oil market. The second question was what price scenario was the most probable to adopt in estimating the budget and making reliable medium-term projections.

1/ IMF figures since the official presentation indicate a surplus of 10.1 percent and 7.4 percent of GDP in 1984 and 1985, respectively, because the authorities regarded the revaluation of the central bank international reserves as public sector revenue rather than financing.

On the budget side, the authorities faced two conflicting policy considerations: first, to avoid an abrupt impact on the economy, particularly on the labor force and the private sector after having promised an economic reactivation in 1986; and second, to keep the depletion of international reserves at a manageable level, given the traditionally high external assets of the country and its overwhelming dependence on oil exports.

Finally, the 1986 Quantitative Economic Program (QEP), designed by the authorities early in 1986, was based on an average oil price of $15 per barrel, representing a drop in oil export earnings of about $5 billion. My authorities felt that because of Venezuela's relatively large international reserves and the surpluses in the public sector registered during 1985, they were in a position to continue with their economic growth strategy for 1986 for which the QEP projected a shift in the consolidated public sector finances from a surplus of 4.5 percent of GDP in 1985 to a deficit of 9.5 percent in 1986: the current account was projected to shift from a surplus of $2.7 billion in 1985 to a deficit of $1 billion in 1986, while limiting the loss of official reserves to $3.9 billion. It also projected no changes in real GDP for the non-oil sector and an increase in broad money, M2, of 18 percent. Finally, the consumer price index and wholesale price index were programmed to reach 12 percent and 15.3 percent, respectively, at the end of the year.

The Fund mission recommended for 1986 that: (i) the public sector deficit be held at about 6-8 percent of GDP; (ii) broad money be increased not more than 12 percent; (iii) the interest rate be maintained positive in real terms and be moved to a more flexible stance; and (iv) wage policy be kept firm and structural reforms implemented in different areas of economic activity.

However, the weakening of the oil market and the fall in oil prices were worse than the most pessimistic forecast. Venezuelan oil export prices dropped from $24.09 a barrel in January 1986 to $9.77 per barrel at the end of July, and ended 1986 at an average price of $12.89 per barrel. Oil export earnings were 44 percent lower than expected, reaching $7.2 billion ($12.9 billion in 1985).

In July 1986 when it was evident that the magnitude of the oil shock was greater than anticipated, the Government decided to overcome this problem by taking the following measures: first, the President of the Republic announced an economic package outlining the Government's main objectives, namely, to foster adjustment without hampering growth. These objectives were to be attained through a combination of demand management policies and an intensification of structural reforms. To this end, fiscal policy envisaged an increase of resources through a package that included reform of the income tax structure, a new sales tax, increases in stamp and real estate taxes, and the elimination of the exchange subsidy given to the private sector. Fiscal objectives were to be met mostly through revenue measures since public capital outlays were expected to remain high; there was no further room to reduce current expenditure because it had fallen by 12 percent in real terms over the past four years. The execution of the envisaged investment program has been delayed. The most recent figures of the consolidated public sector deficit reached 5.7 percent of GDP, 3.8 percent lower than programmed and lower than the range recommended by the staff.

On the structural front, the authorities reiterated their intention to improve resource allocation and to increase productivity in the state-owned enterprises; for this purpose a law concerning the selling, closing, and merging of various enterprises was to be enacted. On trade policy, they emphasized their interest in seriously challenging the almost total dependence on oil exports, and urged the World Bank to finish its trade policy report requested in mid-1986. At the same time, when the World Bank management finally suspended the graduation of restrictions imposed on Venezuela as of 1973, the authorities requested an economic mission to evaluate the country's sectoral problems with a view to further enhancing the economic package of July 1986. Trade policy discussions began in November 1986 and are proceeding as one of the main objectives of the Government and the World Bank's economic mission that visited Venezuela in January of this year. The report, with an emphasis on medium-term policies for economic development and agriculture and industrial sectors, is expected to be ready in May 1987. Meanwhile, in the last quarter of 1986 my authorities announced additional measures, reinforcing some of the expenditure-switching policies. These envisaged a modification of the multiple exchange rate; rationalization of import regulations; liberalization of the foreign investment code; increase of the minimum wage and the salaries of those who have experienced a real-term erosion of 37 percent in the last three years, and introduction of a new subsidy for certain agroindustrial products.

The Government's view is that it is not advisable for Venezuela to have a floating exchange rate because of its overwhelming dependence on oil exports, the price of which has been fluctuating and sharply reduced, thus seriously affecting the free market rate. Since the controlled rate again appreciated in 1986, the authorities decided first to select the most conservative approach in determining the real effective exchange rate for the controlled rate. To this end, the evaluated different indexes--consumer prices, wholesale prices, and home good prices for Venezuela and its trade partners--on the basis of different years--to arrive at the most appropriate rate for the country's products to be competitive. After several exercises, a final methodology was agreed upon, namely, that of home goods prices for Venezuela versus export unit values for its trading partners. Then the controlled rate was devalued on average close to 30 percent, which in real effective terms is lower than the exchange rate of the mid-1970s. Although the authorities seriously considered a unified exchange rate and direct subsidization of low income groups, they thought this could be more cumbersome and expensive and could result in more corruption. Therefore, the system incorporates two preferential exchange rates and a free market rate that has been fluctuating around Bs 22 per U.S. dollar. This represents a reduction in the spread between the two rates from 200 percent to 52 percent.

In view of the overwhelming weight of the Government on the economy, when the country experienced its first oil shock in 1982-83, it became necessary to devalue the currency. The extent of the private sector debt was unknown. To prevent failure and nationalization of private enterprises, the Government decided to guarantee the private debt service at an exchange rate of Bs 4.30 per U.S. dollar. The registration period was longer than predicted. In the meantime, a second oil shock took place, and the authorities realized that they were no longer able to guarantee that exchange rate. A new decision adopted in mid-1986 created serious problems with creditors. Therefore, after consultation with foreign commercial banks and the private sector and because of the deterioration of the external sector, the authorities introduced a new scheme that represents, on average, an effective exchange rate of Bs 13 per U.S. dollar. This implies that the cost to repay private sector debt has increased in bolívar terms close to 203 percent, reducing the government subsidy by that amount.

To devalue the currency on a trade weighted average of 30 percent, after a real deterioration of wages, the Government negotiated with trade unions and agreed to a partial wage increase. The adjustment in domestic prices was allowed to reflect the exchange rate devaluation, and an adjustment in electricity rates--of 2 percent a month up to 30 percent--started in January 1987. Even though the staff in its report estimates that the full set of measures adopted in December 1986 will result in a weakening of public sector finance, the authorities have reservations on this since they found methodological discrepancies that they would like to clarify with the staff in the next midyear Article IV consultation.

The outcome for the year as a whole, compared with the targets in the QEP and the Fund recommendation, is as follows:

	1986		
	Projected in the QEP	Actual	IMF Recommendations
1. Non-oil GDP in real terms (percent)	0	3.3	
2. Consolidated public sector (deficit as percentage of GDP)	7	5.7	6-8
3. External current account (deficit in millions of U.S. dollars)	943	1,628	
4. Net international reserves (in millions of U.S. dollars) (Central Bank & Investment Fund of Venezuela)	10,966	11,858	
5. M2 (annual percent) change	18	16.8	12
6. CPI (percentage change, year-end)	12	12.7	
7. WPI (percentage change, year-end)	15.2	18.8	

Nonpetroleum GDP grew 3.3 percent in real terms in 1986, after a modest increase in 1985. Agriculture, manufacturing, and construction were the main sectors driving the economy toward growth: agriculture rose by 7 percent, manufacturing expanded by 5 percent, and construction increased by 12 percent. All economic sectors recovered, and unemployment fell from 13 percent in 1985 to 10.5 percent in 1986, accomplishing one of the main objectives of the Government's economic strategy.

On the external sector, it was not possible to compensate the abrupt fall of 43 percent in oil export revenues with an increase of 11.6 percent of nontraditional exports, since they constitute only 17 percent of total exports. Furthermore, the expansion of nontraditional exports was restrained by protectionist measures imposed by some of our trading partners and by a decline in the prices of some of our main commodities that have a comparative advantage, such as steel and aluminum. The commitment of the authorities to amortize debt; higher-than-programmed interest payments on the public and private debt; lower interest income from investment and the fact that Venezuela has received practically no external financing for some years, were the main factors that worsened the balance of payments and international reserves, since imports leveled off in real terms.

Broad money increased by 16.8 percent, which was lower than the programmed 18 percent. Since the consumer price index remained on track, the authorities decided to keep interest rates unchanged in nominal terms.

One of the authorities' most remarkable achievements was in the debt area. Public debt negotiation ended early in 1986 and as of that date Venezuela became one of the few countries in Latin America that had reduced its external debt (from $37.5 billion in 1982 to $32 billion in 1985). Total debt service during 1984, 1985, and 1986 amounted to 42.3 percent, 38.9 percent, and 72 percent of oil exports, respectively, which represents $6.1 billion of public and private debt amortization. 1/

1/ Venezuela: External Debt Service, 1984-86

(In millions of U.S. dollars)

	1984	1985	1986	Total
Public sector	5,151	4,249	4,023	13,423
Amortization	2,378	1,009	1,396	4,783
Interest	2,773	3,240	2,627	8,640
Private sector	1,110	748	1,234	3,092
Amortization	513	66	746	1,325
Interest	597	682	488	1,767
Total debt	6,261	4,997	5,257	16,515
Amortization	2,891	1,075	2,142	6,108
Interest	3,370	3,922	3,115	10,407
Percentage of Oil exports	42.3	38.9	71.9	

The authorities have started to prepare the Quantitative Economic Program for 1987, and they expect to have it ready in the very near future. They emphasized that the economic orientation for this year will be mainly to arrest the economic growth achieved in 1986, taking into consideration the disequilibrium of the external sector. To this end, they are committed to continuing with implementation of the adjustment program announced in December 1986, coupled with further structural adjustment measures. Even though they did not specify any timetable for implementation of the program, my authorities reiterated their intention of progressively unifying the exchange rate. On trade policy, serious consideration is being given to a possible agreement with the World Bank on a medium-term economic program that includes, as its first priority the modification and streamlining of the trade sector through the introduction of a simplified tariff system and adequate incentives.

The Government continues with its fiscal austerity by curtailing current expenditure that will be affected only by the 1986 salary increases and new subsidies. Nevertheless, one of its first priorities will be to continue the execution of the triennial plan, especially those investment outlays that were initiated in 1986. Within the strategy of correcting and enhancing the external sector disequilibrium, the basic industries of production-oriented goods to improve import substitution and export-led growth are of crucial importance. The authorities express their intention of progressively lowering the overall public sector deficit.

On monetary policy, the authorities reiterated their intentions to protect and stimulate internal savings, and to prevent excessive money growth that could put pressure on aggregate demand and hence on prices. To this end, they intend periodically to review interest rates, taking into account, among other variables, the rate of inflation. In addition, the Central Bank is ready to participate actively in the open market with its own paper.

The authorities emphasized their compromise of allowing price adjustments to reflect the devaluation and cost increases. On the incomes policy, they indicatd that the salary increase of 1986 was granted because of the real wage deterioration for so many years, but further adjustments will be framed only under collective agreement.

Extending her statement, Mrs. Filardo informed the Board that the Minister of Finance and the President of the Central Bank had reached agreement with foreign commercial banks over the weekend on a multiyear rescheduling arrangement on public and publicly guaranteed debt of more than $20 billion. That arrangement allowed for lengthening the repayment period by two years, stretching the amortization payments through 1999, and reducing the spread over LIBOR from 1 1/8 percent to 7/8 percent.

The authorities were committed to making annual amortization payments--$250 million in 1987, $400 million in 1988, and $700 million in 1989--and those payments would continue in the years beyond.

Mr. Almeida made the following statement:

> The authorities have been gradually adjusting Venezuela's economy to the changing circumstances of the world economy, but in spite of all their efforts, the country is still facing balance of payments imbalances. The external current account deficit was higher than programmed because of the sharp drop of about $5.5 billion in oil exports from the 1985 level. Because the share of petroleum accounts for about 83 percent of total exports, the effect of the drop in oil prices has overshadowed the adjustment efforts made by the authorities.
>
> Some measures have been taken already to alleviate the current fiscal imbalances, and it is encouraging to observe that the authorities are conscious of the need for further improvement. However, in contrast to the staff's opinion, we do not consider that these imbalances should be addressed by the introduction of new taxes. If the goal is to provide incentives for growth by means of private sector investment, the authorities should envisage administrative improvements. Possibly the fiscal system required some improvement in tax administration, which in turn could lead to higher tax collection. Staff comments on these matters would be helpful.
>
> On monetary policy, I do not find that there has been a major deviation from the desired level of credit expansion. However, the authorities will have to be careful in implementing interest rate policy. The authorities are pushing for further economic growth, as envisaged in the investment plan, but it is essential to avoid an overly expansive interest rate policy. Perhaps the staff or Mrs. Filardo would comment on the how authorities' plan to approach interest rate policy.
>
> The authorities seem to have acted cautiously on the exchange rate, and have taken some action by moving to a more realistic level of Bs 14.50 per dollar, where most of the transactions now take place. I regard this action as a step toward the unification of the exchange rate system and gradual adoption of an appropriate exchange rate. In this respect, I wonder whether the recent increase observed in the international price of petroleum could mitigate the need for intensified action on exchange rate unification. Taking into account the particular circumstances of the Venezuelan economy, in which the oil price plays the key role in shaping the current account, I fear that strong action on the exchange rate to benefit competitiveness of non-oil exports might not be worth the cost, in terms of the threat to price stability.

Following the recent visits of the World Bank staff to Caracas to discuss the implementation of certain structural adjustment policies, particularly on tariffs, I would appreciate an update on whether the staff recommendations have been accepted by the authorities. In addition, I would like to know the current nominal tariff protection range and the range or the maximum nominal tariff for industry recommended by the World Bank staff.

The Government is planning to undertake a privatization plan, which will benefit public sector accounts while having a positive effect in reducing the public sector to a more sustainable level. It might have been a good idea for the staff report to include in the medium-term outlook a scenario on the possible effects of the privatization plan on the debt ratios. Staff comment would be helpful.

It is encouraging to note that the authorities have reached agreement with the commercial banks. I would appreciate it if the staff could add any comments to those that Mrs. Filardo made.

Mr. Yamazaki made the following statement:

On the occasion of the previous Article IV consultation with Venezuela (EBM/86/122, 7/25/86), while commending the authorities for significant improvements in public finance and in their external position during 1983-85, the Executive Board expressed concerns about their economic program for 1986 and about the significant differences of views that existed then between the authorities and the Fund staff, particularly in the context of enhanced surveillance. Developments during 1986 have proved that these concerns were not groundless. The external current account deficit was more than $1 billion larger than projected, with the public sector deficit reaching 7 1/4 percent of GDP. This is a dramatic swing, compared with the surplus of 4 1/2 percent of GDP during the previous year, although the deficit figure was lower than anticipated.

It is true that the sharp drop in oil prices in early 1986 was a decisive factor behind the deterioration of the economy. However, it is also apparent that the economy has to undergo a substantial adjustment to the new external environment. Such an adjustment will require structural reform measures as well as a tightening of demand management. In particular, a sizable reduction in the public sector deficit will be instrumental to the restoration of a viable balance of payments position, which is a precondition for a resumption of economic growth. To be more precise, I note that the size of the public sector deficit--about 4 percent of GDP in 1987 and no more than 2 percent in 1988 and beyond--would still imply a reserve loss in 1987-88, but would be consistent with the achievement of approximate equilibrium in the overall balance of payments by 1989. In my view, the public sector deficit is a useful illustration of the additional adjustment efforts needed in the fiscal policy area. Against this background, I can support the thrust of the staff appraisal.

Given the cutbacks of current expenditure in recent years, and the need for maintaining an appropriate level of public investment, fiscal policy should accord high priority to structural reform measures on both the expenditure and revenue sides, including a more comprehensive review of the price system of public enterprises and tax reforms. Nevertheless, the adoption of structural reforms should be accompanied by continued restraint on current expenditures and the reappraisal of low-priority capital outlays.

Reflecting the large domestic bank financing of the public sector deficit, the growth of broad money accelerated during 1986, and in turn led to the acceleration of inflation and reserve losses. Against this background, a cautious monetary policy is required for 1987. In order to encourage savings and repatriate capital flight, the interest rate policy should be managed more actively and flexibly.

I welcome the external policy measures announced in December 1986, which included an effective depreciation of the bolívar by about 30 percent. A flexibly managed exchange rate will help Venezuela to facilitate export diversification and import substitution. However, the multiple exchange rate system--and the large spread between the controlled and the free market exchange rates--gives rise to distortions and could impede the needed structural reforms. I can therefore support the staff's argument that the exchange rate system should be unified as soon as feasible.

I would like to express my concern about the delay in the formulation of the 1987 Quantified Economic Program. I hope that the forthcoming staff mission--scheduled for April 1987--will produce fruitful results, particularly in that respect. Last, but not least, I very much appreciate the additional information that Mrs. Filardo has supplied; I particularly welcome the statement that an agreement has been reached between the authorities and the commercial banks on the renegotiation of the multiyear rescheduling arrangement.

Mr. Di Mauro made the following statement:

Prudent and pragmatic macroeconomic management since 1983 has allowed the Venezuelan economy to absorb the impact of the recent oil price swings and to keep the burden of the debt to a manageable level by Latin American standards. However, the economy still shows a high dependence on oil revenues, and the authorities need to take a more decisive approach toward enhancing diversification and efficiency of the economic system.

On structural policies, we recognize that some progress has been made in diversifying the production base. The oil component of total export earnings has declined from 95 percent in 1982 to 85 percent in the first semester of 1986. Moreover, the non-petroleum share in the composition of GDP has increased slightly. However, this progress still appears limited and the results of the recent expansionary policies adopted in 1986 provide clear evidence that a more forceful approach to structural adjustment is needed. Monetary and fiscal expansion alone has not resulted in a significant stimulus to the restructuring of the economy. Fixed investment remained sluggish and the economy, after using the spare capacity available subsequent to the previous long recession, began to suffer from bottlenecks on the supply side, inflationary pressures, and a worsening in the external accounts. The reasons for this outcome are clearly depicted by the staff. A complex system of tariffs and widespread quantitative import restrictions continue, in fact, to hamper the diversification of the economy. Moreover, the extensive system of regulations does not seem to favor an efficient allocation of resources.

In these circumstances, the authorities need to take actions to improve the climate for new capital formation, and should concentrate on exchange rate management by accelerating the speed of exchange market unification. Moreover, a timely modification of the trade regime should be implemented along the lines suggested by the World Bank. Finally, price controls and government regulations should be limited. In this respect, we consider the recent modification of the investment code as a positive step. However, we would appreciate some further elaboration from the staff on the objectives of the new code.

We have some doubts about the effectiveness of monetary control in Venezuela. Net domestic assets rose in 1986 by more than 30 percent instead of the planned 27 percent. Moreover, the report on policy discussions implies that the instruments of monetary control are somewhat inadequate and need to be improved. We would be interested in knowing the progress made on the issue of central bank securities, which could allow open market operations. In the current situation, cautious and stable monetary management is needed, because the 1986 expansionary policies have in fact triggered inflationary pressures while interest rates have decreased to a negative real level. We agree with the staff that an active interest rate policy should be followed to enhance financial savings and to avoid pressures on the external accounts and the free market exchange rate.

We are convinced that in the current circumstances, a policy of fiscal austerity can have a crucial function in reducing overall economic imbalances. First, a reduction in the fiscal deficit can help relieve the burden on the economy of the constraints of the external accounts. Moreover, it can limit the crowding out of the private sector. In this context, we note with concern the planned increase in the public sector deficit to 8 percent of GDP in 1987 from the 5.7 percent of 1986. We are also concerned that the authorities and the Fund diverge in their evaluation of the effects of the December 1986 measures on the 1987 budget. As a means of improving the enhanced surveillance exercise, we believe that such differences should be explained more fully. Moreover, we wonder how the medium-term scenario would be affected if Venezuela followed the Government's evaluation versus that of the Fund.

Second, a different mix of expenditures may enhance the efficiency of public sector intervention. Current expenditures should be contained. At the same time, public sector investment should be enhanced to ensure structural improvements and to counteract the sluggishness of private sector initiatives. In this respect, however, we would like to have more information on the monitoring of public sector investments--which seem to have been implemented with some unjustified delay--and on the World Bank's involvement in this monitoring process.

Third, a careful wage policy in the public sector can reinforce the current incomes policy followed by the authorities. We are particularly pleased that the staff explicitly endorses this policy. In our opinion, reaching a social consensus on the needed adjustment efforts should be a matter of priority in the current circumstances, and we encourage the authorities to continue this policy.

We are encouraged to see in the medium-term scenario the objective of a zero current account deficit by the end of the decade, as well as a forecast of a steady decrease in total debt outstanding and in the debt service ratio. However, we wonder whether the growth hypothesis of the scenario could not have been more positive. The international reserves position seems to be quite comfortable. While we understand that the authorities would like to maintain a level of reserves that would cushion possible swings in export earnings, we wonder whether they could envisage a level somewhat lower than the targeted $10 billion.

Mr. Goos made the following statement:

Comparing this staff report (SM/87/22, 1/21/87) with that for the previous Article IV consultation (SM/86/152, 6/25/86), one cannot but conclude that the authorities have made only limited progress in those policy areas that the staff and Board had identified for corrective action. This state of affairs is clearly less than satisfactory, the more so since it apparently reflects the persistence of significant differences in the views held by the authorities and the staff on the appropriate course of economic policy. Such differences of view had already given rise to considerable concern at the Board's 1986 consultation discussion with Venezuela (EBM/86/122, 7/25/86); it was felt then that those differences could undermine the basis of the existing arrangement for enhanced surveillance. The execution of our surveillance task is complicated further because the authorities apparently have been unable thus far to provide the staff with detailed information on their policy intentions for the current year. In the absence of both specific data for financial policies and clear commitments with respect to structural reform, it is virtually impossible to draw firm conclusions on the country's economic prospects. I therefore would hope to see a more cooperative attitude on the part of the authorities in their future discussions on these areas with the staff, so that the surveillance exercise will be more meaningful than has been the case to date.

I acknowledge, of course, that with regard to specific policy areas, the authorities recently have taken a number of commendable steps that go in the right direction. I welcome especially the devaluation of the regulated exchange rate, the liberalization of the foreign direct investment code, and the announced intention to simplify exchange and import controls. Other encouraging features that merit emphasis include the progress made in resolving the issue of the private sector external debt; the most recent agreements between Venezuela and the banks on a retructuring of the external public debt; the reactivation of economic growth; and last, but not least, the containment of the fiscal deficit below the original target of the Quantified Economic Program for 1986.

Nevertheless, I feel that the staff's analysis, especially in the framework of the medium-term scenario, once again makes a clear case that more needs to be done to bring the economy back on a path of sustainable growth. This applies in particular to the need to tighten further the stance of financial policies as one of the most important prerequisites for restoring external equilibrium. In this context, I would appreciate some clarifying comments on the staff's and Mrs. Filardo's differing assessments of the fiscal policy stance.

With regard to structural policies, the pervasive government controls and regulations remain a matter for serious concern in view of their distorting impact on resource allocation, their paralyzing effect on investment activity, and the burden that they entail for the budget. There are a number of indications in the staff report that these concerns are not of a purely academic nature, such as the staff's finding of shortages in many sectors of the economy as a result of restrictions, and its observation that private sector investment has remained low despite the expansionary financial policy stance. Against this background, I found it quite worrisome to note that the regulatory environment has been tightened even further in important respects, with the recent substantial broadening of the price freeze and the transfer of a considerable part of international transactions from the free market rate to the regulated exchange market. In concluding, I should also express my concern about the recent imposition of a 40 percent import surcharge, which seems to run counter to the authorities' intention to rationalize the tariff system, and therefore will have to be replaced sooner or later by other revenue-raising or expenditure-cutting measures in order to protect the fiscal position. Finally, I fully agree with the staff appraisal and its recommendations.

Mr. Pineau made the following statement:

The Venezuelan economic situation of early 1987 calls for a mixed judgment. As was foreseeable, the reflationary measures taken by the authorities at the end of 1985 translated into a higher level of activity and a slight improvement in labor market conditions, a valuable outcome for an economy that has remained sluggish since the late 1970s. Furthermore, the main economic targets for the public finances and the gradual scaling down of the external debt, set under the Quantified Economic Program, have broadly been met. Nevertheless, on the darker side, the main boost behind the current pickup in activity has been provided by public and private consumption. This shift in the domestic demand impulse was excessive and had a negative impact on monetary conditions, inflationary expectations, and the external position, as evidenced by the widening spread between the official and parallel exchange rates.

In the face of such developments, the authorities' policy response does not seem appropriate. Despite the Fund's recommendations, the authorities remain firm in their intention to remove the economic slack, and they have recently taken additional fiscal steps that will result in an aggravation of internal imbalances. Like Mr. Di Mauro and Mr. Goos, I would appreciate further information on the difference of views between the staff and the authorities on this point. This projected worsening of the fiscal deficit cannot but contribute to a further weakening of the external position. The substantial depreciation of the bolívar, together with the more flexible stance toward the exchange rate policy announced at the same time, can help to deflect these unfavorable effects. However, a new deterioration of the current account is not unlikely, and the better prospects for the progressive reduction of the external debt could be jeopardized.

Likewise, this new fiscal package could well delay the implementation of some important supply-side measures aimed at developing more diversified and outward-looking economic activities. Actually, the contribution of private investors to the diversification of the economy has always been viewed as essential but could be hampered by this increased involvement of the public sector. The interest rate policy seems also to act as a brake on the mustering of private savings and its orientation toward domestic use.

Compared with other Latin American countries, Venezuela's economic situation can continue to be described as relatively good. However, the noticeable imbalances that emerged in 1986 are likely to continue and even worsen in 1987. These strains can still be brought under control, but the authorities should act in a timely manner in order to preserve the favorable medium-term prospects for the economy.

Mr. Fayyad made the following statement:

During 1983 and 1984, the Venezuelan authorities embarked on a series of policy measures aimed at dealing with the effects of the global recession of the early 1980s. These measures led to significant improvements in Venezuela's internal and external balances. However, the collapse of oil prices in 1986 has rendered rather costly the expansive policy stance that was adopted by the authorities toward the end of 1985. While nonpetroleum GDP grew in 1986 by approximately 3 percent and unemployment declined, the public sector finances worsened considerably, inflationary pressures intensified appreciably, and the current account--despite a further tightening of import restrictions--experienced an adverse swing of nearly $5 billion. Indeed, the deterioration of over 40 percent in Venezuela's terms of trade, the substantial decline in its official reserves, and the widening to more than 200 percent in the spread between the controlled and free market exchange rates all attest to the severity with which the sharp decline in oil prices has hit the economy in 1986.

The share of the petroleum sector in Venezuela's nominal GDP is relatively low when judged by the standards of most major oil exporting countries. However, both the external position as well as the public sector finances are highly vulnerable to adverse shocks in the oil sector. That vulnerability becomes readily apparent when one considers that in 1986, despite a substantial loss in oil revenues, oil still is estimated to have contributed more than 80 percent of total merchandise exports and about 45 percent of central government revenues. In view of this consideration, and given the recent signs of volatility in the international oil markets, it is imperative for the authorities to pursue policies consistent with an early restoration of a viable balance of payments position under conditions conducive to the resumption of sustained economic growth.

The fiscal imbalance in Venezuela does indeed call for immediate attention. The authorities' projection of a public sector deficit of 6 percent of GDP--a projection that the staff seems to view as optimistic--implies a substantial reserve loss in 1987, which would impede the achievement of balance in the overall balance of payments in the medium term. While the fiscal measures already taken by the authorities are commendable, additional strengthening of the public sector finances, particularly expenditure restraint, will be necessary if Venezuela's international reserves are to stabilize at an adequate level.

Monetary policy should also be tightened in order to curb inflation and to reduce balance of payments pressures. While I generally concur with the staff's assessment on this point, I wonder whether the potential gain from the issue of central bank securities as a means of controlling liquidity may not be more than offset by the costs it could entail. Specifically, I am concerned about the potential of this measure to soak up funds that would otherwise be available for private investment, which has recently been particularly weak. The staff may wish to comment on this point.

I do share the authorities' concern about the adverse impact on mortgage-lending institutions of an adjustment in the interest rate ceilings. Nevertheless, one should recognize the need to encourage savings, restrain capital flight, and reduce pressures on the balance of payments and on the free market exchange rate. Therefore, I welcome the authorities' intention, as indicated by Mrs. Filardo, to stimulate internal savings and to review interest rates periodically.

The latest modification in Venezuela's multitple rate exchange system is welcome. Indeed, this modification can be viewed as an important step toward the elimination of exchange restrictions on payments and transfers, and toward the establishment of an appropriate structure of relative prices. Finally, I should note that the policy measures adopted in December 1986 underscore the difficulty of the choices facing the authorities as a result of the recent decline in oil prices. These measures, together with Venezuela's encouraging performance under the Quantified Economic Program, serve as a strong indication of the authorities' firm commitment to correct the imbalances precipitated by the collapse of oil prices and to move the country to a new phase of recovery and sustained economic growth.

Mr. Foot stated that he welcomed the fact that the previous staff report--for the 1986 Article IV consultation (SM/86/152, 6/25/86)--was distributed to creditor commercial banks by the Venezuelan authorities. Enhanced surveillance for Venezuela could henceforth be conducted in closer accordance with the manner intended, although Mr. Goos's remarks still carried considerable weight.

He endorsed wholly the staff appraisal in SM/87/22, which set out well the priorities--particularly the fiscal and monetary restraints--that the authorities should establish in dealing with the difficult problems they face, Mr. Foot said. Therefore he had only a few remarks to make by way of extension. First, he could not stress too strongly the importance of the liberalization of the exchange and trade regime if distortions were to be reduced and the allocation of resources improved. If major exchange rate action was not continued, for example, the 10 percent a year rate of growth of non-oil exports assumed in the tables in the staff report seemed implausible.

Second, Mr. Foot joined others in welcoming, after a period of difficult relations, the conclusion of discussions between the banks and the Venezuelan authorities. He asked the staff to confirm his presumption that the semiannual staff reports under enhanced surveillance would still be needed under the new arrangement. Third, he had seen press reports that Venezuela was contemplating a debt equity conversion scheme, and would be interested in any news of the scheme either from the staff or Mrs. Filardo.

Finally, he wondered whether the staff would like to comment on how the authorities intend to carry forward their commitment to increase the role of the private sector. In particular, he would like to know whether any attempt had been made yet to formulate a detailed program for the privatization that the authorities had envisaged.

Mr. Al-Assaf noted that the sharp decline in oil revenues in the past year had made the reactivation in economic activity initiated by Venezuela in 1985 unsustainable. The boost had occurred at a time when it could least be afforded, and as a result, the current level of economic activity was beyond the country's means. If Venezuela continued that level of fiscal expenditure, it would soon find itself in a position of being not only without reserves, but potentially with even higher debt. Thus it was important to lower expenditure on projects that could be deferred and, to reduce current expenditure as much as possible. The fiscal deficit must be reduced convincingly; however, he would not go as far as the staff in suggesting that it be reduced sharply to about 2 percent of GDP by 1988. The authorities had already taken a number of fiscal measures to strengthen the public finances, and those are steps in the right direction. He would only urge them to persist in their efforts to strengthen those finances. Furthermore, to complement the fiscal efforts, the authorities needed to unify the exchange rates as early as possible. In that connection, he was encouraged by Mrs. Filardo's statement that her authorities were committed to a progressive unification of the exchange rates.

Like other oil exporting countries, Venezuela would have to emphasize export diversification with a view to maintaining competitiveness, Mr. Al-Assaf said. That meant the adoption of realistic pricing and wage policies. However, Venezuela's trading partners must help the country to diversify and to expand non-oil exports. It was important for Venezuela to continue the structural reform of the economy so as to be ready to resume sustainable growth at an early date.

Mr. McCormack made the following statement:

We have had many opportunities to express our views on macroeconomic policy management in Venezuela within the framework of enhanced surveillance procedures. We were pleased to note that the 1986 Article IV staff report was actually distributed to the commercial banks; our efforts in the Board have thus not been in vain. During our previous discussion (EBM/86/122, 7/25/86), we expressed concern that the authorities' strategy of fiscal stimulus, monetary accommodation, and price and trade controls was extremely risky, because it could result in a rapid depletion of reserves and a buildup of inflationary expectations and distortions within the Venezuelan economy. The latest staff report shows that our concerns were justified. There is now an even greater need for the authorities to implement more cautious demand management policies, while reducing regulations and controls that are limiting market signals and thus preventing a more efficient allocation of resources.

The authorities have indicated that it is their intention to design policies based on an expectation of no major recovery in oil export earnings, as well as on a desire to stabilize reserves at about $8-9 billion. These goals are wise, given the existing uncertainty in international oil markets. Furthermore, the staff's medium-term scenario suggests that Venezuela can achieve a viable balance of payments position over the medium term, with interest payments on foreign debt lowered to less than 4 percent of GDP by the end of the decade, and with a speedy reduction in the total debt service ratio. The authorities can reach this position by adopting appropriate demand management policies, exchange rate policies, and structural reforms that promote economic diversification. Therefore, despite the much-worsened external climate now facing Venezuela, there is a viable path to stabilization. However, achieving that stabilization will require a credible, consistent set of policy measures, speedily implemented. From this perspective, the recent measures--particularly the real effective devaluation of the bolívar--are welcome but not sufficient, and may well result in a further weakening of the public finances in 1987, acceleration of inflation, and loss of reserves. Stronger measures are necessary to bring absorption more quickly in line with present levels of income, while regulations and restrictions are reduced.

I welcome the recent depreciation in the controlled rate of exchange. However, the authorities lessened the positive impact of this step by retaining the old rate for essential imports, and by moving a number of items from the much lower free market exchange rate to the new controlled rate. The continuing existence of a multiple rate system creates great potential for distortions, and the authorities would be better off to unify the exchange rate as soon as possible. Furthermore, tight import controls have contributed to shortages in many sectors of the economy during 1986, which suggests that progress on the elimination of import and export restrictions, coupled with a more flexible exchange rate policy, would help ensure more efficient resource allocation. The role of the World Bank in this area has been helpful, and we urge action on the part of the authorities with respect to the World Bank's recent study on the trade regime.

While the budget projects a small reduction in the fiscal deficit to about 6 percent of GDP in 1987, the staff report (SM/87/22, 1/21/87) suggests that the economic measures taken in December 1986 will result in a weakening of the fiscal position by almost 2 percent of GDP, although admittedly, the prospects beyond 1987 do not look as bad. This increase has worrying consequences for inflation and the external balance. The staff is then correct in stressing that public finances need to be strengthened. On the revenue side, measures such as a general sales tax and reform of the import tariff structure should be investigated. On the expenditure side, capital expenditures have already been reduced, and I find it hard to reach a judgment on where capital and current outlays can be scaled back further. I would appreciate the staff's comment on the extent to which capital and current outlays can be further reduced. With respect to the latter, I note the staff's reference to "low priority" areas, and wonder how large a proportion of capital outlays these are.

Another concern is the projected increase in the rate of inflation; I understand that private forecasters are suggesting inflation rates of 20-30 percent in 1987. A firm monetary policy will be required if the inflationary pressures arising from exchange rate adjustment and fiscal policy, and also the necessary changes in relative prices, are to be contained. Firm monetary control can also help protect official reserves. I support the staff recommendation that domestic interest rates be increased to return them to positive real levels, and it would be preferable if interest rates were determined subsequently in a more market-related manner. Certainly it is critical that domestic savings be encouraged in order to support the desired level of investment.

With respect to structural policies, I welcome the steps taken to improve the environment for foreign investment through the liberalization of the foreign investment code. However, as part of the December 1986 measures, it was announced that prices of all goods still imported at the preferential official rate of 7.5 bolívares per dollar would be kept unchanged, and the temporary price freeze that previously applied to only 30 items was extended to cover 114 items or groups of items. This extension of price controls is detrimental to the efficient adjustment of relative prices, and their elimination would be desirable. Given the steep decline in real purchasing power since 1979, it may be unrealistic to expect no increase in wages, but a firm wage policy should be maintained to facilitate the adjustment to reduced external income.

I am encouraged by Mrs. Filardo's announcement that the authorities have been able to conclude successfully with the commercial banks the current rescheduling negotiations on Venezuela's external debt. If Venezuela does intend, as indicated in recent reports, to enter international bond markets in the near future, the completion of successful negotiations with the banks will aid the authorities' efforts. Finally, it goes without saying that in the longer run, creditworthiness and policy implementation are intimately linked. A more forceful implementation of adjustment policies could help Venezuela to reach its goals quickly, and could pave the way for smoother access to external credit. However, a failure to act forcefully is likely to yield only a further depletion of reserves, higher rates of inflation, and serious debt management problems looming on the horizon. However, we are encouraged by the steps being taken thus far.

Mr. Donoso made the following statement:

Faced with a reduction in oil prices--and therefore, in export revenues--between 1985 and 1986, the authorities of Venezuela maintained the overall level of expenditures in the economy. This maintenance of domestic expenditures, despite a drop in exports that exceeded $5 billion, led to an equivalent deterioration in the current account balance, which went from a surplus of $2.9 billion in 1985 to a deficit of $2.3 billion in 1986. The total change of $5.2 billion was equivalent to 11 percent of GDP.

Of course, the authorities' policy stance was made possible by a high level of international reserves, which were affected in the process. Given Venezuela's comfortable international reserve position, one could consider that the authorities' use of reserves to soften the adjustment to a new economic structure was a reasonable approach that could facilitate the reorientation of the economy and avoid excessively drastic reductions in domestic demand. However, such an approach is necessarily transitory in nature, and to be fully useful, it must be accompanied by other measures that can lead the economy to sustainable growth despite the weaker situation of traditional exports. And it is here that we see some difficulties with the policies being applied in Venezuela.

During 1986, the exchange rate system was characterized by multiple rates, which had negative effects on resource allocation. In addition, the authorities relied heavily on administrative controls over trade operations, and kept relevant prices in the economy under direct control. Interest rates were subject to ceilings--clearly at inefficient levels, at least in connection with financial operations by certain sectors of the economy.

The authorities have recognized the dangers of the situation, and in December 1986, introduced some measures that simplified somewhat the exchange rate system and entailed a depreciation of the bolívar. This is a positive development. However, the exchange system still contains multiple rates, and administrative controls continue to play an important role in the allocation of foreign exchange. We understand that the number of domestic prices under control has increased, and that in the near term, no changes in the system of control of interest rates is expected.

We do not have a clear understanding of the changes introduced that will affect the financial position of the public sector, given that Mrs. Filardo disagrees with the information presented by the staff. Some clarification of these aspects of Venezuela's policies would be helpful.

Looking ahead, we think that the authorities should consider seriously the recommendations that they received from the staff, with respect to both demand management and pricing policies in general. As Mrs. Filardo has noted, the authorities wish to improve resource allocation, increase productivity in the state-owned enterprises, reduce the dependence of the economy on oil exports, and rationalize the trade system. We hope that the prompt implementation of policies in this direction will have positive effects on the economic outlook. We would urge the authorities to keep under review the recently modified exchange system and to continue considering the unification of exchange rates. Reforms in this direction, accompanied by realistic demand management policies, should help the country to resume growth on a more sustainable basis. We are quite pleased to hear that Venezuela has reached agreement with its creditors on the rescheduling of payments of external debt and publicly guaranteed debt.

Mr. Salehkhou made the following statement:

The review of the Venezuelan economy under enhanced surveillance since the previous Article IV consultation must be seen in the light of the major oil price drop in early 1986. Having experienced a decline in real GDP and mounting unemployment during the preceding year, the authorities adopted a comprehensive development strategy under the Quantitative Economic Program in the hope of stimulating the economy through higher public investments and increased export performance. However, given the loss in oil revenues and increased social and investment expenditures, a shift has occurred in public finances, leading to a deficit of 7 1/4 percent of GDP in 1986, in comparison with a surplus of 4 1/2 percent in 1985. Bank financing of the public sector showed a strong expansion, as did credit extension to private enterprises, which led to a sharp growth in broad money. Inflationary pressure has been exacerbated despite stringent price controls.

As for export revenues, the lower oil prices were not sufficiently compensated for by higher volume production. Imports on the contrary grew in nominal terms, as did interest payments on public and private debt. The overall balance of payments deficit for 1986 is estimated at $4.5 billion, which is $0.5 billion higher than that of the previous year. The medium-term outlook for the economy is tied to changes in the external economic environment. While a low price of $15 a barrel for oil is projected for the 1987 and 1988 budgets, a relative volume increase of 3 1/2 percent a year is projected to offset partly the decline in budgetary receipts. At this level of revenue, the authorities hope to stabilize the external debt in nominal terms. This would require in turn that the authorities adopt strong demand management policies while curbing the growth of inflation and diversifying the resource base of the economy away from total dependence on petroleum exports.

The existing constraints placed on the economy by the substantial level of external debt make it difficult to expect improvements in the short term despite possible estimates of higher revenues from oil exports. Only if non-oil exports are performing more positively, sustained by a greater inflow of investment capital to the private sector, can the level of debt be expected to begin receding over the next few years and thus pave the way for sustained economic growth.

The authorities have made efforts to maintain a balance between available resources and expenditure requirements for the economy. They have reduced their external debt despite adverse exogenous constraints. It is disturbing, though not uncommon at present, to note that Venezuela's substantial amortization payments exceeding $6 billion since 1984 and its successful adjustment efforts have been made at the expense of growth and employment. While I welcome the authorities' determination to continue with adjustment measures and further payments of amortization on external debt, I do hope that the international financial community, and the World Bank in particular, will do their part by extending the necessary assistance to enable Venezuela to move ahead in the direction of economic equilibrium and sustained growth.

Mr. Dallara made the following statement:

We appreciate Mrs. Filardo's reassurances that her authorities welcome this midyear Article IV consultation, and that they have circulated the staff report for the previous Article IV consultation to the commercial banks. This suggests some movement on the part of the authorities since the previous Article IV consultation toward making the enhanced surveillance process more effective, although more remains to be done. In addition, we find it encouraging that the authorities agree with the staff that there is an urgent need to move ahead with comprehensive, sound economic adjustment measures. In this regard, like other Directors we welcome the measures taken in December 1986 as generally positive steps in the direction of recognizing and actively trying to deal with the serious distortions in the economy. Nevertheless, these actions fall short of what is needed to bring about viable adjustment both domestically and externally.

Therefore, we encourage the authorities to follow through with the December 1986 measures and to take additional steps in a number of specific areas. In this context, a clearer outline in the staff report of specific policy commitments and intentions of the authorities for the period ahead would have helped them to develop their plans further, in the light of staff recommendations.

The results of the Quantified Economic Program that had been framed by the authorities for 1986 have now become available. One difficulty we had in considering the developments of 1986 was in determining how much validity to attach to the use of the quantified targets in the Quantified Economic Program as benchmarks for judging the appropriateness of performance. The Board is faced with a rather unusual situation of quantified targets that the staff does not appear to accept as an appropriate basis for evaluating progress. The point that comes across to us from the staff report is that the Quantified Economic Program targets, even if achieved, would not have constituted sufficient progress in certain key policy areas. While some movement on various policy areas appears to have been made toward agreement between the staff and the authorities, it is evident that substantial differences remain, particularly with regard to exchange and interest rate policies, trade liberalization, and fiscal policy. It would be helpful to have these differences outlined more explicitly in the future so that the Board can gain a more complete sense of the remaining issues, since the authorities and the staff are working toward a consensus, where feasible, in certain policy areas. The lack of consensus in key policy areas continues, however, to raise questions about the effectiveness of this enhanced surveillance procedure.

Although some progress was made with regard to certain targets, progress in other areas was not as great as projected and was clearly insufficient. In the fiscal sector, the staff now estimates that the combined effects of the December 1986 measures will be a worsening of the public sector deficit to 8 percent of GDP. While we certainly recognize that this is attributable in part to a one-time expenditure related to subsidies on private sector debt, we agree with the staff that the level of this fiscal deficit is not appropriate in the circumstances. We would urge the authorities to take additional steps to reduce the deficit, including not only a reduction in current expenditures, but also a reduction of capital expenditures in areas of a lower priority, as well as appropriate revenue measures.

In the context of the existing inflationary environment, monetary policies should remain restrictive. To help control liquidity, the authorities' intention to issue government notes is a welcome step. We continue to have concerns about interest rates, which have remained negative in real terms, and with the rate of inflation rising, they may become more negative. In order to encourage financial savings, foster investment and economic diversification, and alleviate pressures on the balance of payments and exchange rate, an active positive real interest rate policy appears essential. In the light of the effort to move toward a more rational market-based structure of exchange rates, we urge the authorities not only to review interest rates periodically, but to take immediate action to bring about a more flexible interest rate structure that could result in consistently positive real interest rates over time.

Pricing policy is still determined largely through controls, which make it difficult for businesses to make decisions on investment and which impede adjustments in relative prices as a means of efficient resource allocation. We understand that the authorities intend to allow price adjustments to reflect the recent exchange rate actions. However, this might be only a partial solution to the distortions that remain in the pricing area, and we hope that the authorities will move toward a more general liberalization of prices in the future.

The authorities' recent changes in the exchange system are steps in the right direction. However, the system remains extremely complex, involves a large subsidy to one category of imports, and leaves room open for channeling exchange transactions outside the official system. We understand why the authorities might not want to move toward immediate unification of the exchange rates, yet we believe that prompt unification of those rates would facilitate the Government's medium-term objectives, and we therefore urge the authorities to move in this direction.

The multitude of restrictions on the trade and payments system continues to have adverse effects by imposing serious distortions in the economy. We welcome the authorities' announcement of their intention to simplify some import controls and the fact that they are considering implementation of the World Bank's proposals on trade policy. However, it is unclear how promptly the authorities intend to move in this regard and what their plans are for working with the World Bank. We would welcome any additional information that Mrs. Filardo or the staff may have on this point, since we view the continued lack of substantial liberalization in the trade area to be a major hindrance to the attainment of the authorities' medium-term objectives. We welcome the measures taken to liberalize the foreign investment regime, although we would have appreciated additional information about the steps that have been taken, and we certainly agree with the staff that complementary action will be important if these measures are to have the desired positive effect.

With respect to the external debt situation, we welcome the recent agreement that has been reached by the authorities and the international banking community on the restructuring of the public sector debt. We also welcome the registration of private sector debt for access to foreign exchange for debt servicing, although we recognize that this system does continue to involve substantial subsidies and is therefore a burden on the Government. At the same time, further changes in this regime might not be helpful.

We welcome the authorities' recent efforts to tackle and reduce the imbalances in the economy. Despite these efforts and some positive factors in 1986, we are particularly concerned about the potential unsustainability of both the fiscal and external positions during the period ahead. Given the uncertainties in the oil market and the need to maintain a certain level of reserves, we would encourage the authorities to act decisively in the near future to strengthen their adjustment efforts and to enhance the prospects that the medium-term objectives will be achieved.

Mr. Seyler made the following statement:

Surprisingly, Venezuela's problems, unlike those of other large Latin American countries still seem to be manageable, especially in the areas of inflation and foreign debt.

We welcome the establishment of the Quantified Economic Program with its clearly defined economic targets. This program has analogues in some other countries; for example, in 1982 Belgium initiated a shadow program that was effectively monitored by the Fund, a forerunner of the enhanced surveillance concept. This concept could usefully be applied on a wider scale, because the

Article IV consultations with countries being monitored by the Fund have an entirely different scope than those of countries that do not maintain such a close dialogue with the Fund.

A first glance at the results of the Quantified Economic Program for 1986 is reassuring: although the outcome for the current account deficit was worse than projected, the public sector deficit was better than forecast, and although inflation was slightly off track, it was still extremely low by Latin American standards. It was remarkable that the real growth achieved in GDP did not occur at the expense of an increase in external debt. With its interest payments now in the range of 30 percent of exports, Venezuela is out of the debt trap that has caught so many other countries. The medium-term scenario predicts that the external accounts will be balanced, although non-oil exports represent a small proportion of total exports, and the slow growth of the latter makes it evident that there are structural problems affecting the balance of payments.

A second glance at the results of the Quantified Economic Program shows that deep-rooted structural rigidities, especially in the areas of exchange and interest rates, are impeding the normal operation of the economy and threatening Venezuela's future development. The public sector deficit was lower than forecast only because of a delay in certain expenditures. In addition, the existence of multiple exchange rates combined with exchange rate guarantees places a heavy future burden on the public finances. The authorities hesitate understandably to increase the prices of imported goods used by people with lower incomes. A comparison of the official and free market exchange rates applied to certain imports, however, reveals that some prices are subsidized by up to 200 percent. Therefore, the gradual removal of these subsidies seems to be unavoidable, not only for public finance reasons, but also because these heavily subsidized prices imply that an import substitution industry may never develop. This is a difficult issue, and the authorities may not be able politically to remove these distortions immediately. Since it appears that for the immediate future, subsidies will remain necessary for social reasons, I would prefer to see them applied to the development of local industries that would produce import substitution products, thereby strengthening the external account. It is clear, however, that in the near term the prices of some goods need to be adjusted, while at the same time wage increases will have to be granted to cushion the effect of higher prices on the low-income classes. This would not only reduce some of the existing price distortions, but would also achieve a more equitable distribution of wealth, because as matters now stand, the wealthy also take advantage of the heavily subsidized prices.

Another heavy burden on the public finances is the exchange rate guarantee covering the external debt of private enterprises. Although we understand the authorities' concern over the financial difficulties imposed on private enterprises by the continuous devaluations of the bolívar, it seems that if companies borrow in the currencies of which their receipts are also composed, they can avoid the exchange rate risks. Since this would be somewhat difficult for companies that produce primarily for the domestic market, the Government could limit its exchange rate guarantees to producers of import substitutes or essential goods. However, even in this case the borrowers should be required to make some contribution to offset the benefit they receive with each devaluation through the increase in value of their fixed assets. Finally, we wonder whether the heavy subsidies granted to the agricultural sector through preferential interest and exchange rates are an efficient use of available resources, given the already low world market prices for agricultural products.

Because of the heavy burden that the numerous transfers and subsidies place on the public finances, we doubt that the public sector deficit can be brought down to 2 percent by 1988, as projected in the medium-term outlook, without some liberalization in certain areas, especially the exchange rate. Such a step seems even more urgent, given that private investment has been severely affected by the uncertainties created by the multiple exchange rate system. Not only does the resulting stagnation of productivity and output create inflationary pressures, a problem the authorities are addressing with price controls, but the lack of investment also hampers the developments of alternative export industries that could strengthen the balance of payments structure and offset somewhat the revenue losses caused by the drop in oil prices. Needless to say, negative interest rates do not promote the kind of private savings rate essential for productive investments. Finally, we would stress that price controls should be only a temporary expedient until more fundamental changes can be made. In all these matters, Venezuela would be well advised to solicit the opinions of the International Finance Corporation, an institution with long experience in the development of private initiatives.

In conclusion, I would like to draw attention to some of the long-term constraints on Venezuela's development policies, given that the natural growth of the population is 2.8 percent, while the real rate of GDP growth that can be expected on the basis of previous experience is not much higher. As long as the demographic trends remain as they are, Venezuela with its abundant resources must aim for higher growth in order to ensure an adequate per capita income. This can be obtained only through a better allocation of resources.

The staff representative from the Western Hemisphere Department noted that the medium-term projections in the staff report assumed that action would be taken by the authorities to bring the fiscal deficit to the level recommended by the staff. On that basis, the staff expected reserves to be stabilized at $8-9 billion, a seemingly high level of reserves, that might lead one to wonder whether there was not more scope for using those reserves to enhance growth over the medium term. However, it was important to note that Venezuela's liquid reserves were only in the range of $2 billion to $3 billion. Both the authorities and the commercial banks had accepted the need for an oil producing country such as Venezuela to maintain a high level of reserves in order to guard against large fluctuations in oil prices. Neither the authorities nor the staff felt that there was much margin for using reserves over the medium term to increase the rate of growth.

As to whether recent developments in oil prices might ease the constraints on the balance of payments, the staff representative pointed out that the staff had taken note of the latest OPEC agreement. At a price of $18 a barrel, along with cutbacks in production, the net benefit to Venezuela would be only about $0.5 billion.

Although the commercial bank rescheduling would provide relief to Venezuela in terms of amortization, the staff representative indicated, it would not alter the balance of payments projections used in the medium-term scenario because those projections assumed that Venezuela would be able to maintain a constant level of public external debt--either by securing additional debt relief or by obtaining new loans. Thus, the balance of payments constraints outlined in the staff report would not be significantly affected by recent oil price movements or the latest debt rescheduling.

None of the modifications agreed under the debt rescheduling arrangement had referred to enhanced surveillance, and therefore that aspect of the arrangement remained intact, the staff representative added.

Both the staff and the authorities viewed the Quantitative Economic Program as a useful means of ensuring the consistency of policies, the staff representative commented. The staff had been hampered in the preparation of its report because no Quantitative Economic Program was available for 1987, and the policy discussions had consisted mainly of a review of the 1986 outturn compared with the program. The staff expected, during the next enhanced surveillance review mission, to be able to elaborate more fully the prospects for 1987 and beyond. Some convergence of the staff's and authorities' views had indeed occurred, and it also had to be recognized that the implementation of policies such as exchange rate unification and liberalization of the economy might take some time.

The staff had estimated a fiscal deficit of about 6 percent of GDP before the implementation of the December 1986 measures, the staff representative pointed out. Afterwards, it had forecast that at least initially, that deficit would rise but the authorities believed that it would be less than the projected 8 percent. The difference in views stemmed mainly from a technical issue related to the effect of the devaluation on the stock of external credits held by the petroleum company; the staff and the authorities needed to discuss that issue further. In terms of the margins of maneuver on the fiscal side, it was important to note that although the fiscal outturn in 1986 had been in the lower range of what had been recommended by the staff, the balance of payments outturn in many ways had been worse than envisaged. That outturn underlined the need for a cautious fiscal policy, particularly if conditions were to be laid for a recovery in private sector investment. When that happened, the large excess of private savings over investment would diminish. As a consequence, the fiscal deficit would need to be brought down sharply.

Responding to the question whether there was an argument for new taxation measures, the staff representative recalled that for the past several years, current expenditures had been tightly restrained. At the same time, the tax ratio was extremely low in Venezuela--about 12 percent of GDP. In addition, both the staff and the authorities recognized that substantial public investment would be needed to foster the export diversification necessary for medium-term economic growth. Improvements in tax administration would certainly be helpful, and the staff had welcomed many of the features of the tax reform that had been introduced by the authorities, such as the reduction in tax brackets, the expansion of the taxable base for corporations, and increases in stamp and real estate taxes. Moreover, the staff, following up on recommendations of an earlier mission of the Fiscal Affairs Department, had been recommending that Venezuela shift over the medium term to a value-added tax system. Other types of measures recommended by the staff were improvements in public sector pricing; for example, gasoline prices in Venezuela were extremely low by world standards. The implementation of the recommended measures could provide significant revenue for the public sector.

Under the enhanced surveillance procedure, along with quantitative programming, a marked improvement had occurred in the monitoring of the public sector, but much remained to be done, the staff representative remarked. Venezuela had a wide range of state enterprises that had a great deal of autonomy, and some of the reasons for slippage in the execution of public investment were to be found in the inability of some of those enterprises to move as rapidly as had been planned. At present, the World Bank was not involved in monitoring the public investment program. The World Bank had just begun to be reinvolved again in Venezuela, and the first steps had included some technical missions and an economic mission to the country.

The question of open market operations by the Central Bank was currently under discussion, the staff representative reported, but to the staff's knowledge, nothing had yet been decided.

The staff had recommended that interest rates be adjusted to positive real levels, the staff representative noted. A technical study made by the Central Bank had recommended a significant increase in the interest rate structure, but the issue was still under discussion by the authorities.

The recommendations of the recent World Bank economic mission were much along the lines of those in SM/87/22, notably, rapid movement toward a unified flexible exchange rate, and efforts to liberalize and deregulate the economy, including tariff reforms in particular, the staff representative indicated. The Bank had suggested a narrower range of tariffs but its wider application across the import spectrum. At present, tariffs ranged from zero to 100 percent, but about four fifths of imports were exempt from tariffs. Thus, there was a great deal of scope to improve the tax base and to reduce the dispersion of tariffs. In addition, the World Bank report, like the Fund report, recommended moves to reduce the fiscal deficit over the medium term.

The changes to the foreign investment code had been in the direction of removing some of the restrictions on foreign investment in certain key sectors in Venezuela that resulted from the Andean Investment Pact, foreign investment in certain key sectors in Venezuela, the staff representative mentioned. The criteria had been liberalized for permit registration, repatriation of capital, and qualification as a Venezuelan national company. The staff hoped that liberalization of the investment regulations would be extended further in the course of time, because both the authorities and the staff recognized the importance of such a step for encouraging private investment.

The staff was not aware of a concrete plan for the privatization of state enterprises, the staff representative from the Western Hemisphere Department said. Although the authorities intended to sell many of the subsidiary enterprises of the Guayana Corporation of Venezuela, which was a big holding company, he was not aware that much had been done yet to implement that intention.

Mrs. Filardo made the following statement:

After implementing a successful stabilization program, Venezuela was badly shocked early in 1986 by an abrupt fall of 43 percent in oil income. It was not possible to compensate for this drop because of the small base for diversification of the economy; nevertheless, nontraditional exports increased by 11.6 percent during 1986. The reduction in export revenues and the commitment of the authorities to repay external debt were the main factors driving the external sector into a serious disequilibrium, since imports decreased in real terms.

The overall public sector recorded a deficit as a result of the reduction in oil revenues and the authorities' decision to implement the triennial plan, which envisages capital expenditure. With respect to current expenditure, the Government intensified its austerity measures, closing many state enterprises, such as CVF, the transportation institute, and CORPO-MERCADEO, which accounted for the larger deficit of the public sector. Current expenditures have decreased 12 percent in real terms since 1984, and the nonfinancial public sector has shifted from a deficit exceeding Bs6 billion to a surplus exceeding Bs20 billion.

Venezuela is one of the few debtor countries that, in the past three years, has reduced its external debt by more than $6 billion in absolute terms. My authorities are committed to continue honoring their external debt obligations despite the overwhelming economic difficulties faced by the country.

The Venezuelan economy remains highly sensitive to developments in the oil sector, which makes it difficult to implement any economic program on a medium-term basis. Because of the remaining uncertainties and great dependence on oil, the economy can be turned around in the direction of considerable diversification only in the medium term. Therefore, it is crucial for the authorities to embark both on a comprehensive stabilization program and structural reform. To this end, they are making every possible effort to implement progressively those reforms. Nevertheless, when a country is trying to accomplish trade policy reforms, several features are fundamental for the success of those reforms: the external environment should be appropriate, the availability of foreign resources should be adequate, and the domestic institutional framework should be responsive. Given an external environment in which protectionism is increasing, especially among industrial countries, it is all the more difficult to convince politicians and the private sector to implement fully a liberalization program. The level of exports depends not only on timely implementation of export promotion measures, but also on market penetration. In addition, institutional reforms are more difficult to implement than policy reforms because the process of legislating and executing reforms takes much longer than one anticipates. If, in addition, the country is experiencing a stringency of foreign resources, the task of trade liberalization becomes nearly impossible.

Some Directors inquired about the tariff structure suggested in the World Bank's policy report on Venezuela's trade, whether the authorities have agreed with its conclusions, and what steps are contemplated by the economic mission that visited the country in January 1987. As for the tariff structure, the report noted that on average, tariffs were 30 percent and that the final tariff collection amounted to 6 percent of import value. The real problem is the rationalization of foreign exchange that has taken place. In this respect, the authorities have announced measures to eliminate RECADI, the agency charged with allocating foreign exchange, and they will make foreign exchange resources available for a period of six months. The conclusions of the report are one of the main issues under discussion. The World Bank staff plans to complete the report of the previous economic mission when it resumes discussions with the authorities in May. Nevertheless, it should be emphasized that structural reforms do take time to negotiate and implement, and that there may be a delay because Venezuela is entering an election year.

As for Mr. Dallara's questions on the enhanced surveillance approach, and his concern about the viability of the Quantitative Economic Program, I would like to reiterate our previously stated position: "Enhanced surveillance was set up as a special policy within the broad concept of surveillance, and, accordingly, different from the Fund policy programs. This distinction is made clear, among other elements, in the sense that in the case of enhanced surveillance the Quantified Economic Program is an integral part of the debtor country's policymaking process, reflecting the autonomous nature of the country's objectives and policy intentions. In this regard, the role of the Fund is to collaborate with the country in providing technical assistance, in articulating the Quantified Economic Program, and in assessing it. But, unlike the case of a program in the upper credit tranche, the objectives and the economic policy package are not part of an agreement with the Fund." This does not mean that enhanced surveillance has not been positive. The staff advice and suggestions have been very useful to my authorities, and based upon that dialogue, they have taken several steps in the right direction.

Regarding domestic interest rate policy, the interest rate paid on domestic deposits has not been positive in real terms every month because prices have been fluctuating greatly, mainly because of the behavior of the exchange market, which reflects in part the spread between the controlled and free market exchange rates during the entire year, and the agreed salary increase. In view of the volatility of prices and the fact that the authorities consider the price adjustment as being temporary, they prefer to wait for the consumer price index and the wage price index to stabilize first and then to proceed with the adjustment of the interest rate. Nevertheless, I want to note that the Central Bank has prepared studies recommending an increase of 5 percent to 7 percent on average, although this recommendation is still under consideration by the Central Bank Board.

Some Directors inquired about the possibility that Venezuela would design a debt reconversion scheme. I am pleased to say that my authorities are taking all the necessary steps to implement such a scheme as soon as possible.

Other Directors emphasized the danger of the subsidy to private sector debt. My authorities have been very cautious regarding this issue; even though they originally had adopted a preferential rate of Bs 4.30 per US dollar, after the oil shock they realized that they could not continue to guarantee this rate

Subsequently, they increased the bolívar value of the private sector debt by more than 200 percent, shifting the effective exchange rate to approximately Bs 13 per U.S. dollar.

Other questions from Directors have dealt with the Quantitative Economic Program for 1987 and the macroeconomic policies envisaged for its implementation. In my opening statement, I mentioned that my authorities were preparing this program, and had asked me in advance to outline their intentions related to the macroeconomic policies that they expect to discuss during the next mission.

Mr. Dallara observed that in a sense, the enhanced surveillance arrangement in each country was unique, but there were nonetheless certain guidelines that had evolved and had received endorsement from the Executive Board. Thus his interpretation of the enhanced surveillance procedure differed from that just articulated. If he had understood correctly, Mrs. Filardo viewed the determination of the Quantified Economic Program as the prerogative solely of the authorities. It was his recollection of the agreed procedure that enhanced surveillance involved collaborative efforts by the authorities and the staff not only on technical assistance, but also on policy formulation.

Mrs. Filardo agreed that the collaboration between the authorities and the Fund staff had been very useful. However, enhanced surveillance did not involve a compromise or a fulfillment of performance criteria on the part of the authorities in relation to the staff; it was an exchange of views between the authorities and the staff on the consistency of the program, and in that sense enhanced surveillance was similar to technical assistance.

The staff representative from the Exchange and Trade Relations Department noted that a full discussion of all the issues pertaining to enhanced surveillance was scheduled for March 18, 1987, when Directors would be considering a staff paper on the Implementation of Debt Strategy--Current Issues (EBS/87/38, 2/20/87; and Sup. 1, 3/9/87).

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the appraisal in the staff report for the 1986 midyear Article IV consultation with Venezuela.

Directors observed that following the application of strong adjustment policies for several years, the Venezuelan authorities had adopted in late 1985 more expansionary financial policies to promote reactivation of the economy. They noted that in 1986, for the first time in several years, Venezuela had registered positive economic growth, and the rate of unemployment had declined. However, speakers added, Venezuela's pursuit of expansionary financial policies at the same time that world oil prices were declining had resulted in the emergence of large domestic and external imbalances: the rate of inflation had accelerated, the differential between the controlled and the free market exchange rate had widened, and international reserves had fallen sharply. Some Directors noted that Venezuela's reserve position still provided some flexibility to the authorities in facing the transition to a viable external position; however, official reserves might soon fall to dangerously low levels if they continued declining at the pace of 1986.

Directors thus welcomed the significant adjustment of the controlled exchange rate in December 1986, which would improve the competitiveness of the Venezuelan economy, strengthen the balance of payments, and help to promote economic diversification. However, they noted that the multiple exchange rates gave rise to distortions and required complex administrative controls. Most Directors, therefore, emphasized the need to move rapidly toward a unified exchange system. Such a system, based upon a flexible exchange rate, would facilitate the elimination of most import and exchange restrictions and the implementation of reforms to the tariff structure, they indicated. In that regard, the authorities' intention to implement the recommendations of the trade policy study recently concluded with the collaboration of the World Bank was welcomed.

Directors stressed that restoration of a viable balance of payments position as a basis for sustainable economic growth also required the adoption of tighter demand-management policies. They noted that the thrust of the fiscal measures taken by the authorities in late 1986 would tend to raise the overall fiscal deficit in 1987 to a level exceeding that of 1986. Speakers generally took the view that additional fiscal action, including both new revenue measures and restraint on expenditure, was urgently required in order to reduce the overall deficit from that recorded in 1986. A cautious monetary policy was also needed to curb inflation and reduce balance of payments pressures. Most Directors encouraged the authorities to raise interest rates to positive real levels in order to promote the growth of financial savings and discourage the export of capital.

Several Directors observed that extensive price controls and other government regulations had held back private sector investment and had contributed to the underutilization of resources. In that regard, Directors urged the authorities to pursue structural policies to diversify the economic base, and to reduce further the scope of government controls and regulations so as to stimulate investment and growth.

Directors noted the sizable repayments of foreign debt in recent years and welcomed the just-announced, successful conclusion of Venezuela's negotiations with creditor commercial banks to modify the terms of the 1986 multiyear rescheduling agreement.

Finally, in regard to the enhanced surveillance arrangement between Venezuela and the Fund, the hope was expressed that there would be a further convergence of views between the authorities and the staff on economic policies. It was also noted that when differences existed, Directors found it helpful to have a candid discussion of those issues in the staff reports.

It is expected that the next 1987 Article IV consultation with Venezuela will be held in about six months.

2. YEMEN ARAB REPUBLIC - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with the Yemen Arab Republic (SM/87/28, 2/4/87). They also had before them a background paper on recent economic developments in the Yemen Arab Republic (SM/87/42, 2/17/87).

The staff representative from the Middle Eastern Department recalled that the staff report had indicated that the Yemen Arab Republic had requested a mission to negotiate a program under the structural adjustment facility. The authorities also wished to discuss the possible use of other Fund resources. The mission had been scheduled, and an advance team had already arrived in the Yemen Arab Republic.

Mr. Finaish made the following statement:

The Yemen Arab Republic achieved considerable progress during the 1970s in effecting a rapid transformation of the economy from traditional activities into a more modern and diversified economic structure. The development efforts were facilitated by substantial inflows of workers' remittances and external aid from the Arab oil exporting countries. A growth rate of nearly 9 percent in real GDP was achieved during the 1970s and GNP per capita nearly doubled. By the early 1980s, however, the economy was adversely affected by the slowdown in economic activity in the Arab oil exporting countries. The growth in workers' remittances and external aid slowed down, and subsequently declined significantly in absolute terms. Although economic growth remained strong through 1982, financial weaknesses began to emerge because of these adverse external developments. A major earthquake at the end of 1982, and drought conditions in the next three years added new strains on the economy and economic growth dropped significantly. The authorities recognized the need for early adjustment and since 1983 have undertaken substantial policy actions to stabilize the financial environment and bring about a speedy recovery in economic activity.

The policy response entailed measures to contain demand pressures while promoting domestic resource mobilization to compensate for the loss of external resources. A particularly courageous action was the introduction of a large degree of exchange rate flexibility, which resulted in a depreciation of the Yemen rial from US$1 = YRls. 4.50 in the fall of 1983 to US$1 = YRls. 12.25 in November of 1986. The exchange rate action was supplemented by fiscal retrenchment, a less expansionary monetary policy, and a variety of adjustments of a structural nature, which have been discussed in the staff report. As a result of these measures, the fiscal deficit in relation to GDP declined by about one third between 1982 and 1985, and the balance of payments deficit was cut in half.

The authorities maintained the adjustment momentum in 1986. The Council of Ministers issued several directives in July 1986 to improve revenue performance and tighten control over government expenditures. On the revenue side, the measures undertaken included increases in customs tariffs, removal of some import tax exemptions, raising user charges of public services, and other measures to improve collection of taxes. Revenues have also benefited from adjusting the exchange rate used for customs valuation and the proceeds from the newly constructed oil refinery. Consequently, domestic revenues as a percent of GDP did not decline in 1986, despite the adverse impact on customs duties of a sharp decline in imports and a shift in their composition away from higher- to lower-taxed commodities. On the expenditure side, a selective freeze on government employment has been implemented. The policy of wage restraint adopted in 1983 has continued and projects that had not started have been postponed. Public enterprises have also neem required to service thier own loans instead of burdening the budget. As a result, budget expenditures declined by 9 percent of GDP in 1986. The authorities have initiated further fiscal measures, particularly to enhance revenues, in the light of the recommendations made by the staff and those of a recent Fund technical assistance mission. For example, the authorities implemented in December 1986 a further adjustment in the exchange rate used for customs valuation. Furthermore, to enhace budgetary discipline and accountability, a gradual integration of extrabudgetary expenditures into the budget was intitiated in 1987.

Although the financing requirements of the budget deficit have been declining, they have continued to exert upward pressures on domestic liquidity. Other factors contributing to these pressures include improvement in the balance of payments and some credit expansion to the private sector. Apart from continuing to reduce the budget deficit and its bank financing, the authorities undertook other measures in 1986 to reduce liquidity expansion and tighten monetary control. These measures included raising interest rates paid to banks on their excess deposits with the Central Bank, increasing margins on letters of credit so that banks maintain higher deposits in earmarked accounts, and limiting credit extended by the Central Bank to public enterprises, which have also been required to shift their deposits to the Central Bank. The authorities are in broad agreement with the staff on the need for further action to control liquidity expansion and promote domestic resource mobilization. They agree that there may be some scope for raising interest rates but social resistance to the interest rate mechanism has been an important constraining factor. Instead, they are considering using quantitative measures to control banks' lending to the private sector. In order to reduce the bank financing of the budget deficit they are also considering the issuance of investment bonds that comply with Islamic principles to gain wider public acceptance, and have requested Fund technical assistance in this connection. Although the expansion in domestic liquidity has contributed to inflationary pressures, the depreciation of the exchange rate has been a more important factor in raising the rate of inflation because of the heavy reliance of the economy on imports.

Balance of payments estimates for 1986 point to a significant strengthening in the external sector in response to policy measures and certain nonrecurring factors such as the receipt of delayed grants from 1985. The current account deficit is estimated to have been reduced to 2 percent of GDP, while the balance of payments is expected to register a surplus for the first time in several years. Imports are estimated to have declined further by one third, to a level equivalent to only 37 percent of their peak level in 1982. This rate of compression of imports clearly cannot be sustained without jeopardizing growth prospects. It is, therefore, crucial that the adjustment efforts of the Yemen Arab Republic be supported by adequate external assistance in the period ahead. The country's external debt profile reflects the authorities' prudent approach, emphasizing borrowing on concessional terms. The principal payments owed to the main bilateral creditor of the Yemen Arab Republic have also been rescheduled recently. Accordingly, the debt service ratio has been kept at the relatively comfortable level of 12 percent in 1986.

While economic activity has been dampened by fiscal retrenchment and reduced availability of imports, a more sustainable economic structure had emerged. The substantial depreciation of the exchange rate in real terms has improved external competitiveness and helped stimulate growth, particularly in agriculture and import-substituting industries. Although the start of oil exports in early 1988 should further improve the growth prospects, the authorities remain committed to sustain economic adjustment over the medium term, since oil export revenues are not expected to offset fully the decline in workers' remittances and external aid. In the absence of adjustment measures, the medium-term scenarios prepared by the staff indicate the re-emergence and widening of external imbalances after 1988. In order to avoid heavy reliance in the future on oil revenues, the authorities are aware that measures are needed to further diversify the economic structure and promote growth.

The Yemen Arab Republic has a liberal economic system and follows traditionally market-oriented policies with respect to both domestic economic activity and international trade. The exchange and trade regimes remained free of restrictions on current and capital transactions through 1983. However, as mentioned above, faced with substantial deterioration in the external environment, the authorities found it necessary to place certain restrictions on the trade and payments system. The authorities emphasize the temporary nature of these measures and reaffirm their intention to remove the restrictions gradually over the next three years. The start of oil exports in 1988 should also ease the external constraints and facilitate the unification of the exchange rates and the removal of restrictions. The authorities have pursued a flexible exchange rate policy, with the commercial bank rate depreciating by over 50 percent in 1986, while the official exchange rate continues to be adjusted to limit its divergence from the commercial bank rate. Furthermore, the coverage of the official rate which is already limited, will be narrowed further. The authorities also intend to liberalize somewhat the payments procedures governing import financing in 1987.

The authorities have formulated a package of adjustment measures, on the basis of which they have requested Fund support under the structural adjustment facility. The authorities' program will be discussed with a Fund mission which is scheduled to visit Sana'a shortly in connection with the possible use of Fund resources.

Mr. Al-Assaf made the following statement:

Since the end of 1983, the Yemen Arab Republic authorities have undertaken major stabilization policies aimed at reducing the imbalances in the economy. To a large extent these policies were successful. The fiscal deficit was reduced from 32 percent of GDP in 1982 to 12 percent in 1986. The overall balance of payments deficit was turned around to reach an estimated surplus at the end of 1986. More generally, a stronger economic structure is emerging. I commend the authorities for these achievements.

Although much has been achieved on the fiscal front, there is still room for improvement. The past fiscal adjustment has been largely the result of expenditure cuts, in particular in capital outlays, and freezes in wages and salaries. The scope for further significant improvements in expenditure appears to be limited. Thus, revenue measures along the lines proposed by the staff are the best candidates for making such improvements. I am encouraged that the authorities are thinking along these lines as well, as evidenced by the directive from the Council of Ministers issued in July 1986. I am also encouraged by the authorities' efforts to incorporate extrabudgetary expenditures into the main budget. Such action will result in more budgetary discipline and credibility.

With respect to monetary policy, the expansion of liquidity by 20 percent in the 12-month period ending in September 1986 resulted in the intensification of inflationary pressures and was inconsistent with the pace of economic activity. If this trend continues, it could undermine achievements on other fronts, and it is, therefore important to strengthen monetary controls.

As for developments in the external sector, the two major sources of foreign exchange--workers' remittances and foreign aid--have declined substantially in recent years, with 1986 transfers being about half their 1982 levels. The Government has made commendable efforts to minimize the impact of this decline through exchange rate adjustments, supported by more cautious financial policies. However, in view of the prospect that this decline will continue in 1987, I urge the authorities to persist with their adjustment efforts while seeking ways to reduce the economy's dependence on traditional foreign exchange earnings.

The staff points out correctly that the restrictions on imports not only lead to misallocation of resources and create administrative burdens, but they could also divert imports to unofficial channels, resulting, inter alia, in a reduction in customs receipts. However, I am encouraged by the authorities' emphatic reassurances that these measures are of a temporary nature.

Looking ahead to the medium term, the projected decline in foreign aid and workers' remittances makes it essential for the authorities to recognize the need to implement structural changes. Given the likely scope of the required structural changes, the Fund can play an important role in support of the authorities' efforts. The authorities have already formulated a package of adjustment measures that would form the basis for Fund support under the structural adjustment facility and other arrangements. I believe that such arrangements, complemented perhaps by World Bank programs, would be quite appropriate. These programs would also help to catalyze additional resources. Finally, such Fund involvement would enhance the Fund's image, since none of the countries in that region currently has a Fund-supported program.

In conclusion, I am encouraged by the authorities' recognition of the difficulties that lie ahead, and by their determination to put their economy on a sustainable path of economic growth and stability. I support the proposed decision.

Mr. Salehkhou made the following statement:

The authorities have commendably pursued prudent policies during a difficult period of adjustment. Despite the problems facing the economy at present, the staff report conveys an overall sense of optimism on the medium-term prospects. The fiscal retrench that has already taken place, the emergence of a stronger economic structure in favor of agriculture and industry, and the prospects for oil revenues, together with the prudent policies that the authorities intend to implement in the medium term, have all placed the economy in a relatively good position to foster increased participation by the private sector.

The staff's major short-term concerns, which are also highlighted by Mr. Finaish, and the medium-term prospects include: the need for unification of the exchange rates; the vulnerability of the external position and the fear of intensified balance of payments pressures toward the end of the decade; and the existence of high domestic liquidity, which may exert upward pressures on prices. The overall recommendations of the report include measures to unify the exchange rates and to enhance government revenues; a substantial increase in the rate of interest is also recommended.

The staff expresses satisfaction with the authorities' intentions to undertake measures, albeit gradual ones, to unify the exchange rates. As for fiscal measures, it is noted that a Fiscal Affairs Department mission will soon report on ways and means to enhance government revenues. There is an implicit recognition in the staff report of the tensions that the attempts to increase rates of interest tend to create in an Islamic society. It appears that the authorities have expressed their concerns regarding the implementation of this recommendation, but the report seems to indicate that as a way of circumventing this conflict, the Fund is about to recommend means by which the Government of the Yemen Arab Republic can borrow from the public by the introduction of "investment banks" that would "comply with Islamic principles."

I find it rather odd that instead of making attempts to understand the particular cultural or religious constraints of individual economies and making policy recommendations commensurate with those values, attempts are made first to persuade the authorities to undertake measures that are contrary to the values of the society--in this situation, to raise interest rates--and if this is not successful, there is then a resort to subterfuge. The result is a paradoxical policy recommendation that runs counter to the Fund's much-heralded and implicit but fundamental commitment to promote the strengthening of the private sector. I wonder whether the staff is aware of this contradiction.

It is difficult for me to understand why the staff insists on ignoring the substantive issues involved when it makes recommendations that are contrary to the fundamental values of the people of countries such as the Yemem Arab Republic. I was heartened by the remarks of the Managing Director at the Joint Fund-Bank Symposium on Growth-Oriented Adjustment Programs (February 25-27, 1987), remarks that called for popular support for adjustment policies.

Often, adjustment measures would have more popular support and accomplish their objectives if greater sensitivity could be shown to the basic values of a people, as expressed through their authorities. I submit that the Yemen Arab Republic is a case in point and can potentially serve as a major test of the veracity and efficacy of the Managing Director's recommendation.

The staff has correctly argued, that a need exists for a positive real rate of return on all assets in the Yemen Arab Republic. The question is whether the staff is interested in the results or insists on particular means of achieving them.

Within the past two years, a number of technical papers have appeared in this institution that leave little doubt regarding the viability of Islamic banking, not only in promoting a positive real rate of return that reflects the scarcity of resources in the real sector of the economy, but also to a great extent in enhancing the private sector. Moreover, one senses from the staff report that the authorities are amenable to the Fund's technical advice on how to institute and implement Islamic banking. Therefore, I cannot understand the lack of enthusiasm displayed in the staff report on the implementation of this measure, which could address a major concern about the prospects of the Yemen Arab Republic economy.

The staff has also expressed concerns about the ways and means of enhancing government revenues in the Yemen Arab Republic. Here again, the religious and cultural values of the Yemen Arab Republic provide the most efficient means of enhancing revenues, through the net wealth tax measure called zakat. The staff report mentions that government revenues had benefited further by an increase in zakat collection. However, I venture to guess that the extent of the potential contribution of zakat to government revenues has not been explored or estimated at all. This extremely important measure has the potential not only to alleviate fiscal deficits but to provide the needed revenue for the Government to stimulate the economy.

I look forward to reading the Fiscal Affairs Department mission report on methods to enhance government revenues in the Yemen Arab Republic. I will be pleasantly surprised if zakat receives much attention in that report; if not, it will be a sad state of affairs, since the Fiscal Affairs Department of the Fund is fortunate to have on its staff one of the world's foremost authorities on various aspects of Islamic economies, including net wealth taxation.

Mr. Fox stated that he welcomed the news that the authorities had requested use of other Fund resources as well as a structural adjustment arrangement; perhaps the staff could elaborate on that point. Certainly on reading the staff report his chair had formed the view that the combination of a stand-by and a strutural adjustment arrangement would lead to a more productive adjustment path. Certain features were necessary for a program under the structural adjustment facility, whether or not it is accompanied by a stand-by arrangement, Mr. Fox added. Perhaps most important would be measures designed to strengthen the current limited degree of budgetary control. Fund expertise in that area had already been called upon, and he hoped that the authorities would be able to respond positively to the recommendations of the recent Fiscal Affairs Department mission. Domestic liquidity also needed to be brought under better control. It would have been interesting to have more discussion of the recommendations made by the Central Banking Department mission, which visited the Yemen Arab Republic in July 1986. The authorities had requested a Fund technical assistance mission familiar with Islamic laws, and the recommendations of that mission would also be interesting. Finally, he placed considerable emphasis on the urgent need for unification of the exchange rate regime and the removal of trade and payments restrictions. He had not been convinced by the argument that a program of unification required as long as three years to implement.

Mrs. Walker made the following statement:

The Yemen Arab Republic has faced growing financial imbalances during the past several years, yet it appears that progress has been made during 1986 to ease these imbalances, at least temporarily. While stabilization efforts pursued by the authorities--particularly in the fiscal, monetary, and exchange rate areas--have contributed to the amelioration of the economy, the large improvement in the balance of payments position was attributable largely to exceptional circumstances. This means that the balance of payments position did not necessarily reflect a reversal of underlying imbalances.

The prospects for the economy in 1987 and 1988 appear favorable in certain respects, most notably because of the projected start-up of oil exports that should generate substantial revenue for the Government. However, oil receipts are not expected to offset fully the continued decline in private remittances and foreign aid projected for the future. Furthermore, growing oil export receipts are not a long-term proposition. Therefore, I would agree with the staff that the medium-term balance of payments outlook remains vulnerable unless additional measures are taken to diversify the economy's dependence on foreign exchange earnings from remittances and foreign aid, while avoiding dependence on oil export receipts. Among the measures needed are a continued reduction in the fiscal deficit, maintenance of a restrictive monetary policy, and pursuit of a flexible exchange rate policy, combined with the removal of payments and import restrictions.

Projections for the 1987 budget do not show an improvement, in percentage of GDP, over the 1986 budget. In this light, it appears that additional measures are needed to deal with the fiscal imbalance. The improvements in the fiscal position resulting from oil export receipts may be deceptive. In order to reduce the fiscal deficit, there may be less room for further expenditure cuts than for revenue-enhancing measures.

Therefore, I urge the authorities to implement the measures recommended by the staff in the light of the technical assistance report of the Fiscal Affairs Department. The staff also makes positive suggestions regarding expenditure savings through selective wage adjustments and selective capital expenditure, and those suggestions should be pursued. The reclassification of extra-budgetary expenditures should also help in this regard. Furthermore, as the World Bank has recommended, it is important for the investment plan to enhance capacity utilization in the productive sectors and to conserve natural resources. We also support the Government's plans to strengthen further the performance of the small public sector.

While monetary policies have been restrictive and measures were taken in 1986 to reduce central bank liquidity and to increase monetary control, the current rate of liquidity expansion is not consistent with other trends in the economy, and inflationary pressures remain high. In order to address the problems in the monetary sector, additional measures need to be taken along the lines of those suggested by the staff in SM/87/28. The authorities are in general agreement with these measures, but are reluctant to raise further the interest rate structure. I would be interested in staff comments on the authorities' plan to use quantitative measures in place of changing the interest rates. The issuance of investment bonds will also be useful.

With regard to the external sector, we agree with the authorities' plan to discourage inefficient industries and to channel resources to areas in which the country has a comparative advantage, and away from oil. We also agree with the World Bank's recommendations regarding the conservation of scarce water resources.

The recent depreciation of the official exchange rate is welcome, although we support the staff recommendation that the exchange rate be unified as soon as possible, particularly since the official rate applies to so few transactions. A flexible exchange rate policy will be an essential ingredient to achieving the objective of expanding and diversifying the productive base of the economy. The existing trade and payments restrictions should also be eliminated because they lead to a misallocation of resources and hinder the achievement of increased production. We agree with the staff that the authorities should take advantage of the oil export receipts to remove these restrictions. We hope that the timetable agreed by the staff and authorities will result in an immediate reduction in these restrictions, and in their elimination as soon as practical.

In conclusion, it appears that in spite of the favorable outcome in 1986, the authorities realize that the future is less certain and thus are willing to adopt additional adjustment measures designed to bring about a better medium-term economic outlook. We caution them against relying too heavily on expected oil receipts, which will be temporary, and we urge them to take advantage of the improved situation and adjust the underlying economy through many of the measures suggested by the staff.

The staff representative from the Middle Eastern Department said that the staff had discussed with the authorities the possible use of other Fund resources in addition to those of the structural adjustment facility. Because the Yemen Arab Republic's comprehensive package of adjustment measures included a large number of demand management measures--which would be implemented for the most part in 1987--a stand-by arrangement was feasible. The comprehensive policy package also included structural adjustment measures aimed at reducing the dependence of the country on future oil resources.

Another possibility was for the authorities to request a drawing under the compensatory financing facility, the staff representative added. Remittances had declined rapidly in the past; they were continuing to decline, but at a slower rate, and were expected to stabilize in 1988-89. In those circumstances, the initial staff calculations indicated that a drawing under the compensatory financing facility was possible, without taking into account future oil earnings.

With respect to the issue of exchange rate unification raised by Mr. Fox, the staff representative remarked that the authorities felt that the external acccount had been under great pressure in 1985 and 1986. As a result, they had depreciated the exchange rate quite rapidly, which in turn, had led to a surge in the rate of inflation--to perhaps as much as 40 percent in 1986. Consequently, the authorities were reluctant to initiate any further action that would increase pressures on the external account or would raise the rate of inflation in 1987. Because the authorities considered 1987 their most difficult year, they were hoping to take some steps toward unification of the exchange rates in 1987, but they planned to wait until 1988--when oil revenues were expected to relieve most of the pressure on the external account--to complete the unification process. The same factors held true for the temporary restrictions on trade. The authorities had already moved to liberalize the payments for trade by allowing some importers to use their foreign exchange holdings. However, with the easing of pressures in 1988, the authorities expected to liberalize the system substantially.

Recalling Mr. Salehkhou's remarks on the use of the interest rate, the staff representative noted that the Yemen Arab Republic traditionally had used the interest rate as a policy instrument. For example, the Central Bank provided interest to the commercial banks for their excess reserves, and increased the interest rate whenever it was necessary to mop up some of those reserves. That policy had been quite successful. By the same token, the cultural and religious considerations in the country were important, and the staff had been quite sensitive to those issues. What the staff had implied in SM/87/28 was that the authorities were not averse to a small increase in interest rates, but they were resistant to a substantial rise, preferring to fall back on quantitative targets for credit until instruments that were consistent with Islamic principles could be developed and used to increase yields on financial assets denominated in domestic currency.

The staff had approached the question of interest rates with an open mind, the staff representative continued. The Central Banking Department mission that had recently gone to the Yemen Arab Republic had pointed to two possibilities: the commercial banks could open branches in which people could place deposits on a profit- or loss-sharing basis, and a bank based on Islamic principles could be created. The Governor of the Central Bank had taken up those possibilities with the staff during the Article IV consultation; the Fund staff was hoping soon to advise the Yemen Arab Republic on the modalities for selling public investment bonds in conformance with Islamic principles, and to help the authorities explore the possibility of establishing an Islamic bank. Efforts were currently under way to recruit a consultant from Egypt who was an authority on Islamic banking.

Finally, one way to reduce the gap between yields on foreign instruments, real estate, or inventories of goods, and yields on domestic financial assets was to reduce the rate of inflation and to improve the real interest rate, the staff representative from the Middle Eastern Department commented. The staff was hoping that those goals could be achieved by means of demand-management policies and tighter credit policies.

Mr. Finaish recalled that after a favorable period in the 1970s, the Yemen Arab Republic had been faced with some problems in the early 1980s that were related to changes in the region, which had led in turn to a substantial decline in remittances and foreign aid. Exogenous factors such as the earthquake of 1982 and years of severe drought had also contributed to the authorities' difficulties. The authorities had responded courageously to the challenges facing them, and had taken particularly effective steps to improve the exchange rate and budgetary situations. However, the adjustment efforts would have to continue in the medium term, because although the discovery of oil in 1984 was expected to result in exports in 1988, those oil revenues would not be sufficient to compensate for the decline in remittances and foreign aid.

The Yemen Arab Republic, with its wise economic management and exemplary adjustment record over the years, was a good candidate for possible use of Fund resources, Mr. Finaish observed. The country had a long-standing record of close contact with the Fund--notably through the technical assistance of the Central Banking Department and the Fiscal Affairs Department--and had been following Fund advice without using Fund resources. The Yemen Arab Republic had a low debt service ratio--about 12 percent--and had used Fund resources only once, after the earthquake of 1982, when emergency assistance of SDR 9.8 million had been authorized by the Executive Board. The Board had doubled the amount of emergency assistance recommended by the staff, in the light of the magnitude of the damage to the country and given that the country's quota was extremely low relative to the size of the economy; in fact, the ratio of its actual to calculated quota was the fourth lowest of the Fund members.

The Board might wish to advise the staff to be flexible in the negotiations for a program by striking a balance between the financing constraint entailed by the country's limited quota and the recommended measures to be taken, Mr. Finaish mentioned. The Yemen Arab Republic was looking forward to the availability of additional resources under the structural adjustment facility to enable it to embark on a medium-term program that included demand-management policies and structural adjustment measures. Furthermore, as Mr. Al-Assaf had noted, it would be useful to diversify the list of users of Fund resources, particularly since that region did not have many such users. He was not asking for any special treatment for the Yemen Arab Republic, but it was important for the Fund to make use of the opportunity to show its members, particularly in that region, that when they needed help, it could be provided. The contributions from the World Bank had been extremely limited in the past, but since the World Bank was taking part in the current negotiations, it should be able to help the Yemen Arab Republic as well.

It was true that the use of interest rates met with social resistance in the Yemen Arab Republic, Mr. Finaish indicated. Nevertheless, the authorities had raised interest rates in the past. What was important was to establish an appropriate mechanism to ensure an adequate real rate of return on assets for mobilizing domestic resources. Toward that end, the authorities had shown a willingness to adopt a variety of measures, including measures to help lower the rate of inflation. As the staff had noted, moreover, the authorities had proposed the issuance of investment bonds that complied with Islamic principles, and they had requested Fund technical assistance for that purpose.

The authorities intended to bring about 30 percent of the extrabudgetary expenditures under the budget in 1987, and to bring the remainder under the budget over the next two or three years, Mr. Finaish noted. The inclusion of extrabudgetary expenditures in the budget was a difficult task in many countries, including the Yemen Arab Republic, which had become independent only in the 1970s. Perhaps the staff could elaborate more fully on the authorities' plans.

The staff representative from the Middle Eastern Department commented that the extrabudgetary expenditures had been problematic for a long time because the authorities had excluded several items such as defense security, foreign debt repayments, and interest on foreign debt. The Fund had long advocated that those expenditures be integrated within the budget to increase fiscal discipline and accountability. The authorities had taken some steps to integrate some of the extrabudgetary categories within the 1987 budget, but they considered that three years would be required to achieve a full integration. Given the political and other considerations, the authorities wanted to move slowly on that task.

Mr. Salehkhou, welcoming the explanation on interest rates by the staff representative as well as the remarks of Mr. Finaish, said that his concerns had been alleviated in part. It was appropriate for the Fund to provide the authorities with the requested assistance in implementing the Islamic banking and taxation measures, rather than to insist that the authorities raise interest rates. Fund studies had shown that in the few countries where the Islamic system had been put in place, the rate of return had always been positive.

The Chairman made the following summing up:

Executive Directors expressed broad agreement with the thrust of the appraisal of the staff report for the 1986 Article IV consultation with the Yemen Arab Republic.

Directors observed that since 1983 the authorities had made a commendable effort to correct internal and external imbalances by strengthening government finances and by pursuing a flexible exchange rate policy. They considered that the stabilization measures, which included a sharp depreciation of the Yemen rial, had been broadly successful in lowering considerably the fiscal deficit in relation to GDP, reducing the pressures on the balance of payments, and strengthening the economic base. Nevertheless, Directors added, the rate of monetary expansion remained high, the inflationary pressures had intensified, and the underlying pressures on the balance of payments and the exchange rate had persisted.

Directors stressed that those trends indicated the need for a prompt implementation of a comprehensive adjustment package with the aim of further reducing the fiscal deficit and of laying the ground for the expansion of the non-oil sector to promote a diversified productive base and enhance the role of the private sector. They noted that stronger demand management should be achieved by mobilizing domestic resources and containing government spending, strengthening budgetary controls and discipline, and tightening monetary and credit policies. In addition, they said, greater exchange rate flexibility that would permit a restoration of a unified exchange rate would alleviate balance of payments pressures while improving the competitiveness of the traded goods sector.

Directors expressed the hope that the authorities would soon be in a position to submit a broad-based adjustment program that the Fund could support with the use of its resources.

Finally, Directors noted the commitment of the authorities to a free and liberal economic and exchange system. In that respect, they encouraged the authorities to seize the opportunity to unify the exchange rates and liberalize import and payments procedures as soon as circumstances permitted.

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

The Executive Directors then took the following decision:

1. The Fund takes this decision relating to the Yemen Arab Republic's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1986 Article XIV consultation with the Yemen Arab Republic, in the light of the 1986 Article IV consultation with the Yemen Arab Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The payment procedures related to imports, as described in SM/87/28, constitute an exchange restriction subject to approval by the Fund under Article VIII, Section 2(a). A differential in excess of 2 percent between the official exchange rate and the commercial bank rate evidences a multiple currency practice subject to approval by the Fund under Article VIII, Section 3. The Fund notes the intention of the authorities of the Yemen Arab Republic to eliminate this exchange restriction and unify the multiple exchange rates as soon as possible and grants approval for the retention of these practices until February 29, 1988 or the completion of the next Article IV consultation, whichever is earlier.

Decision No. 8539-(87/35), adopted
March 2, 1987

3. SOMALIA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1 AND NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATIONS

The Executive Directors gave substantive consideration to the Managing Director's report and complaint under Rule K-1 with respect to Somalia's overdue financial obligations to the General Resources Account, and the notice of Somalia's failure to settle obligations to the Trust Fund (EBS/87/43, 2/25/87; and Sup. 1, 3/2/87).

Mr. Finaish made the following statement:

I would like to emphasize Somalia's commitment to honor its financial obligations to the Fund and indeed to all its creditors, and to assure the Board that the authorities attach the highest priority to the settlement of the arrears to the Fund. Against the background of the financial constraints facing Somalia, the authorities' partial payment of SDR 2.6 million in December 1986 should be indicative of their eagerness to become current with the Fund, thus enabling the Fund to resume fully its constructive role in support of Somalia's adjustment efforts.

Somalia's financial situation has been quite fragile over the past two or three years, leaving the authorities with little room for maneuver. This in turn made it critical that external financing be available in a timely manner to enable a smooth implementation of adjustment policies and to avoid debt-servicing difficulties. Unfortunately, delays in aid disbursement have been experienced over the past two years, which has resulted in cash flow problems and difficulties in servicing financial obligations--including those to the Fund--on time. As we all know, once an interruption of this kind takes place, it becomes quite difficult to repair the situation, because policy slippages occur and other sources of finance become less available. Nevertheless, Somalia has made great efforts to rectify such situations in the past and indeed succeeded in becoming current with the Fund before the arrears reached the stage of a Board discussion. On other occasions, such as the present one, it proved impossible for Somalia to become current with the Fund.

This dilemma is clearly not unique to Somalia, and as I have stated on previous occasions, it is my view that efforts should be made to improve the coordination of external assistance flows so that adjustment programs, and the ability to meet financial obligations on time--conditions based on certain financing assumptions--are not jeopardized by cash flow problems such as those experienced by Somalia. This is particularly true when export proceeds have a seasonal pattern, as is the case in Somalia, and when the country is in the process of genuine structural change and is showing willingness and determination to do its part to remain current in its obligations to the Fund.

The authorities recognize that policy slippages have occurred recently, although as EBS/87/20 indicates, many of these slippages were associated with unforeseen developments, including, in addition to aid disbursement delays, substantial import shortfalls and higher than programmed interest payments on external debt. In the next few days, the authorities will be discussing with the staff mission the elements of an economic program that will help Somalia settle its obligations and thus enable the Fund to resume fully its supportive role. Of course, adequate external support will continue to be crucial for the success of the authorities' efforts. As pointed out in the staff paper, the medium-term outlook indicates a need for continued large donor support, including debt reschedulings.

The recent delays in the discussions between the staff and the authorities, which were associated with the political process in Somalia--including elections and the appointment of a new cabinet--were unfortunate but also unavoidable. The authorities are hopeful that the forthcoming discussions with the staff and the Consultative Group meeting scheduled for mid-March will make possible a full settlement of the arrears in the near future.

I would like to read portions of a telex that I received yesterday from the Governor of the Fund for Somalia:

> Please assure the Board that the timely discharge of our obligations to the Fund, to which we have given our highest priority, is a matter of our own deepest concern. This has been demonstrated among other things by our extraordinary efforts last year, during which we have repaid a substantial sum to the Fund on a net basis, at a considerable cost in terms of our other foreign exchange needs. In the same spirit we have made recently a partial payment, so that Somalia is almost current with all its obligations to the Fund as of end-1986. As the Fund staff knows, these are months of extreme foreign exchange scarcity in Somalia, both overall and in the official sector. The overall scarcity is caused by the seasonally low export receipts and private remittances. With respect to the scarcity in the official sector, it is important to recall that we, in concert with the donors and with the Fund, and to assist private economic activity, have been selling to private importers in open auctions substantial sums that would otherwise have accrued in part to the Central Bank and thus would be available for debt service. Therefore, it is impossible for us at this time to settle the outstanding arrears to the Fund.
>
> I am, however, hopeful that aided by the successful completion in substance of new arrangements with the Fund, we shall be able in the near future to find a solution to this problem as we were able to do last April when the problem was of a much larger magnitude.

Mr. Archibong made the following statement:

Intermittently since January 1985 Somalia has accumulated, and subsequently cleared, arrears with the Fund. The most recent occurrence was in August 1986, when the Executive Board considered the Managing Director's complaint concerning, Somalia's accumulated arrears amounting to SDR 12.7 million. However, by September 15, 1986, the country became current in its obligations to the Fund. Shortly thereafter, Somalia slipped back into arrears, and remains in that situation despite payments made in December 1986 totaling SDR 2.6 million. The authorities deserve to be commended for those payments--they demonstrate Somalia's commitment to stay current with the Fund in spite of the difficult situation the country is facing. In cases such as that of Somalia, it would have been pertinent and useful if the staff had explained in some detail the underlying problems that have brought about a persistent recurrence of these arrears.

The staff paper referred to the continued balance of payments pressure caused in part by slippages in policy implementation and delays in the disbursement of donor assistance. These delays have recently become an important factor contributing to the disruption of a number of adjustment programs. Perhaps the staff and the Somali authorities could work together to produce more realistic estimates of such assistance, given the existing circumstances.

Notwithstanding these shortcomings, the experience of Somalia and some other countries in arrears gives the impression that the measures that had been put in place might have been inadequate. This is because Somalia quickly encountered difficulties in meeting subsequent obligations to the Fund and other creditors. This issue suggests that the bigger question of existing debt strategy needs to be reviewed, ideally to incorporate mechanisms that minimize the recurrence of payments arrears over short intervals. One advantage of such an approach is that program targets would reflect more realistically a country's capacity to service its debt as well as its ability to implement policies designed to achieve them.

I can go along with the proposed decision as presently formulated.

Mr. Goos expressed appreciation for Mr. Finaish's opening statement, and in particular, the assurances of his authorities that they remained committed to honor their external obligations, especially their obligations to the Fund. Nevertheless, Somalia's history of repeated overdue obligations to the Fund was a matter of grave concern. While it was true that exogenous factors, including the delays in the disbursement of official aid, had played a role, the arrears clearly could be traced in large measure to difficulties that were of the authorities' own making. Therefore, it appeared that a determined, sustained stabilization effort was the only way to restore the normal relations between Somalia and its external creditors that were absolutely essential for the country's economic prospects.

Against that background, the authorities' recent efforts to improve revenue collection and to tighten monetary policy were certainly welcome steps in the right direction, Mr. Goos continued. Also welcome was the progress made in reorganizing the public enterprise sector and in liberalizing the exchange and trade system, although it was disappointing that the authorities had failed to fulfill their earlier commitment to unify the foreign exchange markets before the end of 1986. Nevertheless, the recent further deterioration in the overall economic situation, and in particular the continued existence of arrears to the Fund, clearly suggested that more needed to be done. In that context, he welcomed Mr. Finaish's statement that the authorities were prepared to continue their discussions with the staff, and that in that process they would be looking for solutions to the problems. Even before the conclusion of those discussions, the authorities should make every effort to settle their arrears to the Fund, consistent with the obligations under the Articles of Agreement and with the cooperative spirit of the institution. Finally, he could go along with the proposed decision.

Ms. Lundsager indicated that her authorities deeply regretted the recurrence of arrears after Somalia, along with its donors and creditors, had made extraordinary efforts to clear those arrears early in 1986, thereby allowing the 1985/86 stand-by arrangement to be reactivated. In fact, the Board had agreed to extend that program by some six months in order to rekindle the adjustment effort. In addition, her authorities and some others had engaged in difficult processes to refashion their bilateral aid into a form that would better suit the needs of the Somali economy. However, it was true that problems did remain with maintaining adequate donor support.

Under the program, performance in 1985 had fallen somewhat short of expectations, largely because some policy actions had not been fully implemented, and because Somalia had encountered some problems related to shortfalls in donor assistance, Ms. Lundsager observed. Somalia's performance had improved in early 1986 as the program was being reactivated, but after its expiration in September 1986, significant slippages in policies had occurred and had contributed to the re-emergence of arrears in November 1986. Those arrears could grow rapidly. With arrears in payments due in 1987 totaling some SDR 40 million, the authorities had to act swiftly to eliminate the arrears and to conclude negotiations on a program under the structural adjustment facility. Such a program, along with World Bank assistance and bilateral aid, could provide financing for 1987 and help the authorities lay the basis for a medium-term improvement in the payments position, while implementing domestic reforms aimed at fostering growth. However, she shared Mr. Goos's concerns about some of the specific policy measures. In that regard, she welcomed the return of a staff mission to Somalia to continue the discussions on an adjustment program, and she hoped that no further Board discussion of Somalia's arrears would be necessary.

The staff representative from the African Department remarked that as Mr. Goos had rightly noted, problems in domestic policy had been responsible in part for Somalia's difficulty in remaining current with the Fund. Nonetheless, one had to take account of the fact that Somalia's balance of payments had been and continued to be heavily dependent on foreign assistance.

Each time a Fund mission went to Somalia, a cash-flow estimate was prepared to help facilitate the payment of obligations, not only to the Fund but to other creditors, the staff representative continued. Somalia's own resources accounted only for about 20 percent or 25 percent of the total flows in the balance of payments, and thus it was extremely important to be able to estimate accurately when, and in what form, the other 75 percent or 80 percent of the resources--coming from abroad--would be disbursed. Over the past two years, there had been repeated difficulties in making the cash-flow estimates, largely because the assistance that was in the most useful form--cash--was delayed the most, given that donors attached greater conditionality to such assistance. Moreover, at the beginning of the current stand-by arrangement, Somalia had had virtually no free foreign reserves. The experience of 1985/86 showed that shortfalls had averaged about 16 percent from the amount that donors had indicated was forthcoming to help close the financing gap, and it was in part that difficulty that gave rise to the recurrence of Somalia's arrears.

Finally, Mr. Finaish had rightly pointed out that some of the difficulties that Somalia faced were attributable to political events, in that the discussions on a new stand-by arrangement could not be initiated until after the elections and the appointment of a new cabinet, the staff representative commented. Those delays had meant that it was not possible to finalize a Paris Club rescheduling before end-1986 or to have a Consultative Group meeting with the World Bank in early 1987.

The Executive Board then took the following decision:

1. The Managing Director has reported to the Executive Board, under Rule K-1 of the Fund's Rules and Regulations, the facts on the basis of which it appeared to him at the date of this report that Somalia was not fulfilling its obligations under the Articles of Agreement, and submitted a complaint on February 2, 1987 (EBS/87/20) in accordance with that Rule. The complaint under Rule K-1 was that as of February 2, 1987, Somalia was not fulfilling its obligations relating to repurchases and the payment of charges in the General Resources Account in the total amount of SDR 9,412,077. In addition, the Managing Director issued a notice of the facts on the basis of which it appeared to him that as of February 2, 1987, Somalia was not fulfilling its obligations under Decision No. 5069-(76/72) with regard to the Trust Fund to repay disbursements and to pay interest under its Trust Fund loans in the amount of SDR 1,083,789, and pursuant to Decision No. 8165-(85/189) G/TR to pay special charges that are overdue to the Trust Fund in the amount of

SDR 622. These facts and the complaint and notice of the Managing Director were communicated to the authorities of Somalia on February 9, 1987.

2. Taking into account that further obligations of Somalia have become overdue since February 2, 1987, Somalia's overdue obligations to the Fund now total SDR 10,642,434 in the General Resources Account, SDR 208,251 in the SDR Department, and SDR 1,091,319 to the Trust Fund.

3. Having considered the report of the Managing Director, the complaint under Rule K-1 and the notice, and the views of Somalia, the Fund finds that Somalia has failed to fulfill its obligations under the Articles of Agreement and under the Trust Fund as stated in paragraphs 1 and 2 above.

4. The Fund regrets the nonobservance by Somalia of its obligations, urges Somalia to resume their observance forthwith, and decides:

(a) pursuant to Rule K-2 of the Fund's Rules and Regulations that Somalia shall not make use of the general resources of the Fund until such time as Somalia has become current in its obligations under the Articles of Agreement relating to repurchases and the payment of charges in the General Resources Account, and

(b) if Somalia were otherwise eligible to make use of the general resources of the Fund, to take into account the existence of any overdue obligation to the Trust Fund in considering any request by Somalia for the use of the general resources.

5. The Fund shall review this decision within a period of three months from the date of the decision.

Decision No. 8540-(87/35) G/TR, adopted
March 2, 1987

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/87/34 (3/2/87) and EBM/87/35 (3/2/87).

4. BOLIVIA - REPRESENTATIVE RATE FOR BOLIVIAN BOLIVIANO

The Fund finds, after consultation with the authorities of Bolivia, that the representative exchange rate for the Bolivian boliviano under Rule O-2(b)(i) against the U.S. dollar is the buying rate for spot delivery of U.S. dollars in the official exchange market as determined by the Banco Central de Bolivia. (EBD/87/62, 2/25/87)

Decision No. 8541-(87/35) G/S, adopted
March 2, 1987

APPROVED: October 6, 1987

LEO VAN HOUTVEN
Secretary