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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/21

10:00 a.m., February 4, 1987

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	Song G., Temporary
C. H. Dallara	
J. de Groote	
A. Donoso	E. Feldman
M. Finaish	
G. Grosche	B. Goos
	D. V. Nhien, Temporary
	H. A. Arias
T. P. Lankester	M. Foot
H. Lundstrom	
	D. McCormack
	D. Saha, Temporary
Y. A. Nimatallah	I. A. Al-Assaf
	L. Filardo
H. Ploix	
G. A. Posthumus	
C. R. Rye	C.-Y. Lim
G. Salehkhou	
A. K. Sengupta	
	M. Sugita
	N. Kyriazidis

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

IBRD: C. Jones-Carroll, Latin America and the Caribbean Regional Office; J. de Leede, Eastern and Southern Africa Regional Office. African Department: E. M. Taha. Asian Department: E. Gurgen. Central Banking Department: L. M. Koenig, Deputy Director. Exchange and Trade Relations Department: M. Guitián, Deputy Director; C. Atkinson, J. T. Boorman, J. M. F. Braz. External Relations Department: H. P. Puentes. IMF Institute: P. R. Rado; I. Habib, Participant. Legal Department: J. K. Oh, J. V. Surr. Middle Eastern Department: J. R. Dodsworth, M. A. El-Erian, P. L. Joyce, M. F. Melhem, K. Nashashibi, M. Yaqub. Research Department: A. Mirakhor, J. J. Soladay. Secretary's Department: P. D. Péroz. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Berthet, J. E. Blalock, J. C. Corr, J. A. Gons. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; P. D. Brenner, M. Caiola, L. E. Escobar, J. Ferrán, P. Kohnert, J. Jaramillo-Vallejo, J. E. Leimone, C. M. Loser, J. Sol-Perez. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, A. Bertuch-Samuels, M. B. Chatah, L. P. Ebrill, S. M. Hassan, K. Murakami, A. Ouanes, P. Péterfalvy, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, F. E. R. Alfiler, J. R. N. Almeida, O. S.-M. Bethel, S. Binay, W. N. Engert, S. Fayyad, R. Fox, M. Hepp, G. K. Hodges, O. Isleifsson, J. M. Jones, K.-H. Kleine, M. A. Kyhlberg, M. Lundsager, V. K. Malhotra, R. Msadek, C. Noriega, J. K. Orleans-Lindsay, C. A. Salinas, G. Schurr, G. Seyler, H. van der Burg, D. A. Woodward.

1. CHILE - REVIEW UNDER EXTENDED ARRANGEMENT AND EXCHANGE SYSTEM

The Executive Directors considered the staff report for the review under the extended arrangement for Chile effective August 15, 1985 together with a proposed decision on Chile's exchange system (EBS/87/3, 1/7/87).

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

> The Chilean economic situation is still essentially as presented in the staff paper on the review under the extended arrangement (EBS/87/3, 1/7/87). Since the report was issued the staff has received the following supplementary information.
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> Data for end-December 1986 show that the net international reserves of the Central Bank were US$109 million higher than had been programmed and the net domestic assets of the Central Bank were below their limit by Ch$17 billion. In addition, the ceiling on the short-term external indebtedness of the nonfinancial public sector and the Banco del Estado was observed with a margin of US$90 million. Information for end-December is not yet available for the other quantitative performance criteria.
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> Provisional data show a trade surplus of US$1,080 million in 1986; this surplus is some US$105 million (or 0.6 percent of GDP) larger than the estimate contained in EBS/87/3. In 1985 the trade surplus had amounted to US$850 million. The improved trade performance reflects higher than projected noncopper exports by about US$155 million across a broad range of products. Imports were some US$50 million higher than projected.
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> Chile is currently engaged in negotiations with its commercial bank advisory committee for the restructuring of principal maturities falling due after 1987 and for medium- and long-term financing to meet its 1987-88 requirements. The latest discussions involve a package totaling US$650 million for the period 1987-88, which would include new money and the relief to be provided by a repricing of existing obligations.
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> In accordance with earlier understandings, effective January 12, 1987 the authorities reduced the interest rate subsidy on swap operations from the previous range of 0.6 to 1.3 percent, based on final maturity, to a range of 0.3 to 1.0 percent.
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> Consumer prices increased by 1.5 percent in December 1986, and the 12-month inflation rate was brought down from 26.4 percent in December 1985 to 17.4 percent in December 1986.

Extending his remarks, the staff representative noted that according to information received that morning, Chile had met all the debt contracting and rescheduling-related ceilings. No information was yet available on the ceiling for the nonfinancial public sector deficit, although that deficit had been within the ceiling through November 1986.

Mr. Donoso made the following statement:

> The Chilean authorities wish to express their deep appreciation for the support and excellent advice received from management and staff through recent years in relation to both the design of policies and the efforts to obtain the financing required by the economy.
>
> During 1986, economic activity in Chile strengthened, while the external accounts were adjusted in line with the program's objectives and available financing. Real GDP increased by 5 percent in real terms in 1986, the third consecutive year of positive growth after the 1982 crisis. This was accompanied by a significant reduction in the rate of unemployment to below 10 percent, while real wages experienced a moderate recovery.
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> The favorable developments in the areas of growth, employment, and real wages occurred in circumstances when the external current account deficit was reduced by the equivalent of 1 percent of GDP (to reach 7.2 percent of GDP) and the rate of inflation declined from 26 percent in 1985 to 17 percent in 1986.
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> The external current account deficit was similar to projections under the program and the accumulation of international reserves above the level established in the program occurred during the year.
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> In part because of the effect of external debt conversions, the increase in total external debt during the year reached only US$300 million, which implies a reduction in the ratio of debt to GDP between 1985 and 1986.
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> The Chilean authorities fully share the staff's view on the role played by monetary, fiscal, and exchange rate policies established in the context of the present program, and on the progress made by the economy both in terms of economic growth and in adjusting to financial constraints during 1986.
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> The staff report fully covers the relevant aspects of policies and developments in the past year. I shall add only some considerations relating to the context in which policies have operated or to the significance of last year's results.

The magnitude of the crisis of 1982 seriously damaged the financial system as numerous companies became unable to serve their debts. Different policies were enacted, starting in 1983, to re-establish a solvent private financial system.

-- To solve the problem of insolvency of the most adversely affected financial institutions, the Central Bank bought from the private banks nonperforming assets, which were paid with central bank notes. Profits generated by the operation of banks which sold nonperforming assets to the Central Bank have to be applied to buy back those assets from the Central Bank.

The next step required that undercapitalized banks enter into arrangements to increase their capital through the issue of additional shares. After being capitalized, banks could distribute a percentage of profits directly related to the percentage of total capital corresponding to the new shares. This made possible an assurance that the original losses would be paid out of the capital of the original owners of the banks and that capitalized banks would operate according to appropriate incentives and would be oriented to maximize their profits.

-- At the same time a preferential exchange rate was established, so that companies could service debts expressed in foreign currency, while reducing the impact of drastic devaluations of the domestic currency.

-- In addition, a subsidy in the form of interest paid on swap operations was established to reduce the cost of funds.

-- On several occasions the Central Bank set up special lines of credit to commercial banks, which they could use to refinance at lower costs the obligations of debtor companies unable to service their debts as originally contracted.

These policies and programs entailed significant costs for the public sector and seriously constrained the flexibility of monetary policy to pursue the Government's objectives. As reported by the staff, the efforts to strengthen the financial system have been highly successful and have made possible the almost complete phasing out of the policies mentioned above.

The enhanced flexibility of monetary policy facilitated a careful management of this area in 1986. As of December 31, there was full compliance with the limits established in the program for the net domestic assets of the Central Bank and the target for the net international reserves of the Central Bank.

The appropriate design of interest rate policies, the reduction in inflation, the growth of the economy and confidence in policies induced a recovery in the demand for currency and M1, which had experienced a pronounced decline in 1984. It was possible to satisfy that demand while fully complying with all targets in the program due to the positive effect of a generally stable environment and the adjustment effort on the availability of foreign financing of a more autonomous nature and on the current account.

The authorities are in the process of completing their program to strengthen the financial system. To avoid some of the elements that produced the financial crisis of 1982, the relevant legislation and regulations have already been revised.

Public finances also showed a notable improvement in 1986. Entirely in line with the program, the overall deficit of the nonfinancial public sector declined to 2.2 percent of GDP in 1986.

It is important to consider some elements behind this figure.

a. The deficit is being reduced at the same time that revenues from the General Goverment have declined (as a proportion of GDP) in part due to two factors: a reversal of previous increases in tariffs to imports, bringing them down to 20 percent and the implementation of a new income tax legislation.

The advantages of a reduction in import tariffs is clear in terms of its effects on consolidating a growth strategy based on exports. In turn, the new income tax legislation determines that companies do not pay a so called "additional tax" (at a rate of 40 percent) on undistributed profits. The purpose of this modification is to promote reinvestment of profits and reduce the relative attractiveness of using indebtedness to finance projects which was the effect of the tax legislation in its previous form. During 1986 the "additional tax" was still paid, but the rate was only 15 percent.

b. A second aspect worth considering is the major effort being made to increase the efficiency of current expenditures, and particularly of expenditures in social sectors, to be able to make additional progress in relation to social objectives, in circumstances when there is also the need to increase public sector capital formation.

After the crisis in 1975, when the terms of trade deteriorated dramatically, Chile started to implement a set of programs oriented to improve the living standards of the poorest segments of its population. The more traditional policies in areas like health, social security, and education were complemented with specific subsidies (monetary, or in kind) aiming at providing special protection to extremely poor sectors. These programs include, among others, the allocation of subsidies to families with children, even if no member of the family was in the formal labor market, the distribution of free food in schools to children belonging to extremely poor families, the establishment of unemployment allowances for workers, the establishment of subsidies for people unable to generate income when they are not beneficiaries of the social security system and the expansion of preschool education to provide a comprehensive set of services to children of poorer families. Through the National Program of Supplementary Nutrition, milk and enriched foods were distributed to children below six years of age in a program which linked the food distribution to regular health control of the children.

Also, during 1975, when unemployment rates reached very high levels, a Minimum Employment Program was established to offer a subsistence job to anyone requesting it. With the improvement of employment in the late 1970s the number of workers in this program decreased; but again in the 1982 crisis, the program helped to alleviate the situation of the unemployed.

This set of programs, systematically developed for several years, proved to be of help to protect the most vulnerable segments of the population in the years of crisis after 1982. Rates of malnutrition decreased dramatically from the levels they had reached in the early 1970s. Rates of infant mortality went down from 75 per 1,000 children born alive in the early 1970s to below 20 per 1,000 born alive in recent years.

In a recent publication, the World Bank 1/ has stated "The Chilean case is particularly interesting because it represents a successful attempt to focus government social spending on the poorest segments of the population. By slashing government spending on upper-income groups and targeting spending on the poorest, it has been possible to provide the most urgently needed social services in spite of the great economic crisis."

In my view the Chilean experience in social areas during this period is interesting as it indicates that specific social policies (the same as growth elements incorporated

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1/ See "Poverty in Latin America. The Impact of Depression." A World Bank Publication, September 1986.

in programs) can play an important role in reducing the adverse effects of adjustment for the most sensitive sectors of the population.

c. Another important transformation taking place in the Chilean public sector relates to the policy of privatization of public enterprises, as described in the following table.

The first column presents a list of public enterprises for which some degree of privatization is contemplated. In the second column, the percentage of total shares of each enterprise which is going to be sold is presented. In the third column, the percentage of shares of each enterprise already sold by October 1986 is shown.

Enterprises	Percentage of shares to be sold	Percentage of shares already sold
IANSA (sugar production)	49	14
CHILGENER (electricity production)	49	35
S.Q.M. (nitrate production)	65	48
CHILMETRO (electricity distribution)	65	55
CHILQUINTA (electricity distribution)	65	62
ENTEL (communications)	30	30
LAB. CHILE (pharmaceutical production)	49	19
C.T.C. (telephone)	51	11
C.A.P. (steel production)	80	49
TELEX (telex)	100	100
ENAEX (chemicals)	100	100
ECOM (computing)	100	100
EMEL (electricity)	100	100
EMEC (electricity)	100	100

This is a very ambitious program, important not only in terms of the amount of resources involved but especially because it opens the possibility for private sector participation in the development of key sectors of the economy (especially energy production and distribution and telecommunications).

d. A final consideration refers to the interpretation of an overall deficit of the nonfinancial public sector equivalent to 2.2 percent of GDP in Chile.

Until 1981, Chile had a publicly managed social security, which was financed with contributions from active workers. The system was perceived as discriminatory among different groups of workers and suffering from high rates of evasion in contributions.

In 1981 the system was replaced by one in which the retirement pension of each worker is determined by his own contributions plus the return of investments made with those funds provided by the individual contributor. The funds are administered by private institutions subject to special regulations.

A minimum pension is guaranteed by the State, which complements the resources in the individual account of workers who, because of low wages or because of a short active life, are unable to finance that minimum pension with their own accumulated resources.

Workers could choose between staying in the old system and moving to the new one, and they massively joined the new one. Since then, the public sector does not obtain contributions of active workers anymore (with the exception of the contributions of the few who stayed in the old system). On the other hand, the public sector keeps paying pensions to beneficiaries who had already retired when the new system started.

The new pension system has developed rapidly and it is showing efficiency in terms of avoiding evasion and in capitalizing contributions. Being a new system, it is generating important surpluses, which are being invested in a variety of assets.

It is important to keep in mind this "structural change" in the public sector to appropriately appreciate the meaning of the 2.2 percent of overall deficit in the nonfinancial public sector. As the surplus of the new pension system is higher than 2.2 percent of GDP, the present public finances position, once this situation is taken into account, would be comparable to a surplus in the nonfinancial public sector as defined before the changes in social security institutions. A more direct way to see the effect of the reform of the social security system is in terms of its effect on the internal capital market. Given the magnitude of its surplus, the new pension system has become the most important source of demand for financial assets, shares of public companies being privatized, and also of debt instruments issued by the public sector to finance its deficit.

The highest priority has been given to reducing the dependence of the economy on foreign borrowing. The emphasis put on strengthening the external competitiveness of the economy through exchange rate policy, complemented with restrained demand management is clear from the staff papers. The trade balance increased from US$293 million in 1984 to US$850 million in 1985 and to over US$1 billion in 1986. This tendency should continue in 1987. The current account deficit, which reached the equivalent of 10.7 percent of GDP in 1984, was reduced to 7.2 percent of GDP in 1986 and should further decrease to 5.6 percent of GDP in 1987.

In spite of the improvements, the situation remains vulnerable. However, on the basis of the maintenance of policies oriented to adjustment, Chile's external accounts should reach a more comfortable position in the next few years.

To complement the adjustment, the authorities are implementing mechanisms to facilitate the reduction of Chile's external debt.

One possibility is for residents or nonresidents to purchase external claims on Chile's private and public sectors and use it to cancel indebtedness to domestic banks or to buy assets without acquiring remittance rights. This option has facilitated repatriation of capital. Another possibility is for nonresidents to exchange external claims on Chile's private and public sectors for equity. In this case, the operation corresponds to a form of foreign direct investment and remittance rights are granted. This second possibility, as the first one, also alleviates the burden of the country's external obligations as foreign investors have to pay taxes on profits which brings the value of remittances below the value of the extinguished debt.

As noted by the staff, the amount of debt conversion was close to the current account deficit in 1986 so that the total external debt of the country increased only by 1 1/2 percent.

Terms of trade changes or higher interest rates could affect the outlook for the next years. The authorities, fully aware of the difficulties ahead, closely monitor developments and remain prepared to act as to assure their objectives.

Access to financing from the international banks appears to be increasingly difficult for debtor countries. In these circumstances, the authorities attach the greatest importance to the Fund's continuous support. They are thankful for the permanent cooperation received from this institution and, once again, expect that the Board's support to the Fund's arrangement with Chile will facilitate a successful completion of financing arrangements on which further progress depends.

Mr. Arias made the following statement:

At the outset, let me say that I strongly support the proposed decision. I am particularly happy to see that the staff has shown a great deal of understanding while considering "the continued constraints imposed by the limited availability of external financing," to use the authorities' precise language, and proposes to put off for one year the effectiveness of the performance criterion that called for the elimination of the required 120-day deferment for import payment.

The Chilean economy has done well in the last three years, and a significant increase in gross domestic investment has occurred. Real interest rates have been kept low through a cautious monetary policy and a pro-business attitude by the authorities that helped to improve the financial position of the enterprises.

An accumulated 37 percent real effective depreciation in the past three years was a key factor to higher profitability of business and a further inducement to investment.

In all areas, therefore, substantial progress was made. I believe this reflects the close monitoring that was exercised by the Chilean authorities during the year. The overall deficit might have been higher, but there had been an almost automatic reaction to compensate for the drop in revenues by adjusting total expenditures; in fact, the expenditure reduction was relatively higher than the drop in revenues. Also, it is evident that the policy pursued by the authorities to improve public sector efficiency has been relevant in achieving the major objectives of the program, as reflected in the gradual increase of public sector savings from the negative growth rates in 1983.

In his very descriptive statement, Mr. Donoso shows a list of public enterprises, a large number of which are intended to be privatized. I would like to know whether the proceeds from the portion to be sold have been taken into account in the financial program for 1987.

The staff has done a thorough job in producing the medium-term balance of payments scenarios, which are based on clear, more realistic, and differentiated assumptions that permit us to look carefully at the Chilean economy. The economy is subject to an unusual degree of uncertainty, in large part derived from unusually high interest payments--48 percent of exports and nonfactor services in 1986--that can be reduced only in the context of a medium-term program based on export diversification, export growth of nontraditional products, and careful external debt management.

On public sector policies, it is interesting to see how the administration of the social security system has been streamlined. The authorities have undoubtedly prevented the change from becoming a sensitive political issue. In addition, since the funds which are derived from the workers' contributions are being administered by private institutions, such as pension funds, the opportunity has been provided to develop a domestic capital market that, together with the process of privatization, would allow that market to be established on a solid basis. However, my impression from Mr. Donoso's statement is that the scheme of private management of the social security system will enlarge the scope of the private sector in overall economic activity and will somehow relieve the public sector from the burden of managing and financing over the long run the old system. Still, in the short and even in the medium term, the volume of transfers from the public sector to the old pension system will continue to represent a meaningful portion of total expenditures and, consequently, will make the achievement of a balanced fiscal position more difficult. Nonetheless, it is interesting to note from Mr. Donoso's statement that the overall public sector would be in surplus if the financial position of the pension funds were to be included as part of the public sector. I would appreciate Mr. Donoso's or the staff's comments in this respect.

In conclusion, the Chilean authorities have done their homework in admirable fashion. It is now up to the financial community to show its appreciation through the prompt finalization of the negotiations for $650 million of new money, which represents, as stated by the authorities, only a 4.5 percent increase in exposure over the two years from mid-1986. Finally, I am happy to see that the staff supports the authorities in their intention to limit new official guarantees on private sector debt. This is the logical consequence of the present successful drive of the authorities toward a system operated with the smallest degree of government interference as possible.

Mrs. Filardo made the following statement:

I would like to acknowledge the success of the adjustment and structural programs that have been implemented by the Chilean authorities. In the face of the most difficult economic crisis, the Government, in collaboration with multilateral institutions, embarked on designing and implementing a strong medium-term program, which has produced satisfactory results, as can be seen from the observance of quantitative economic criteria. The main positive features are an increase in real GDP, a reduction in unemployment, and the strengthening of the external sector, as well as a correction of the nonfinancial public sector deficit.

My main concern and comments are related to the public sector deficit, privatization, external debt policy, and consolidation of the economic package. In Mr. Donoso's very useful statement, he explains the rationale behind the overall deficit of the nonfinancial public sector that he attributes to the social security scheme that has been phased out. He also stresses the importance of increasing the efficiency of current expenditure, particularly expenditure in the social sector, versus the necessity of public sector capital formation. Nevertheless, Table 8 of the staff report on operations of the consolidated nonfinancial public sector shows that on the expenditure side, the fundamental problem, more than social security expenses, seems to be the transfers and subsidy payments to the private sector that are larger than capital formation, not to mention the huge losses of the Central Bank. While I agree that the public sector should be enhanced with the view to achieving a more efficient and productive allocation of resources, I wonder what the fiscal distribution will be like. Mr. Donoso or the staff may wish to comment on this and on what the losses of the Central Bank will amount to, what the proportion to GDP is, and whether capital formation will be at the expense of social security reduction, because the basic problem is one of allocating economic losses. Whose income should go down? The problem with zero sum "games" is that the essence of problem solving is loss allocation.

My second remark relates to the first point and to the matter of privatization. Mr. Donoso presents a list of public enterprises for which some degree of privatization is contemplated. The rationale of this principle is that the private sector is efficient and the public sector is inefficient. In my view, whether or not privatization is desirable depends, in the long run, on whether the return on private enterprises is higher than that on public enterprises. If the return is lower, there is a real loss of output for future generations, and a real burden is imposed on society through taxes to repay internal or external debt. In the case of Chile, the private sector would seem to have been poorly managed, as observed from the collapse experienced by the financial sector, which was absorbed by the Central Bank, imposing losses and rigidities on the management of monetary policy.

The plan now is to return the banks again to the private sector and to continue privatization in general. The question is whether this does not represent dead-weight losses, inasmuch as the public sector is incurring new debt that has to be repaid through new taxes to be levied on society. It would seem that this implies an increase in costs through misallocation and inefficiency. Perhaps the staff or Mr. Donoso could comment on the main features of the privatization plan in terms of economic objectives.

On external debt policy, the expectation is to reduce dependency of the economy on external borrowing. The staff and Mr. Donoso emphasize the success of the mechanism for debt reconversion, stating that total operations since the introduction of the scheme in June 1985 have amounted to $1,250 million, and a further $800 million is projected to be reconverted in 1987. I understood that the main objective of debt reconversion was to reduce the burden of debt, to stimulate the repatriation of capital and to attract domestic and foreign investment. The sources from which this reconversion have been financed are not very clear from the paper. It seems important to clarify who is financing the mechanism, because my impression is that multilateral institutions are bailing out the commercial banks. Furthermore, Table 8 shows that total debt has increased and is programmed to increase further.

On the consolidation of the economic package in the medium-term scenario, the staff points out that "if external developments are less favorable than presently assumed, the policy strategy may have to change. In particular, tighter financial policies and a further change in relative prices may be needed to strengthen domestic service." I wonder about the intention of this paragraph. Unfortunately, the correction of the nonfinancial public sector deficit came from lower investment expenditure, which has declined substantially, and we have seen the rigidity of the Chilean economy. What kind of economic measures is the staff envisaging? Finally, we can go along with the recommendations of the staff and the terms proposed to us in the report.

Mr. Sengupta made the following statement:

We commend the Chilean adjustment effort during 1986 and the authorities for meeting, by a considerable margin, the performance criteria through end-September and for achieving, in respect of almost all variables, better outcomes than targeted. We are pleased to note that the authorities intend to continue with the basic policies carried out since the unveiling of the extended arrangement.

The 1987 economic program is formulated with growth and price stability in mind, probably because of the many imponderables in the current situation: there are, for example, uncertainties regarding petroleum and copper prices. The need for extraordinary financing is also very large. As the staff notes on page 28, there are uncertainties in respect of the date of completion of the negotiations with commercial banks in regard to the restructuring of principal maturities falling due after 1987 and for medium- and long-term finance to meet Chile's 1987-88 financing requirements. The success of these negotiations will to a large extent depend not only on the country's track record in adjustment and its commitment to adjustment, but also on what Mr. Donoso calls the Fund's "continuous support."

I am deeply impressed by Mr. Donoso's description of Chilean efforts to increase the efficiency of current expenditures of the Government and particularly of expenditures in social sectors. I fully agree that for reducing the adverse effects of demand-management-oriented adjustment on the economically weaker sections of population, it is necessary to have specific social policies and programs. I hope nothing will be done to deflect the Chilean authorities from continuing with, indeed expanding, the programs for the poor.

The pace of privatization is rapid, but I wonder whether it will not create problems for entrepreneurial skills and manpower, particularly in skilled positions. It will be interesting to know how many of the shares of public enterprises already sold have been purchased by the markets and how many by the nonresidents. I also found Mrs. Filardo's points in regard to privatization very interesting, and I shall wait for the staff's comments on these.

I followed with interest the mechanisms for reducing the external debt and the success achieved so far in this regard. The one point on which I think some more effort has to be made is in regard to the strengthening of the financial system. We encourage the authorities to go ahead with the banking legislation and to increase the supervisory powers of the Superintendency of Banks so that the portfolio of loans will be sustainable. Finally, we support the proposed decisions.

Mr. Lim made the following statement:

Chile's economic performance in 1986 was impressive, and it is encouraging to see the program moving forward so well. It is estimated that the authorities met all the performance criteria for the end of 1986, some by a considerable margin. The authorities exceeded the program's targets for inflation, the current account deficit and the overall balance of payments surplus. Real GDP growth was stronger than expected, while unemployment continued to decline.

The authorities' efforts to reduce the public sector deficit from 2.6 percent to 2.2 percent of GDP, in spite of some unfavorable developments on the revenue side of the budget, are to be commended. I would echo the staff's comment that the improvement in the public finances has played a fundamental role in Chile's adjustment efforts.

Two developments in 1986 that may warrant closer monitoring were the increases in real wages and real private consumption and the somewhat weaker underlying improvement in inflation performance, after abstracting the one-time impact of lower oil prices. These developments are not a cause for immediate concern, although, if left unchecked, they have the potential to adversely affect Chile's external position. While it is desirable that the benefits of the recent output growth be distributed more broadly after a number of years of economic belt tightening, I welcome the restraint being sought in these areas.

Looking ahead to 1987, I find the proposed thrust of economic policies both appropriate and well directed. In particular, I welcome the authorities' continued commitment to reducing the public sector deficit and their willingness to implement expenditure restraint in the areas of public sector wages, transfers and subsidies, and social security payments, in order to meet program objectives.

Continuing reform of the public enterprise sector, a prudent approach to public sector investment, the maintenance of the real value of the exchange rate and the stengthening of the position of the Central Bank and the financial system are all important and welcome elements of the program. The willingness of the authorities systematically to undertake major economic reforms, with the assistance of the Fund and the Bank, has contributed significantly to Chile's improved economic performance. The medium-term focus of the three-year extended arrangement with the Fund has helped provide a framework in which the authorities can successfully plan and implement these reforms.

It is clear that the authorities still have some way to go in their adjustment efforts. The staff's medium-term scenarios estimate that the current account deficit will return to a sustainable level only by the early 1990s, and even then external debt will remain high. Until then, Chile's balance of payments will remain vulnerable to external shocks. I therefore urge the authorities to continue their impressive adjustment efforts, and I support the proposed decisions.

Mr. Al-Assaf made the following statement:

I am in broad agreement with the thrust and conclusions of the staff report. I am pleased to note that the Chilean economy continues to register excellent progress. I warmly commend the authorities on this progress, in particular, as they adapted their policies to changing economic circumstances without compromising growth. More important, by being persistent on adjustment, the authorities are restoring confidence and credibility in the economy, as evidenced by the fact that Chile has recently experienced short-term capital inflows and increasing private sector investment.

Furthermore, the required adjustment is being achieved, while at the same time, the welfare of the poorest segments of the population has been protected and enhanced. Chile is one of the pioneers in succeeding at targeting and limiting subsidies to the very poor. This can provide a good example for some countries which suffer from the budgetary burdens of subsidies and which worry, at the same time, about the political and social repercussions of reducing such subsidies. I would like the staff to form a clear view on this matter, so that it can help these countries in formulating their policies.

Another area where Chile is also considered a pioneeer is in converting debt into equity. Data in the staff paper indicate that the authorities have succeeded considerably in that direction by converting, for example, old debt to equity at a discount. At the same time, they are hoping to retain the capacity to secure some new financing. I would like Mr. Donoso or the staff to comment further on the functioning of this process. I would also like the staff to sharpen its views on this matter so it can be more helpful to other countries in similar circumstances.

As the authorities are aware, the economy faces a prolonged period of imbalance that needs continued adjustment without interruption. I am sure that they are also aware of the fragility of private sector expectations and their contribution to economic growth, which again shows the need to resist any temptation to relax the adjustment efforts. Finally, I commend the authorities and support the proposed decisions.

Mr. McCormack made the following statement:

Let me begin by congratulating the Chilean authorities on the substantial success that they have achieved in managing their economic affairs. Since I support the proposed decisions and agree in general with the staff's assessment, I will make only a few additional comments.

I would like to join other Directors in underlining the importance of the authorities following through on their policy intentions, in view of the vulnerability of the Chilean economy to external shocks, and given the large external debt burden.

As a central banker, I was particularly interested in the steps undertaken and proposed in the financial sector. Substantial progress has been made in improving the operating position of the Central Bank, and I welcome the establishment of schedules for the elimination of subsidies granted through preferential exchange and interest rates. I am also encouraged by the improvement in the financial position of the commercial banks, which has been facilitated by the innovative efforts of the Central Bank to effectively help the banks distribute their losses over several years. As I understand it, the authorities have exercised considerable skill in trying to avoid the potentially serious problems of moral hazard often associated with such rescue operations.

On monetary policy, however, I would encourage the authorities to leave the determination of interest rates fully to market forces as soon as possible. I am not entirely clear from reading the paper how powerful the moral suasion aspect of the indicative interest rate policy is; perhaps the staff could provide more information on that. Also, I wonder whether the authorities could not have set a somewhat more ambitious target for inflation than the one they have chosen. In making this point, I want to reiterate that I am impressed by the progress to date and I am not casting doubt on this aspect of the adjustment program.

I read again with interest of the debt conversion mechanism, which has made an important contribution to Chile's external debt management policy. My impression from earlier discussions on Chile is that several countries have expressed interest, on at least an informal basis, in the Chilean debt conversion mechanism. Perhaps the staff could comment on the prospects for other countries establishing a scheme as ingenious and systematic as the one established by the Chilean authorities and on whether it has wider applicability. I am aware that a number of other countries have also established some sort of debt conversion scheme, but it appears that these other approaches generally have not been as well designed as the Chilean scheme; nor have they taken advantage as systematically of the discount on external debt in secondary markets.

Finally, I wonder whether the staff or Mr. Donoso could provide a more detailed update on the status of rescheduling negotiations between the Chilean authorities and the commercial banks. I am particularly interested in the timetable for completion. I would also appreciate it if the staff could clarify what is involved in the reference to "repricing of existing obligations" in paragraph 3 of its opening statement.

Mrs. Ploix made the following statement:

At this stage of the discussion, I can be brief, since previous speakers have already expressed the few points I would have added to staff's comments. Let me only emphasize that the Fund's assistance to the Chilean adjustment effort has been particularly impressive: in the recent past, an extended arrangement following a stand-by arrangement and two drawings under the compensatory financing facility clearly demonstrated the support provided by this institution. Thanks to this assistance, the Chilean economic program appears to be well on track.

The performance criteria have been respected; important objectives have been reached, including the lowering of inflation and the reduction of the deficit in the public sector; and positive results have been achieved with respect to improvements in the external position, a reduction in unemployment, and, above all, a recovery in economic growth.

In light of all these elements, I support the proposed decision. I hope that the recent developments will be confirmed, and that the Chilean economy will soon be financed in a more conventional way. In this respect, any regression in the present relationship between Chile and its creditors would be highly unfortunate (particularly public rescheduling, since such a move could have direct counterproductive effects on the large export credit coverage of the country and thus on the balance of payments financing as presented in the paper).

In view of the Chilean economy's great sensitivity to external developments, it is important that the implemented policies provide more room for maneuver, so that Chile will be in a position to face minor adverse developments on its own (by tightening its policies slightly or by drawing on its reserves) and so that Chile may increasingly rely on traditional financing. Finally, I would like to know the staff's views on the criticism sometimes made that debt conversion is inflationary and will induce capital outflows.

Mr. Goos stated that he had little to add to the staff appraisal, which he fully endorsed. Like previous speakers, he was encouraged by the continued satisfactory performance under the program, which was reflected, inter alia, in the staff's indication that all performance criteria had been met by end-1986. Moreover, he shared the staff's assessment that the objectives and targets set for 1987 provided for further significant progress toward a viable overall economic position and that the program therefore deserved the Fund's support. In that regard, the declining trend in Chile's debt ratios was particularly welcome. However, even if the decline were to continue for 1987 as expected, the ratios would remain clearly excessive, which indicated the need for sustained efforts to reduce the deficit in the external current account. Given the substantial investment needs in the years ahead, such efforts must focus on the stimulation of domestic savings, which naturally entailed continued financial restraint, maintenance of realistic interest rate levels, and, more generally, the promotion of an overall environment that inspired confidence in the future course of economic policy. In conclusion, he could support the proposed decisions.

Mr. Sugita made the following statement:

Strict adherence to the adjustment program by the Chilean authorities has led not only to lower balance of payments deficits, but also to a higher rate of economic growth, a lower rate of inflation, and a better composition of domestic demand compared with the situation prevailing at the start of the program. All the performance criteria were observed through the end of September, and the available data indicate the likely observance of the end-year quantitative targets as well. Strong determination and skillful implementation by the authorities have heightened confidence in economic management, which, together with a favorable external environment, has contributed to produce a virtuous circle. Signs of the restored confidence are bountiful; private investment has shown recovery; and currency and M1 have returned to more normal levels after a decline in real terms in 1984-85. There have also been positive responses from external creditors to a debt-equity swap scheme, and some reflows of short-term capital in the form of a liquidation of private assets held abroad by residents have materialized.

The central element of the program has been fiscal adjustment, but this has appropriately been combined with, and supplemented by, cautious monetary management, an active exchange rate policy, and a prudent wage policy. The efforts to strengthen the financial system and improve supervision have also played a role in enhancing business confidence. The program for 1987 seeks to continue to consolidate these adjustment efforts and, accordingly, deserves our support.

For the future, despite the recent adjustment efforts and the adoption of an innovative debt-equity swap scheme, the balance of payments position is expected to remain vulnerable, even under the standard medium-term scenario.

Chile is likely to require exceptional financing arrangements for some time to come in order to maintain an adequate level of gross reserves. Moreover, growing use of optical fibers and microwave networks may point to a lack of buoyancy in copper prices over an extended period. Under the circumstances, the authorities need to redouble their efforts to diversify exports and to continue vigilance over the sound financial policy. With these remarks, I can support the proposed decisions.

Mr. Lankester commended the Chilean authorities for having met all the September performance criteria--some by a substantial margin--as well as the criteria for December, at least those for which information was thus far available. In general, economic performance in Chile suggested a successful example of growth-oriented adjustment over the past two years. The only disappointment was the fact that the current account deficit had not been further reduced. While the deficit for 1986 certainly was in line with the program, the slight improvement that had been achieved was no more than might have been expected from the combination of lower international interest rates and the 2 percent improvement in the terms of trade that Chile had experienced. In that respect, it appeared as if there had been no real external adjustment in 1986. Similarly, according to the projections for 1987, and taking into account the assumptions for international interest rates and the terms of trade, it did not seem as though the staff was assuming any further external adjustment. In his view, if "windfall" gains were experienced as a result of developments in the terms of trade and international interest rates, the authorities should at the least take full advantage of those improvements; unfortunately, it did not appear that they had done so thus far.

The medium-term balance of payments projections suggested that Chile would continue to need extraordinary financing of between $1.7 billion and $2.8 billion for each of the next five years, and that the external debt would remain at nearly 90 percent of GDP in 1991, Mr. Lankester continued. Such figures gave him cause for concern. He wondered in that regard whether the assumptions for noncopper exports might not be somewhat on the pessimistic side. For the short term, it was important that Chile should secure adequate external financing for 1987 so that it could continue with the adjustment program. The difficulties that the authorities were currently experiencing in obtaining that financing suggested that consideration should be given to picking up the pace of improvements in the current account deficit.

The fact that Chile had done so well in many respects over the past two years but was still experiencing difficulties with respect to the external accounts raised some interesting questions about the debt strategy, Mr. Lankester continued. In a recently issued World Bank paper entitled "The Debt Problem and Growth," it was suggested that countries should increase their net borrowing and even their debt/GDP ratios in the short term to enable them to grow out of their indebtedness problem. On the face of it, Chile would seem to be acting pretty much in line with that model; yet the authorities were having difficulty with external financing. He would be interested in hearing the staff comment on that matter. It was possible, of course, that the model in the World Bank paper would not work if one began from a very high level of external indebtedness.

Like others, he wished to commend the Chilean authorities for the success they had achieved in implementing the debt-equity scheme, Mr. Lankester remarked. However, he had noted that direct investment other than that under the debt-equity scheme had fallen significantly from an already low level in 1984, which seemed to suggest that some of the investment under the scheme might not, in fact, be additional to what would have taken place without it. He would welcome staff comment on the possible extent of such substitution and on what, if anything, might be done to avoid it in future.

The fiscal side of the economy looked healthy, Mr. Lankester said, although the improvement in 1986 had been more than fully accounted for by net sales of fixed and financial assets and repayments of government loans together with a nonrecurrent tax payment by the Banco del Estado. Expenditure reductions, while substantial, had fallen significantly short of the targeted figures, with overruns under every heading except "interest payments." On other areas of domestic policy, he would echo Mr. Sengupta's comments about social expenditures and the Chilean authorities' apparent success in targeting the most needy groups. He too hoped that such social welfare efforts would continue.

For 1987, the projected further reduction in the overall fiscal deficit was welcome, although he wondered whether further progress might not be possible, Mr. Lankester said. The figures currently assumed no projected reduction in interest payments, a rather odd assumption in view of the actual and projected net repayment of domestic debt, lower domestic inflation, lower real interest rates, and the assumed lower interest payments on external debt. Also, the figures assumed a substantial reduction in the operational surplus of CODELCO, despite a projected small recovery in copper prices. He would welcome staff comment on those projections.

For the longer term, Mr. Lankester remarked, the critical issue was whether the Chilean economy would be able to revitalize its national savings performance. The substantial progress that had been made in that area in 1986 was encouraging, although the ambitious targets set under the program had not been met. It was also worth noting that the private sector savings outturn in 1986 and the projections for 1987 both fell significantly short of the savings levels seen by the World Bank as necessary to sustain Chile's recovery program. He wondered whether the World Bank's target of 10.3 percent of GDP for private sector savings in 1990 still looked feasible. An important element in the renewed growth of private sector savings was the restoration of confidence in the domestic financial sector, and he took the return of M1 to a more normal level in relation to GDP in 1986 as an encouraging sign in that respect. Still, further growth in monetary aggregates needed to be contained if the reduction in inflation stemming from oil prices was not to be reversed as oil prices continued to recover. The central bank surplus achieved in 1986 and that projected for 1987 were also encouraging. Finally, he could support the proposed decisions. In doing so, he urged the authorities to eliminate the remaining exchange rate restrictions and the dual rate within the timetable established.

Mr. Dallara made the following statement:

Let me join other Directors in commending the Chilean authorities on their continued progress in 1986 on a broad range of economic fronts--progress reflected in stronger economic growth, a reduction in unemployment, and a strengthening in the external accounts. We are encouraged by several developments, including the recent expansion in noncopper exports, which appears to be related to the flexible exchange rate policy pursued by the authorities. Furthermore, domestic investment, both public and private, is recovering, which is critical to the maintenance of adequate levels of growth, and the public sector share of that investment apparently is being channeled into high-yield projects.

I would however note that while some progress has been made in reducing inflation, the underlying rate might still be considered bothersome to the authorities. The target for 1987 is for a reduction in the rate to 13 percent, which would be a welcome outcome in light of the need to sustain the confidence of domestic and foreign investors in the Chilean economy, thus further encouraging short- and long-term capital inflows as well as domestic investment. A cautious monetary policy will be required to support these efforts; and, now that velocity appears to be stabilizing, monetary management may be facilitated somewhat.

In this connection, we have noted that interest rates have remained high in real terms, encouraging repatriation of funds from abroad. We welcome this maintenance of confidence in Chilean financial assets and urge that interest rate policy remain flexible. With the programmed elimination of some particular incentives, such as interest rate premia on foreign currency deposits, particular care will be needed to continue to encourage capital inflows in the period ahead. In that regard, the ongoing rationalization of the exchange system should contribute to a further reduction in the spread between the official and parallel market exchange rates. In addition, we welcome the continued progress in restoring a sound domestic financial system, which will permit the implementation of monetary policy in an improved environment.

The consolidation of the nonfinancial public sector has further contributed to improved economic performance, with current expenditures declining as a percent of GDP in the past few years. Nonetheless, some categories of spending appear to remain high, such as spending on transfers and subsidies to the private sector, and we support the authorities' efforts to continue rationalizing spending in these categories in 1987 and beyond. The revenue to GDP ratio has been contained with some reduction planned for 1987. In that connection, we welcome the ongoing tax reform efforts, which we believe have contributed importantly to the strengthening of producer incentives in the Chilean economy.

Regarding the performance of the public enterprises, we welcome the privatization which is under way, and we are further encouraged by the indications in Mr. Donoso's statement.

The progress in these various areas is particularly relevant to the medium-term outlook, which remains precarious, in spite of the progress achieved. Even though current account deficits could decline significantly by the end of the decade, the outlook indicates the fragility and vulnerability of the Chilean economy, which results in part from the heavy debt buildup which occurred in earlier years. Thus, it is crucial to maintain the confidence of domestic and international investors. In that regard, the importance of a continued commitment to exchange rate flexibility is underscored, as is the importance of the authorities continuing to work flexibly and efficiently with the international financial community in managing the debt.

On current financial needs, we view with concern the apparent difficulties which have emerged in attaining needed external support from the private banking community. As other speakers have noted, the Chilean authorities have in some respects done their job, and they remain committed to the adjustment effort. Furthermore, the international financial institutions are supporting this effort, and we welcome in particular the constructive role played by the Fund, both in providing policy advice and assisting Chile in securing needed financing. Now it is time for the international banking community to play a constructive role, which we recognize may call for us to encourage the banking community, in whatever ways considered appropriate, to support the Chilean efforts. With regard to paragraph 3 of the staff statement, I would just add at this time that it is not clear that the needed financing will be provided in the form of new money. Nonetheless, we hope that that issue will be resolved promptly.

In concluding, let me add that we are encouraged by the fact that Chile helps teach us once again a lesson which is complex in many respects, but is also simple in a way--that adjustment and growth are by no means mutually inconsistent. Chile also demonstrated to us that reductions in import tariffs and fiscal consolidation are likewise not inconsistent. And we see that while many of us find it useful to comment positively and generally about the attractiveness and worthwhile nature of debt-equity swaps, and while many countries have striven to put into place workable arrangements in this connection, Chile has demonstrated that debt conversions can actually be implemented as a rather important part of an overall external debt management strategy. We would welcome some analysis of this, perhaps in connection with our next Board review of progress under the debt strategy. In the past, the analyses which the Exchange and Trade Relations Department has provided have tended, for understandable reasons, to be largely descriptive. Some comparative analysis of alternative approaches to debt conversions, and the pros and cons of various approaches and their applicability to individual country situations, might be useful to our understanding of this problem.

Finally, one can only express admiration for the effectiveness, the consistency, and the results which have characterized Chilean economic management in recent years. We hope that those characteristics are part of the future as well as the past.

The staff representative from the Western Hemisphere Department observed that the staff had not made detailed medium-term projections on the level of savings in the Chilean economy. However, it was his impression that in view of the recent strengthening of the private sector performance, a private sector savings rate of about 10 percent of GDP was feasible, depending of course on the terms of trade and the policies being pursued.

Responding to questions in the fiscal area, the staff representative remarked that the fiscal accounts and central bank performance were closely connected. As had been mentioned on page 23 of the staff report, the Central Bank had experienced no operational losses in 1986; indeed, there had been profits ranging from 0.3 percent of GDP to 1 percent of GDP, depending upon how one counted interest receipts from the commercial banks. The shift from loss to profit was certainly a positive sign, and the Central Bank was contributing significantly to the adjustment process.

On a question raised by Mr. Arias, the staff representative said, the sale of shares in the public sector had been taken into account in the financial program since the beginning of the extended arrangement. Specifically, the program made explicit mention of the maximum amount that the sale of shares could reach without affecting the public sector deficit. If the sale of shares by the public sector exceeded a certain level--which had been Ch$19 billion in 1986--there would be a corresponding reduction in the public sector deficit. Indications were that the amounts sold in 1985 had been below the triggering level, while the amounts sold in 1986 had been very close to the established target.

Remarking on the impact of privatization on the finances of the public sector and on the economy in general, the staff representative noted that the authorities had established a number of priority areas--particularly copper, petroleum, and electricity--in which they felt the Government should remain involved. However, most other areas currently under the control of the public sector were to be privatized. It was not so much that public sector enterprises were inefficient; indeed, quite the opposite was true in Chile. However, there was a limit to the amount of financing available to the public sector to run those enterprises. In the circumstances, it was expected that the public sector would sell some of the enterprises outright while maintaining an interest in others. As for the impact of such privatization on the public sector finances in the medium term, it was clear that an enterprise, when sold, would pay taxes, which would be the equivalent of an appropriation of profits from that enterprise. In general, the staff and the Chilean authorities felt that privatization would have no adverse impact on the public sector finances in the medium term. In passing, he noted that no information was available on the proportion of shares in the public sector that had been sold to foreigners versus domestic investors. It was clear that different arrangements had been effected to sell shares. Some sales were made through the stock exchange; others were in the form of packages sold to Chilean enterprises. At the same time, under the heading "popular capitalism" there had been a massive effort to sell shares to a variety of individual Chilean residents.

In response to those who had raised questions about the special impact on the public sector finances of the changes earlier implemented in the social security system, the staff representative observed that the public sector continued to have responsibility for paying the pensions of those individuals who had chosen to remain in the public sector social security system. There would be some cost to the Government in making such payments, since no new contributions would be accumulating while the payments were being made. In the longer run, however, the costs to the Government would be reduced and the pension system would be strengthened.

Remarking on the copper company, CODELCO, the staff representative noted that the price of copper was expected to increase somewhat in 1987, although the cost of mining it would also increase, with higher petroleum prices tending to reduce any operating surpluses. With respect to external debt, there had been a change in the distribution between the Central Government and the public enterprises such that the Central Government would continue to pay an amount in interest payments that would remain relatively stable as a percentage of GNP. The public sector enterprises had, however, transferred some of their external debt to the Central Government, and it appeared that the interest payments of the consolidated public sector, as shown on page 19 of the staff report, would decline by 0.5 percent of GDP, reflecting the decline in the ratio of debt to GNP.

In the monetary sector, the staff representative observed that the suggested interest rate was set at inflation plus a premium to provide a positive real rate. The indications from the discussions the staff had held with the authorities suggested that the rates were consistent with market developments. Indeed, real interest rates had moved very much in line with international rates plus an adjustment for the rate of depreciation. It was true that monetary aggregates had increased at a relatively rapid rate; however, the rate was not particularly high by comparison with real GDP when adjusted for the accumulation of the pension funds and for the fact that the debt conversion scheme had resulted in a substitution of domestic assets for foreign assets by some investors, which was reflected in a one-time increase in the liabilities to the private sector. On another matter, Mr. Lankester had mentioned that the current account deficit had not been cut significantly in the recent past. However, between 1984 and end-1987, it was expected that the current account deficit would experience an adjustment equivalent to 5 percent of GDP. Of course, the adjustment had started from a high base. Two elements should be taken into account in focusing on the adjustment in the current account deficit: both investment, particularly private sector investment, and savings had continued to increase, which might help to explain the fact that the current account deficit had been declining at a moderate rate; it was also important to note that noncopper exports in volume terms had increased at a significant rate, equivalent to 12 percent in 1986. Imports had also increased, although not at the same rate. Of course, the process of adjustment would take time. The level of the current account deficit at present was high, but it had moved from US$2 billion in 1984 to an estimated US$1.1 billion in 1986 and a projected US$1 billion in 1987.

In its report, the staff was anticipating a continued reduction over time to a level of US$500 million by 1991, which the staff felt was probably a sustainable level.

With regard to questions on the reliability of the medium-term scenarios, the staff representative remarked that if the situation with respect to copper and petroleum prices as well as interest rates turned out to be less favorable than assumed, further adjustment would be needed. As he had earlier indicated, the staff felt that the projected path for the current account was reasonable in terms of available financing; it was also true, however, that if copper prices were considerably lower than projected, adjustments might be required in the exchange rate, fiscal and monetary policies.

Chile's external debt and the debt conversion mechanisms that were being employed had sparked a number of questions, the staff representative recalled. In the Appendix to SM/86/165 (7/8/86) was a fairly detailed description of the debt conversion scheme and its functioning. The goal was to reduce the burden of debt, although the implementation of such a scheme would by no means cure the debt problem. Indeed, it could be viewed as a solution for only some of Chile's outstanding debt, and interest payments abroad would be reduced. However, if that debt were converted to domestic debt, domestic interest payments would have to be effected, and a calculation would have to be made comparing the domestic interest rate, adjusted for inflation, and the foreign rate, to see whether any benefits would be derived from the change. In addition, if the debt were converted into direct investment, questions arose about profit remittances. The scheme in Chile was such that foreign investors entering into the scheme signed contracts by which they limited the amount of remittances in the short run. The estimate was that such limitations plus the taxes paid on dividends would result in a net gain to the country.

In response to those who had questioned the sources of financing of investment under the debt conversion mechanism, the staff representative said that estimates indicated that some one fourth of total investment in 1986 had been in the form of direct investment with remittance rights, while the remainder had been in the form of investment by either Chilean nationals or foreigners, with no remittance rights. The latter must be viewed significantly as repatriation of capital, and indications were that some US$600 million in 1986 could be explained by repatriation of capital of Chileans abroad.

Another question concerned the effect of the debt conversion mechanism on overall investment, and whether the scheme had led to or represented any additional investment over what might have occurred in any event, the staff representative commented. The questions were not easy to answer. It was known that there had been certain agreements between the Chilean Government and foreign investors on packages combining debt conversion and direct investment. The impact of the scheme on capital outflows and inflation was also difficult to determine. Certainly the debt conversion mechanism, where central bank debt was converted to domestic currency, could be inflationary. However, while part of the debt that had been converted in Chile had been central bank debt, it had been exchanged for long-term bonds, which had tended to offset the inflationary impact of the scheme. The staff also felt that there was little net loss in terms of capital outflow based on the implementation of the scheme.

Finally, with regard to negotiations between Chile and the commercial banks, the staff representative noted that a clear understanding had been reached on the size of the financing required for 1987-88.

The Deputy Director of the Exchange and Trade Relations Department noted in response to a question from Mr. McCormack that other countries had certainly established debt-equity swap schemes, but not on the scale undertaken in Chile. The staff would attempt to take up Mr. Dallara's suggestion to look at such schemes in future from a more analytical perspective. It should be pointed out, however, that such schemes were greatly influenced by the particular environment in which they were set; and the effects of each scheme could vary accordingly.

Responding to Mr. Lankester's question on the World Bank paper entitled "The Debt Problem and Growth," the Deputy Director noted that the models referred to in the paper were useful to the extent that they provided some indications--in orders of magnitude--of how a situation might develop under certain assumptions. In the particular model referred to by Mr. Lankester, certain elements had been kept constant, such as the incremental capital ratios. Under the assumptions of the model, it was inevitable that a high level of debt would represent a large claim on resources in future. Inter alia, this claim could be met by continued high levels of foreign borrowing, which was one of the broad implications that could be drawn from the paper. The Fund staff's interpretation of the model was rather different from that adopted by Mr. Lankester, however, in that the staff had taken the model's results as indications of how urgent and important it would be for policies to be undertaken to change those parameters that would otherwise lead to a continued marked need for foreign savings.

Mr. Sengupta, reiterating a question raised earlier by Mrs. Filardo, asked whether there was any dead weight loss in the privatization process. The staff had indicated that the public enterprises in Chile were reasonably efficient and that stocks had been sold in part to the stock market but also through some other kinds of arrangements. In those cases, whether there was a loss or not would depend on the selling price of the stocks. If they were sold in the market, and if the market were relatively free of distortions, one could say that the prices of the stock reflected profitability at present and expectations of future returns; otherwise, the stock prices might represent a substantial transfer in the form of rent from the public sector to the private sector, in which case the public sector would experience a net loss.

The staff representative from the Western Hemisphere Department agreed that the privatization of public sector enterprises had led to some dead weight loss. However, that loss had been incorporated earlier into the financial situation of the enterprises; and, in an effort to maximize profits in running the public sector enterprises, the Government had maintained the principle of no cross subsidization between various enterprises. Hence, the transfer of shares to the private sector had not involved a significant transfer of resources by the public sector, except insofar as the public sector had already absorbed some losses earlier. The market price of the shares was the key element in most transfers. Financial arrangements with the private sector related mainly to private sector enterprises tied to commercial banks that had been intervened and where the Government had not taken the role of owner but only of the manager of those enterprises. Another scheme was related to those commercial banks that had been intervened by the Central Bank and the Superintendency of Banks. Those banks had had serious financial difficulties that had resulted in a major financial crisis in 1983. Certainly, there had been an absorption of losses by the Central Bank related to the deposit guarantee of the Central Bank, but that absorption had already taken place. The Central Bank and the Government had proceeded to sell shares at a price that could generate some positive returns.

Mr. Kyriazidis wondered whether the staff had made any estimate of inflows and outflows resulting from the debt conversion scheme. Also, was the debt converted at the face value of foreign liabilities purchased or at the actual discounted purchase price?

The staff representative from the Western Hemisphere Department replied that of the US$1.3 billion of debt conversion that had taken place between the initiation of the scheme and end-1986, some US$900 million-1 billion had been in the form of nonregistered foreign investment, which it could be assumed was to a significant extent repatriation of capital. As for short-term debt not related to the public sector, there had apparently been a net inflow of capital.

Two different elements--the external discount and the central bank premium--were involved in determining the value of the debt being converted, the staff representative continued. The debt conversion scheme under which no repatriation rights were granted involved a process whereby the Central Bank auctioned the rights to hold such operations, and the premium was currently at 14 percent while the discount was about 30 percent. Hence, the Government absorbed approximately half the discount. Domestic transactions were negotiated between debtors and creditors at the face value of the transaction, after which the profits were distributed among the various parties.

Mr. Lankester remarked that there were apparently two stages in the debt strategy model in the World Bank paper to which he had earlier referred. In the first stage, debt ratios had to increase because savings performance was not sufficient to bring them down. However, there was then a changeover point at which savings ratios were sufficient and the debt ratio began to fall. It appeared that Chile was already in the second stage. Debt ratios had peaked in 1985, and the trend was already downward. In the circumstances, his question was whether the fall in the debt ratios was sufficiently rapid toward a position at which savings would be able to finance both investment and interest payments. It appeared from the staff projections that Chile would not reach such a position until well into the 1990s, although the model in the World Bank paper would seem to suggest that the point at which national savings should finance both interest payments and investment should occur relatively quickly. As he saw it, the problem for Chile was that it began with a very high level of external indebtedness, which in turn led to very high interest payments by international standards. The implication was that national savings would have to be increased in large amounts and quite rapidly in order to meet those payments; and even if the World Bank's projections for national savings were achieved, those savings would still not fully cover the interest payments. In practical terms, the question was whether the international financial community was prepared to live with such an extended turnaround time. Presumably, matters would be clarified once the financial package for 1987 had been completed, but it was likely that the question he had raised would have to be reviewed in the context of the overall debt strategy.

Mr. Donoso, recalling a question from Mr. Lankester on whether the magnitude of the adjustment was sufficient and on what was being done to reduce the external imbalances, observed that, in general, an attempt to reduce the current account deficit in the context of, say, constant GDP must be done through a reduction of domestic expenditures. And if one viewed the problem in those terms, it could be seen that the adjustment in Chile had been impressive. For example, while GDP had fallen after 1981 when the crisis had begun, it had recovered more recently and was at present at about the same level that it had been in 1981 when the deficit in the trade account had been US$2.6 billion. For 1987, a surplus of some US$1 billion was expected, and the change represented approximately 20 percent of GDP, which was essentially the reduction in domestic expenditures, 5 percentage points of which could be attributed to investment, with the remainder to consumption. In his view, such figures were impressive. However, the adjustment was even more difficult than the figures would seem to suggest. The expectation was that with appropriate exchange rate policies, wage policies, and relative prices, adjustment aimed at containing domestic demand and opening space for resource transfers could occur with few negative effects on production and employment. In practice, however, such negative effects usually occurred; and in the case of Chile, the implication was the equivalent of five years of growth lost in the period 1981 to 1986.

For the medium term, there was a need to increase domestic savings to ensure that appropriate levels of investment and transfers of resources occurred, Mr. Donoso continued. According to estimates he had seen, in order to sustain growth at annual rates of 4-5 percent a year, domestic investment must increase from the current 15+ percent of GDP to 19 percent of GDP by 1990. If, at the same time, net transfers of resources to pay interest were to increase from the current 3.6 percent of GDP to 4.5-5 percent of GDP in 1990--which was consistent with the projected current account deficit of US$500 million--the implication was that domestic savings would have to rise from 18.5 percent of GDP to 24 percent of GDP by 1990. Moreover, consumption would have to fall from the current 81 percent of GDP to something like 75 percent of GDP in 1990. The numbers suggested that the effort required would be great but, given assumed rates of growth in GDP, by no means impossible. The most difficult stage, the initial one, had already been completed, and the authorities should be able to maintain the momentum in the second stage.

The matter of balance in timing and amounts of adjustment and financing was an issue raised in connection with all countries, and the case of Chile was no different, Mr. Donoso continued. While strong adjustment had been effected, the necessary financing had not been generated as speedily as one might like. He hoped the Board would address that matter at some point in a way that would encourage the banks to look beyond the current account projections to the goals and trend for the medium term. Some of his colleagues had made references to potential difficulties beyond those mentioned in the medium-term outlook. As he saw it, what would happen to the economy depended greatly on external factors, policies, and available financing. The authorities were prepared to make additional adjustments if those were required by negative changes in the external environment. In fact, they were already going beyond the conventional set of macroeconomic tools in looking for ways to adjust the economy, as was evidenced by the implementation of debt conversion schemes and so on. Under the assumptions in the basic scenario, it would seem possible for Chile to be able to move toward the necessary reduction in the external imbalances; the only problem at present was the financing from the banks.

Turning to specific questions, Mr. Donoso recalled that Mr. McCormack and Mr. Dallara had wondered whether the Chilean economy should not be doing rather better on the inflation front. The situation in Chile was a complicated one because the economy was open and internal rates of inflation were in large part determined by events affecting international prices. For example, when the U.S. dollar fell at a rapid rate, that affected the level of international prices and, given the exchange rate policy, the outcome for Chile was in the form of higher domestic prices; and that was a process that was very difficult to manage. Of course, one could say that the currency could be revalued in order to offset what was happening outside the country, but that was a dangerous approach. The authorities certainly took account of external events, but they would not want to take the risk involved in attempting to anticipate what would happen abroad and to make changes in the exchange rate in order to ensure a permanently lower rate of inflation domestically. That having been said, the authorities were attempting to bring inflation rates down as rapidly as possible.

In response to questions on the pension scheme, Mr. Donoso said that he understood how some might feel that the creation of a new pension fund system was somehow bad business for the public sector. The reason for introducing a new social security scheme was that in the old one the level of pensions had not been related to the level of contributions made by each worker; hence, a form of evasion had evolved as workers and employers had incentives to get together with a view to reducing contributions and pocketing the difference. Under the new scheme, the pension of each worker was directly related to the contributions of that worker placed in a private account, the resources of which were invested by a private firm. The State then guaranteed a minimum pension for all in case the return on investment should be insufficient. The changeover had had certain effects on the public sector, which had lost the "revenue" of contributions from workers. At the same time, however, the public sector was being relieved of its commitment to pay the pensions of those workers. As he saw it, on balance, the public sector had benefited from the change. For the short to medium term, there might be some outflow, as the public sector remained responsible for those workers who had decided to stay in the public sector system; but beyond that point, it appeared that a saving for the public sector would be achieved.

On the privatization of public sector enterprises, the focus should perhaps not be on the relative efficiency of the public and private sectors, Mr. Donoso commented. External events that affected the Chilean economy, perhaps with mismanagement of macroeconomic policies, had adversely affected the private sector in the early 1980s, but one should not define those adverse effects as private sector inefficiency. Nor was it fair to say that the public sector in Chile was inefficient; it had shown the ability to produce good results in administering enterprises. However, the authorities were interested in enhancing the contribution of the private sector in the development of certain sectors, although not necessarily passing control to the private sector entirely. For example, in the electricity sector, the Government had moved toward establishing a system of tariff determination based on the cost of producing electricity and had devised a system of transfer prices among different entities in the electricity sector. Having done that, the Government considered that the time was ripe for some enterprises in the electricity sector to become privatized and to connect themselves to the entire sector through the system of transfer prices. If the approach worked well and the system of transfer prices operated smoothly, additional private investment would occur. More generally, the notion was that the public sector should concentrate on where it was needed while releasing other enterprises for the private sector to manage. The list of enterprises being sold made it clear that it was not necessary for the public sector to be involved in all areas of the economy. Sugar production, pharmaceutical production, chemicals, and explosives for mining operations and so on were areas that in many countries were handled by the private sector entirely, and the authorities in Chile were moving toward a similar situation.

As the staff had noted, there were two schemes relating to debt conversion in Chile, Mr. Donoso said. Under one, residents or nonresidents could exchange claims on the Chilean private or public sector for resources in domestic currency to pay debts to domestic banks or to acquire assets without the remittance rights appearing from that type of operation. The other was a system which originated foreign direct investment and under which a nonresident took a claim and exchanged it for assets in the economy, retaining remittance rights. The figures for direct investment showed that in 1984, before the debt conversion mechanism had been put in place, some US$60-70 million in foreign direct investment had been registered. The figures for 1985 had been more or less the same, but in 1986, total direct foreign investment had risen to nearly US$300 million, with direct investment not specifically related to the debt conversion mechanism equivalent to something like US$50 million. It was of course possible that some of the remaining US$250 million was investment that would have occurred anyway, even without a debt conversion scheme, but there were reasons to believe the scheme had led to additional investment in a very important degree.

In response to a question from Mr. Sengupta, it should be made clear that shares in public enterprises had been sold at market prices, whatever the form of the sale, Mr. Donoso commented. But the amounts were not particularly significant in terms of the total capital stock being traded in the Chilean economy; indeed, what was being sold was not even equivalent to 1 percent of the total stock of capital in the economy. In any event, if properly announced to ensure that all interested parties participated in the sales, it was unlikely that the stock would be sold at too low a price.

The Executive Board then concluded its review under the extended arrangement for Chile and took the following decisions:

Review Under Extended Arrangement

1. Chile has consulted with the Fund in accordance with Section II. 3(g) of the July 1986 review decision (Decision No. 8342-(86/120)) adopted July 21, 1986 and paragraph 5 of the letter of June 18, 1986 from the Minister of Finance and the President of the Central Bank of Chile (EBS/86/137) in order to establish suitable performance clauses for the second half of the second year of the arrangement.

2. The letter dated December 15, 1986 from the President of the Central Bank and the Minister of Finance, together with the annexed Memorandum on the Economic Policies of Chile, shall be attached to the extended arrangement for Chile, and the letters dated July 9, 1985, January 20, 1986, and June 18, 1986, together with the respective annexed Memoranda on the Economic Policies of Chile, shall be read as supplemented and modified by the letter dated December 15, 1986, together with its annexed Memorandum on the Economic Policies of Chile.

3. Chile will not make purchases under the extended arrangement:

(a) until July 14, 1987, during any period in which he data at the end of the preceding calendar quarter indicate that:

(i) the cumulative limit on the overall deficit of the nonfinancial public sector, as specified in paragraph 15 and Table 1 of the memorandum annexed to the attached letter of December 15, 1986; or

(ii) the target on the net international reserves of the Central Bank, as specified in paragraph 16 and Table 3 of the memorandum annexed to the attached letter of December 15, 1986 has not been observed; or

(b) until July 14, 1987, during any period in which:

(i) the continuous ceiling on the net domestic assets of the Central Bank of Chile, as specified in paragraph 16 and Table 2 of the memorandum annexed to the attached letter of December 15, 1986; or

(ii) the continuous ceiling on the stock of short-term external debt owed by the nonfinancial public sector and the Banco del Estado, as specified in paragraph 24 and Table 4 of the memorandum annexed to the attached letter of December 15, 1986; or

(iii) the continuous ceilings or subceilings on the contracting, rescheduling, and guaranteeing of medium- and long-term external debt by the public sector, as specified in paragraph 24 and Table 5 of the memorandum annexed to the letter of December 15, 1986 are not observed; or

(c) during any period after May 14, 1987, until the Fund finds that satisfactory arrangements have been made for financing Chile's balance of payments in 1987; or

(d) during any period in which the understanding referred to in the third sentence of paragraph 25 of the memorandum annexed to the letter of December 15, 1986, are not being observed.

4. The Fund decides that no further understandings are necessary and that Chile may proceed to make purchases under the extended arrangement.

Decision No. 8512-(87/21), adopted
February 4, 1987

Exchange System

Chile maintains multiple currency practices and exchange restrictions as described in EBS/87/3. The Fund welcomes the progress being made in eliminating these practices and restrictions. In view of the intentions of the authorities in this regard, the Fund grants approval for the retention of the multiple currency practices and exchange restrictions until the earlier of August 31, 1987, or the conclusion of the 1987 Article IV consultation with Chile.

Decision No. 8511-(87/21), adopted
February 4, 1987

2. SUDAN - 1986 ARTICLE IV CONSULTATION; AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered the staff report for the 1986 Article IV consultation with Sudan (SM/87/12, 1/8/87) together with a paper on the second review of the matter of Sudan's overdue financial obligations to the Fund following the declaration of Sudan's ineligibility to use the general resources of the Fund with effect from February 3, 1986 (EBS/87/18, 2/2/87). They also had before them a background paper on recent economic developments in Sudan (SM/87/23, 1/22/87).

The staff representative from the Middle Eastern Department made the following statement:

Since the preparation of the staff report for the Article IV consultation (SM/87/12), a number of major economic developments have taken place in Sudan.

Partial and preliminary budgetary and monetary data for the first half of the fiscal year (July-December 1986) point to a continued deterioration in financial conditions. Budgetary revenues, both from tax and nontax sources, were substantially below the rate projected by the authorities. Recorded current expenditures were also somewhat lower than budgeted; however, this does not take into account any extrabudgetary outlays that may have taken place during the period. Development expenditures were, as expected by the staff, well below the level projected in the budget. External assistance was also substantially below the authorities' budget projections, with the result that borrowing from the banking system continued to rise and was accompanied by a further accumulation of external payments arrears.

Before January 5, 1987, all convertible currency export proceeds, except for those from cotton and gum arabic, were distributed between the official market and the commercial bank market in the proportions of 70 percent and 30 percent, respectively, and received an effective exchange rate of LSd 2.93 per U.S. dollar, being the weighted average of the export rates in the two markets. Export proceeds from cotton and gum arabic were surrendered entirely in the official market and converted at the official market export rate of LSd 2.45 per U.S. dollar. Effective January 5, 1987, the distribution of convertible currency export proceeds, except for cotton and gum arabic, has been changed to 50 percent in the official market and 50 percent in the commercial bank market. Accordingly, the effective exchange rate applicable to these proceeds has been depreciated to LSd 3.25 per U.S. dollar. While cotton and gum arabic export proceeds continue to be surrendered entirely in the official market, they will receive the same effective exchange rate as applicable to other commodities. Calculations made by the Fund and Bank staff, as well as those contained in the authorities' Economic Salvation Program, indicate that some of the export commodities remain uncompetitive even at the new exchange rate.

With no change in payments to be financed at the official rate, the changes in the distribution of export proceeds between the official and the commercial bank markets will result in a further imbalance between the supply and demand for foreign exchange in the official market. Specifically, resources available to the official market will decline, ceteris paribus, by an amount equivalent to 20 percent of the proceeds from convertible currency exports other than from cotton and gum arabic. As regards proceeds from cotton and gum arabic, the Bank of Sudan will incur a loss in acquiring the proceeds at an effective rate of LSd 3.25 per U.S. dollar and selling them at the official rate of LSd 2.53 per U.S. dollar, which will contribute to additional domestic liquidity growth.

Mr. El Kogali made the following statement:

At the outset, let me express my Sudanese authorities' gratitude to the Fund staff and management for the helpful and constructive discussions, and for the continuous dialogue on how to address the economic problems of Sudan.

Directors are familiar with the enormous difficulties facing the Sudanese economy as the Executive Board has been kept informed by the staff on economic developments in Sudan almost on a continuous basis. Therefore, it is not news to state that Sudan has been experiencing one of the most difficult economic and financial situations in recent years. GDP fell by 13 percent in real terms in the period 1982-85, the inflation rate reached more than 74 percent in 1984/85, and export receipts dropped by 34 percent in the last two years. At the same time, debt service obligations rose substantially. This extremely difficult situation inherited by the newly elected Government is a consequence of the combined impact of a number of exogenous and domestic factors. Three years of devastating drought and increasing desertification resulted in famine conditions, influx of refugees, and dislocation of population and production. Shrinking export markets and a sharp fall in prices, decline in capital inflows, and a huge external debt overhang, combined with lack of sustained appropriate domestic policies further weakened the economy and aggravated domestic and external imbalances.

The new democratically elected Government which came to power last May, in recognition of the gravity of the situation and the seriousness of the economic and financial problems facing the country, pledged to give priority to addressing the economic problems through implementing sound economic policies. In fact, the new Government--without wasting much time--while making honest and serious efforts to develop a consensus on economic policy, prepared a package of policies in a framework of an "Economic Salvation Program" and started implementing many of its elements in the context of the 1986/87 budget last September. In line with their commitment to remain in close consultation with the Fund in finding solutions to their economic problems, the Sudanese authorities submitted to the Fund last September a broad outline of the policy measures they intended to implement and requested the Article IV consultation mission which visited Khartoum last November to discuss in detail the Economic Salvation Program and evaluate the policy measures included.

My authorities would like to thank the staff for the frank and valuable exchange of views regarding the Government's economic program, which they found constructive and useful. In noting the staff's views on the policy package included in the Government's "Economic Salvation Program," they would like to underscore a number of fundamental points. First, there is no quarrel regarding the need for adjustment, and the fact that the country has the potential to achieve rapid economic growth within the framework of financial stability, the structural nature of the problems prevailing in the Sudanese economy and the depth and magnitude of the imbalances which accumulated over a long period of time are such that they cannot be resolved over a period of one year, and it will take time to achieve adjustment. Second, in emphasizing strong commitment to adjustment and a desire to achieve a clear progress in reversing the situation quickly, it is to be noted that the economy is in need of extensive rehabilitation and has limited financial resources, which imposes considerable constraints on the pace of adjustment. Third, efforts to push for an unrealistic pace of adjustment would only weaken the sustainability of such an effort. Fourth, when part of the population is facing famine conditions, saving human life becomes a priority as important as achieving quick adjustment and, therefore, should be given due attention. It is with these points in mind that the Sudanese authorities prepared their Economic Salvation Program, which is subject to continuous review with the aim of strengthening the policy package over time.

Turning to the overall performance of the economy in the last two years, my authorities believe that while the situation remains difficult, there are improvements which have been mentioned but not adequately underscored in the staff report. For example, in 1985/86, real GDP recorded a growth rate of about 3 percent following a sharp fall of 7 percent in 1984/85, reversing three consecutive years of negative growth. Although the inflation rate measured by the consumer price index remains very high, it dropped to 32 percent in 1985/86 from 46 percent in the preceding year. As a matter of fact, the end-of-period inflation rate in 1985/86 was only 16 percent, compared with 74 percent at the end of 1984/85. Government expenditure in real terms was substantially curtailed in 1985/86, and the budget deficit as a percentage of GDP was reduced by about 1.5 percentage points. However, these points are not intended to reflect disagreement between the staff and the authorities.

Last September, the Government instituted a one-year policy package, that was embodied in the 1986/87 budget. Preparations are under way for the formulation of a comprehensive medium-term (four-year) program to be made effective on July 1, 1987. The authorities' short-term policy package focuses mainly on production-related supply-side policies supported with demand management measures aiming at expanding production and exports, on the one hand, and containing consumption and inflationary pressures on the other. The supply-related measures emphasized the need for re-orientation of agricultural and industrial policies and a reformation of the parastatal sector. To stimulate agricultural production, a policy of remunerative producer prices was actively supported by policies aimed at securing the necessary inputs for production and encouraging farmers dislocated by drought and famine conditions to go back to production areas. Large increases in floor prices for oilseeds and dura, and substantially higher prices for gum arabic, were announced in October 1986. In the irrigated area, cotton procurement prices for medium- and long-staple cotton for 1986/87 were increased by 8 percent and 17 percent, respectively. The authorities believe that these policies will facilitate the achievement of a real GDP growth rate of 7.8 percent in 1986/87. They also consider the expansion of output in the irrigated sector an indication of a more balanced recovery in agriculture, which they hope will have a favorable impact on the agro-based manufacturing sector.

The second major element of the authorities' production-related policies concentrated on a reform of the parastatal sector. The authorities believe that (and in fact have decided that) as a general principle, public enterprises have to be operated on a strictly commercial basis, and those considered not viable will be liquidated. In this context, the authorities have embarked, with the assistance of the World Bank, on a program of basic structural reform of the public enterprises. A special unit has been set up within the Ministry of Finance to supervise implementation of the reform program. As a first step, all public enterprises operations have been put under strict monitoring and financial control. Technical teams are now undertaking studies with assistance from the World Bank to identify causes of low productivity of public enterprises. Major reform measures being formulated to effect the desired improvements in the operations of public enterprises include new market-oriented pricing guidelines, redeployment and retaining of surplus labor, improvement of managerial skills, and an extensive program of rehabilitation of capital equipment. The authorities expect to see positive results of their parastatal reform policies during the current fiscal year.

The authorities would like to emphasize that the private sector, despite its weaknesses, has a crucial role to play in the implementation of supply-oriented adjustment by supplementing and supporting the Government's effort to revive the economy. In an attempt to foster the development of the private sector to enable it to provide a dynamic lead in achieving sustained growth, a number of steps are being taken. These include steps to revise the 1980 Investment Encouragement Act with the aim of providing more incentives to investors, abolishment of bureaucratic obstacles which prolong investment-related procedures, and creation of a climate conducive to private sector participation. The authorities believe that the effects of price and profit controls and their impact on public enterprises and private investment have been exaggerated in the staff assessment. The staff did not conduct an in-depth study of the private sector in Sudan to conclude that the existence of such controls has been a major factor in discouraging private sector investment. Other factors such as recurrent shortages of critical imported inputs and capital goods and inadequate energy supply were more important. In fact, there was no widespread application of price and profit controls. In any case, the authorities are now considering a comprehensive review of the existing controls on a commodity-by-commodity basis with the purpose of limiting them to a short list of a few sensitive basic commodities.

The authorities are very concerned about the continued large fiscal imbalance and the weak financing position of the Government, despite efforts to contain expenditure growth and expand revenues. The 1986/87 budget incorporated a number of revenue-generating measures. These included increased profits from petroleum sales, collection of arrears and higher transfers from public enterprises, reinstitution of income tax laws, which were abolished in 1984, and introduction of a new wealth tax.

Efforts are also being made to improve tax administration and collection procedures. While some of these measures may be nonrecurrent, it is hoped that they will help in reducing government dependence on bank financing.

On the expenditure side, the authorities, though faced with huge amounts of unidentified operations due to the conflict in the southern part of the country, took a number of measures to enforce strict financial controls aiming at elimination of extrabudgetary expenditure and containment of current expenditures within the budgeted amounts in 1986/87. The increase in budgeted development expenditure is in line with the authorities' production-oriented policies. The Sudanese authorities do not agree with the staff that the budgeted amount for development expenditure is too large to be absorbed by the economy. In this regard, they would like to stress that most of these expenditures are related to externally financed projects and programs which were being delayed because of the nonavailability of the domestic part of the financing, while external finances have already been secured from the Arab Funds and other regional and multilateral institutions. Second, the enlarged public investment programs were mainly for rehabilitation of the existing capital stock for a number of projects and completion of ongoing projects that were affected by the severe cut in development expenditure in recent years. For these reasons, the authorities believe that the implementation rate of development expenditure will be high.

Based on these policies, the Government's fiscal objective for the current budget year 1986/87 is to limit the growth of nondevelopment expenditure to 24 percent in nominal terms and to keep domestic bank financing of the budget within 10 percent of total budgetary revenues. The authorities wish to explain that the apparent higher bank financing in the first quarter was due to two main factors: first, a mismatching problem as a result of the seasonality of revenue collection; and, second, the need to finance government operation of stockpiling of grains to achieve "food security" to prevent recurrence of the famine conditions which the country experienced recently. For the medium term, the authorities plan to raise the revenue/GDP ratio substantially through local and regional taxation of the agricultural sector, particularly the mechanized and irrigated farming. Besides broadening the tax base, the authorities also intend to introduce measures to improve revenue elasticity and reduce fiscal drag along the lines of the recommendations embodied in the report of the Fiscal Department's technical mission. In addition, the Government intends to introduce civil service reforms aimed at reducing overemployment in the public sector, curtail spending on wages and salaries, reduce the size of regional and local governments, and improve efficiency in government operations. Implementation of these reforms will not be easy because of their political and social implications.

The monetary and banking policies of the authorities for 1986/87 aim at achieving a number of objectives. These include limiting the growth in money supply to 20 percent, closely monitoring credit extended to public enterprises by gearing it to production needs, ensuring the retirement of seasonal credit to parastatals, and redirecting credit extended to the private sector to more productive uses and away from speculation purposes. The policies are also aimed at improving the banking sector performance and reducing excess liquidity. The relatively larger credit expansion in the first quarter is a reflection of the seasonal nature of credit to public entities and other producing units, and is expected to be retired within the fiscal year. Moreover, financing of dura operations to secure strategic grain stocks has also contributed to the higher credit expansion. Regarding credit to private sector, the authorities hope that the steps being taken to enhance the role of the private sector and promote investment will help both to revive demand for credit and improve its utilization. On reintroduction of interest-based banking and the use of interest rates as a policy tool, the authorities would like to stress that in an economy with an underdeveloped banking system, primitive money markets, a substantial nonmonetized sector and nonconducive beliefs, interest rate policy could not be expected to play a crucial role. However, the authorities fully understand the need for ensuring positive real rates of return for savers and charges on borrowers to increase resource mobilization and improve its allocation. This would require, first, reduction of inflationary pressure, which is one of the immediate objectives of the Government.

The authorities have noted the repeated emphasis by the staff on the issue of devaluation as an important measure in the adjustment process. They fully agree in principle on the importance of exchange rate adjustment as a policy tool. However, they would like to stress that Sudan's experience with repeated large devaluations in previous years has made it clear that for an exchange rate adjustment to achieve its desired objectives, there is need to ensure conducive conditions first. While they are not ready for a large across the board devaluation at this time, the authorities intend to continue pursuing the ultimate objective of exchange rate unification by gradually narrowing the gap within the existing dual system. Meanwhile, special arrangements are being made to provide incentives for exports on a selective basis.

Sudan's external payments position remains extremely difficult, dominated by huge external debt service obligations. The authorities are aware of the alarming situation, and every possible effort is being made to address the problem and bring the situation under control over the medium term. With the large surplus in dura production, the substantial increase expected in oilseeds, and recent improvements in cotton, oilseed, and gum arabic prices, export growth is expected to exceed 18 percent. The projected increase in imports reflects a partial recovery in developmental imports related to rehabilitation and capital stock maintenance programs under the projected increase in development expenditure. The authorities believe that the projected increase in imports is fully consistent with their policies aimed at emphasizing output growth and expansion of production capacity. In view of the existing substantial idle capacity resulting from shortages of basic imported inputs, the authorities do not anticipate many problems with the capacity of the economy in absorbing the projected increase in imports. On the other hand, every effort is being made to promote exports. Measures taken in this regard included substantial increases in procurement prices of all major export commodities, securing the availability of needed inputs on time, and preferential exchange rates to improve competitiveness of export commodities. While developments in oil producing countries have adversely affected remittances by Sudanese nationals working abroad, a number of measures are being taken to encourage their participation in financing investment and small-scale projects.

One of the most difficult issues facing the Sudanese economy is the huge external debt overhang. With a debt stock exceeding 140 percent of GDP in 1985/86 and debt service obligations approaching five times estimated export proceeds in 1986/87, there does not appear to be any practical way of achieving adjustment without addressing the debt problem first. The Sudanese authorities, while recognizing full responsibility for discharging these obligations, believe that it is not realistic to expect Sudan to do so through improvements in its balance of payments over the medium term. A concerted effort on the part of Sudan and its creditors to find a solution to the debt problem and to reduce debt service obligations to a manageable level appear to be a key step toward resolving Sudan's economic problems and a necessary condition for achieving adjustment. The authorities would like to assure the Executive Board and creditors that by including a debt service ratio of 36 percent in the 1986/87 external payments projection, it was not in any way intended to propose a unilateral limitation on debt repayments. This is an accounting presentation that reflects the practical realities of the extremely tight foreign exchange position and does not have any policy connotations. The authorities agree with the staff that in the absence of a significant increase in external assistance in the form of generous debt relief and substantial concessional flows, it will be difficult for Sudan to meet its obligations.

My final point is related to Sudan's arrears to the Fund. The authorities are concerned with the continued accumulation of arrears and Sudan's inability to meet its obligations. They are disturbed to note that arrears have reached a level that Sudan

> can hardly afford their prompt elimination in the absence of assistance from its friends. The authorities would like to re-emphasize their commitment to clear the arrears to the Fund as soon as possible and that they are willing but unable to do so at this point, basically because of the severe foreign exchange shortage. They hope that the expected recovery of exports will enable them to meet at least part of these obligations soon. They are at present committed to pursuing adjustment and cooperating fully with the Fund and Sudan's major creditors and donors in finding suitable measures for clearing the overdue obligations and remaining current with the Fund.

Extending his remarks, Mr. El Kogali said that his authorities wished to point out that the recent adjustment in the distribution of export proceeds between official and commercial banks' markets was being implemented on an experimental basis and in conjunction with other measures to stimulate exports. Although the authorities believed that with the recent signs of improvement in the prices of Sudan's export commodities, the 50-50 distribution would result in remunerative prices for exporters, they would nonetheless continue to monitor the situation and would be open to making further adjustments, as necessary, to get exports moving.

On Sudan's arrears to the Fund, Directors should note from the staff paper that Sudan had made a number of payments totaling SDR 18.7 million since the previous review in August 1986 and had remained in active consultation with the Fund since that time with a view to finding ways and means of settling the arrears, Mr. El Kogali continued. They regretted that progress toward that goal had not been sufficient. In the most recent communication he had received from his authorities, the Minister of Finance had stated that Sudan was considering allocating $50 million in fiscal year 1986/87 from the Government's own meager resources, which, in conjunction with the assistance the authorities hoped would be made available from Sudan's friends, could be used to reduce the arrears to the Fund. However, a more practical mechanism must be found to resolve the matter. On several occasions in the past, his chair and that of Mr. Kafka had called for consideration of a more pragmatic approach to dealing with the problems of overdue obligations, including the possibility of activating the relevant provisions in the Articles of Agreement, such as Article V, Section 7(g) and 8(e).

Mr. Nimatallah made the following statement:

> Sudan is a country that has been riddled with more than its share of problems for many years. From poor economic and political management, to civil war in the south, to the burden of refugees and the three-year drought. These adverse factors have resulted in a crippled economy with a relatively large external debt and arrears. For the past several years, all we have heard from the staff has been discouraging news about declining output,

shortages, increasing debt and arrears, rising rates of inflation, and a complex exchange rate system. Today, for a change, we have encouraging news, and I see a glimmer of hope.

According to Mr. El Kogali's very helpful statement, GDP grew in real terms at approximately 3 percent following a sharp fall of 7 percent the year before. The rate of inflation declined substantially with the end-of-period inflation rate in 1985/86 only 16 percent, compared to 74 percent at the end of the previous year. I think this is very encouraging. What is more encouraging is that the authorities are taking serious structural measures to improve the performance of the economy. They have adopted better and more realistic producer prices, and, with the help of the World Bank, they have embarked on a program of basic structural reform of the public enterprises. They are also taking steps to encourage the private sector to assume a larger role in the economy.

These are all steps in the right direction. While I can see the need for a more comprehensive adjustment approach to the serious economic problems facing the country, I wonder to what extent the authorities can be realistically expected to implement these measures.

Given the present circumstances and the deep-seated structural problems in the economy, it looks as though the authorities might need more time than normal to restore balance and sustained growth to the economy. However, I must impress upon the authorities the urgent need to accelerate their efforts, at least in the following areas. They should dismantle controls and red tape as much as possible, and that includes management of the exchange rate. I think it is very important for the authorities to accelerate their efforts in encouraging the private sector to play a larger role in the economy. Streamlining administrative procedures, improving the tax system, and moving closer to a unified exchange rate can help restore confidence in the economy and encourage domestic and foreign investors. Another area where the authorities could accelerate their efforts is in reforming the financial system: and the third area is in strengthening parastatals, particularly by strengthening management and by rehabilitating capital equipment.

The disagreement between Sudan and the Fund on whether or not to devalue the Sudanese pound must be addressed in a realistic way. If, for example, the Sudanese authorities are convinced that the several devaluations that have taken place during the past few years have caused more harm than good, and the present debate on devaluation is causing delay in remittances and other potential inflows; and, also, if they feel that devaluation of the Sudanese pound will not make very much difference in promoting their exports, I think the debate on this point should be closed in order to prevent further speculation on the pound. However, if the authorities are in great doubt about the points I have just mentioned, it might be useful to devalue once and for all and restore confidence in the pound. In other words, it is not helpful to prolong the discussion on devaluation. However, it is very important at least to simplify the exchange rate system, with a view to unifying the exchange rate.

I note that, although the staff is in agreement with the objectives announced in the short-term Economic Salvation Program, it is not convinced of the efficacy of the measures proposed to realize such objectives. This is the debate again on the gradual versus the rapid approach to adjustment. It seems to me that the case of Sudan can take an approach in between. That is, while I cannot endorse all the staff recommendations, I see room for the authorities to accelerate their adjustment efforts.

I look forward to the finalization of the authorities' medium-term program to be issued in late March. I urge the authorities to benefit from the views expressed in the Board today and accommodate these views as much as possible in the formulation of such programs.

I am sure the authorities will do their utmost to articulate credible and comprehensive measures to redress their problems. This will be an important way of showing their resolve to restore sustained growth and to clear arrears. It is clear that the Sudanese authorities have good intentions and have shown readiness to do something about their problems and about clearing their arrears. I am pleased to hear today from Mr. El Kogali that Sudan intends to pay $50 million from its own resources when feasible. It remains for Sudan's trading partners and friends to also do more to help Sudan by opening their markets for its exports, and, of course, by more aid.

I hope that the Sudanese authorities and the Fund can soon agree upon a course of action that is convincing enough to the international community to help Sudan clear its arrears and normalize its relations with the Fund.

I support the proposed decisions and wish the authorities well.

Mr. Finaish made the following statement:

We attach particular importance to this Article IV consultation for a number of reasons, including the fact that Sudan is the member with the largest overdue obligations to the Fund and the extreme nature of the economic and financial difficulties facing the Sudanese authorities. Indeed, one is hard pressed to think of any other case where so many factors, exogenous as well as domestic, have contributed simultaneously to the rapid deterioration of an economy of the sort that we have seen in the Sudanese economy in recent years. The famine caused by severe drought conditions, the persistent conflict in the south, the influx of about two million refugees from neighboring countries, and the inadequate policy response of the authorities have all been significant in precipitating the kind of situation in which Sudan finds itself today. But I think there is an even more important reason why our discussion today has a special significance, namely, that this is the first Article IV discussion since the new democratically elected Government has come to power. The fact that the Fund is now dealing with a government which has a clear mandate from the Sudanese public, and which has expressed keen interest in cooperating with the Fund to find solutions to the country's difficult problems, provides some hope that a reversal of the downward trend of recent years is now more likely to be achieved.

Clearly, to achieve such a reversal is an enormous task, one which will require great efforts by the Sudanese authorities as well as the international community. But the stakes, in my view, are just as great. For a solution to Sudan's problem, while obviously beneficial to Sudan, will also demonstrate that even the most difficult case of overdue obligations to the Fund can be dealt with and eventually resolved. It will also strengthen the conviction, in Sudan and elsewhere, that the democratic process is better able to deal with a country's economic difficulties.

As I stated earlier, a solution to Sudan's enormous problems will require enormous efforts. For these efforts to succeed, they should in my view, include the following broad elements.

First, there has to be a clear direction of policy on the part of the authorities. This implies the formulation of a consistent and mutually reinforcing set of corrective measures covering the whole range of economic policy and aiming toward financial viability both external and domestic.

Second, at the same time, there has to be a clear and realistic plan to rehabilitate the productive sectors which have experienced serious deterioration in recent years. It is clear that the Sudanese economy is currently operating at much below its potential, something which the country cannot afford.

Third, it is crucial that the adjustment and rehabilitation effort be accepted and endorsed by the Sudanese public and be seen by Sudan's creditors and donors as credible and commensurate with the desired objectives.

Fourth, however strong and comprehensive the policy plan may be, it will have little chance of reaching those objectives without adequate external financial support. Even a casual look at the medium-term balance of payments projections makes this abundantly clear.

Fifth, the international community also has an important role to play in helping Sudan deal with two problems that have contributed in a significant way to the economic difficulties in recent years. Here, I am speaking of the security situation in the southern region and the refugee problem. I realize of course that these problems are of a different nature, and that the Fund is not the proper forum for addressing them. But one cannot ignore their economic impact. The conflict in the south, for example, has not only disrupted two important projects, such as the oil field development and the Jonglei Canal; it has also accounted for a large part of the extrabudgetary outlays. This, of course, is in addition to the movement of refugees from the south to the north, which is, according to the press, between 1,500 and 2,000 weekly from the south to Khartoum. Sudan can ill afford such a drain on its economy in the period ahead when efforts should be concentrated on adjustment and reconstruction.

On the question of the refugees, we know that Sudan is the largest country in Africa and has common borders with eight other African countries: Ethiopia, the largest, on the east; Kenya; Uganda; Zaïre; Central African Republic; Chad; Egypt; and Libya. The movement of refugees now is related to two things: the famine in certain countries; and political conflicts and other problems inside other countries, particularly Ethiopia and, more recently, Uganda. So, this refugee problem is not a creation of Sudan, but it has to be addressed. In the south, of course, is another political problem, and I am sure the major shareholders are very familiar with its origins and its nature. It, too, has to be understood and addressed. And this is important, not so much because of its political implications as its serious economic implications: the impact on the budget, the disruption of production in the south, and the movement of refugees. Of course, we can debate exchange rate and the interest rate questions and send missions--this is our function--but the other problems are very serious, and one cannot ignore them if one wants to deal with the problems of Sudan in a realistic way. When one reads the staff report, it becomes obvious that much more needs to be done in order to put together these basic elements of a viable package that can successfully deal with Sudan's problem.

On the policy front, a more rigorous and comprehensive medium-term adjustment program has yet to be formulated. Nevertheless, the policy statements made by the authorities, and which are reflected in Mr. El Kogali's very helpful remarks, provide a welcome indication that such a medium-term plan will be formulated soon. Indeed, the agreement between the staff and the authorities on the general principles to guide policy formulation in the period ahead, and the priority given by the authorities to economic reform and adjustment are reasons for optimism that more decisive movement can be achieved soon. Moreover, some of the measures implemented recently, particularly in the pricing area, also provide an indication that the authorities are willing to take difficult decisions, something which is inevitable given the magnitude and depth of Sudan's problems.

The staff report has covered the various aspects of present policies, and the staff has made recommendations regarding specific policy measures. I will not go over these specific issues here. Instead, I will briefly outline the major policy areas which, in my view, any medium-term policy plan should emphasize.

First, the revenue performance needs to be substantially improved. The low ratio of fiscal revenue to GDP and the inelasticity of taxes with respect to income have to be dealt with through a comprehensive tax reform. Without such reform, any effort to reduce the budget deficit through expenditure restraint will continue to be frustrated.

Second, monetary and credit policies have to be consistent with the objective of lowering the inflation rate. The burden of credit restraint, however, should not fall unduly on the private sector, particularly if private investment and productive activity are to be revived.

Third, the banking system and financial intermediation have to be strengthened, and their institutional framework has to be made more transparent. This should help the authorities' efforts to mobilize domestic resources and improve the efficiency of credit utilization.

Fourth, pricing policies should aim at encouraging investment and production in the tradables sector and also at improving the competitiveness of Sudan's exports. It is obvious that Sudan's export performance has been well below its potential in recent years.

Fifth, the remittances and investment flows from expatriate workers need to be encouraged. This is a source of foreign exchange that should be relatively easy to tap if proper incentives are present. Also, one would expect the remittances to respond more quickly to policy measures than commodity exports.

Sixth, in order for any medium-term policy program to succeed in dealing with the financial imbalances and at the same time stimulate investment and productive activity, it has to provide for an adequate level of imports. As we have seen in the recent period, input shortages associated with import compression have been quite disruptive and have contributed to the very low level of capacity utilization in many sectors.

As I stated earlier, these are areas which in my view require particular emphasis, although clearly there are other areas of importance that also need to be dealt with effectively. Of course, the implementation of these broad policies would require the adoption of specific measures, and--as is clear from the staff report and Mr. El Kogali's statement--that on certain issues the staff and the authorities may have different judgments. What is crucial, however, is for the adjustment program to be commensurate with the objectives which are shared by the staff and the authorities.

As the staff paper shows, the medium-term outlook for the balance of payments points to the need for substantial external assistance over the next few years, even under optimistic assumptions. The magnitude of Sudan's debt burden is enormous any way one looks at it. This situation is also compounded by an overhang of external arrears, which is clearly a complicating factor in any effort to normalize Sudan's relations with its creditors. The special difficulty of this case will require, in our view, a special effort on the part of creditors and donors. As the staff paper mentions, the Arab Funds have managed to find innovative ways of circumventing the institutional obstacles to further assistance associated with the arrears situation. At the same time, bilateral Arab aid continues to be provided. Other creditors and donors will, I hope, also do their part in helping Sudan deal with its debt problem. This will also be crucial for the eventual settlement of the arrears vis-à-vis the Fund. In this connection, we welcome the partial payment made recently by Sudan and the statement by Mr. El Kogali this morning regarding future payments. Although small, given Sudan's present foreign exchange situation, the payments recently made are a further indication of the importance attached by the authorities to normalizing Sudan's relations with the Fund.

In conclusion, it is obviously an understatement to say that Sudan's case is a difficult one. But in our view it represents, more than anything else, a challenge--to the Fund; to Sudan's friends; and most of all to the Sudanese authorities. Although a viable solution is not yet at hand, we are still hopeful that all parties concerned will eventually be able to meet this challenge, preferably sooner rather than later.

Mr. Salehkhou made the following statement:

Under persistent adverse exogenous factors and deep-rooted domestic problems, the Sudanese economy has been facing substantial difficulties. Accordingly, given the gravity of the situation, the prospects remain uncertain. One cannot but agree with Mr. El Kogali's candid remark in his very interesting statement that "...the structural nature of the problems prevailing in the Sudanese economy and the depth and magnitude of the imbalances which accumulated over a long period of time are such that they cannot be resolved over a period of one year...."

Moreover, three consecutive years of severe drought and devastating famine between 1982 and 1985, the entry into Sudan of more than one million refugees from neighboring countries, population movement to urban areas, increasing desertification of agricultural land and, finally, the civil conflict in the southern part of the country have all overburdened an economy which, has long been mismanaged.

The economic and financial situation in Sudan has continued to face serious internal and external imbalances. In 1985/86, the return of favorable weather conditions led to an impressive 25 percent increase in overall agricultural output, which helped alleviate the severe famine conditions that had prevailed in the three preceding years. However, this favorable development did not bring about a uniform recovery as, in the rain-fed sector, the yield of cotton was reduced to its lowest level in five years. This was aggravated by a substantial fall in the prices of cotton in international markets. Furthermore, the manufacturing sector, despite improvements in more regular supplies of petroleum and electricity, remained sluggish. Likewise, major agro-based industries of sugar and edible oils suffered from low production levels of sugarcane and oilseeds.

Irrespective of the circumstances, the transitional government did not, understandably, wish to make long-term decisions on a major economic program that might constrain the efforts of the government that was to be elected within a year. The present Government, therefore, faces some very formidable and challenging problems.

On the more positive side, I am happy to note a reversal of negative growth, a fall in the inflation rate, curtailment of government expenditures and a reduction of the budgetary deficit in terms of GDP. I am especially heartened by the authorities' efforts to achieve "food security" through the stockpiling of grains by taking advantage of an expected bumper crop in 1986-87. This reaffirms the Government's top priority for saving human lives, given the recent famine conditions in the country.

In virtually every other area of the economy, deteriorating trends project further uncertainties. With respect to export earnings, for example, there was a reduction in receipts of almost all export items in 1985/86. The most significant was a 50 percent reduction in earnings from cotton, which is considered a principal export item. As for imports, annual reductions have consistently been registered since 1981/82. A further reduction of 5 percent in total imports during 1985/86 has left imports at their lowest level in a decade, and 40 percent below the peak of 1981/82. The staff has observed on page 31 of the paper that "prices have increased at a very high rate" in the last two years. Yet Appendix IV of SM/87/12 and Mr. El Kogali's statement appear to contradict the staff's assertion, showing there has been a substantial reduction in consumer prices from 74.1 percent in 1984/85 to 16 percent in 1985/86. Of course, continuation of a weak budgetary position and excessive borrowing by public enterprises have contributed to a significant growth in domestic liquidity and high inflationary pressures. While the budget deficit in 1985/86 shows improvements compared with the deficit in the previous fiscal year, the projected deficit for 1986/87 is substantially increased. Nonetheless, according to Table 2 of SM/87/12, about one third of the total amount of 1985/86 expenditure is for foreign interest payments.

While significant reductions in the flow of remittances have aggravated the foreign exchange situation, external arrears have rapidly accumulated as debt service obligations have not been met, resulting in a further deterioration in the balance of payments position. Compounding external debt is the most pressing factor in Sudan's economy at present.

I am happy to note that the staff fully endorses the objectives of the "Economic Salvation Program" recently launched by the authorities. The authorities appear to be fully cognizant of the need for increased production and demand management. They also appear to be sincerely and fully committed to achieving the program's objectives. At the same time, they seem to be more concerned about the sustainability of their structural adjustment efforts than about the search for quick fixes. Such a desire, in my view, is quite legitimate in light of past experience of Sudan as well as of other members under Fund-supported adjustment programs. Moreover, it goes without saying that no adjustment effort will bear fruit without sufficient external financing. In the case of Sudan, debt relief as well as concessional financing is absolutely necessary and should be considered an integral part of the adjustment program.

On monetary policy, I note the staff's brief reference to the Islamic banking system, on page 22 of SM/87/12 and page 29 of SM/87/23. While I generally agree with the staff that clear policy directions are required to remove the existing uncertainties, I wonder why, despite the importance some Board members, including myself, have consistently attached to Islamic banking and to the wish to see extensive analyses by the staff of the outcome in those countries which have adopted and implemented this system in their banking operations, such analyses are obviously missing in the papers before us with the exception of only passing and unsubstantiated negative remarks. In particular, I would like to hear from the staff whether, explicitly or implicitly, it is recommending to the authorities a return to interest-based banking in Sudan. If so, I would be anxious to hear the basis upon which such a recommendation is being made. If, as it appears, the staff is primarily concerned with a positive rate of return in the financial sector, then the recent seminar paper on Islamic banking, which ironically was prepared jointly by the Middle Eastern and Research Departments and discussed by the Board, made a strong theoretical case for the fact that, because Islamic banking permits the real sector to freely determine the rate of return to financial assets, it can more efficiently allocate resources and promote higher rates of return.

If the staff is implying that a positive real rate of return is possible only with interest-based banking, then I am afraid that such a position indicates an appalling ignorance of the theoretical issues of Islamic banking. And this would be tragic indeed, since it implies that either the staff was unaware of the paper on Islamic banking--which was prepared by its own department--or was not convinced by its arguments. Either case is extremely disturbing because, in the first instance, it is a sign of a lack of communication on Board papers prepared in that department; in the second, it implies a callous attitude if a department can prepare papers for the Board in which the members of the department, including the senior staff, have no confidence.

I do not mean to overreact to this issue. It may well be that the staff does not question the theoretical viability of Islamic banking but only the process of its administration and implementation in Sudan, and that perhaps if Islamic banking in the true sense were to be fully implemented, then the present uncertainties in the financial sector would have been alleviated, to say the least. If this is the case, then a clear statement from the staff would be helpful. At any rate, this section of the staff report in my view needs clarification, revision, and possible expansion.

Finally, before presenting my views on the review of Sudan's overdue financial obligations to the Fund, I would like to make a brief comment concerning the authorities' relations with Sudan's external creditors. This chair has consistently maintained that countries with overdue obligations should do their utmost to discharge such obligations and to clear any arrears vis-à-vis all creditors in a nondiscriminatory manner. I am happy to note that such is indeed the intention of the elected Government as communicated to some of my authorities who are creditors to Sudan.

Regarding Sudan's overdue financial obligations to the Fund and the review following the declaration of ineligibility, I do indeed welcome the authorities' successful efforts to become, and remain, current in the SDR Department through a number of past and prospective payments since the last review. This could perhaps be partly attributed to the maintenance of an active policy dialogue between the authorities and the Fund.

As far as the proposed decision is concerned, I believe the Fund should not appear rigid or mechanical in its relations with members with overdue obligations by insisting on a "full and prompt settlement of those obligations," in the absence of any realistic prospect to that end. Instead, the Fund could appropriately urge the donors and the international financial community to help the country achieve the stated objectives in its Economic Salvation Program. The Fund should also recognize the significance of the payments already made by the authorities, reflecting that recognition in the text of the decision. This would go a long way to encourage the authorities to redouble their efforts and would send the right signal to the international financial community regarding the seriousness of the authorities' effort to normalize their relations with creditors. The payments already made to the Fund, however small they may appear by prevailing standards, are indicative of tremendous sacrifice by Sudan, given its meager financial resources.

Mr. Lim made the following statement:

The staff report presents a bleak outlook for Sudan. In the past several years, Sudan experienced a convergence of unfortunate events: a severe drought for three years; civil unrest and instability in the political field; and a weakening market for its major exports.

As a result, while favorable weather conditions in 1986 enabled agricultural production to rebound substantially and to reverse three consecutive years of economic decline, real GDP in 1985/86 was still 8 percent lower than what it had been four years earlier, inflation has remained over 30 percent, and Sudan's external position was characterized by continuous deterioration, with about US$2.6 billion in external arrears having accumulated as of June 1986, including overdue obligations to the Fund.

The staff notes that the developments were aggravated by the lack of sustained and sound economic policies that could insulate the economy from these unfortunate shocks.

We welcome the new Sudanese Government's recognition of the need for a more comprehensive package of financial and economic reforms. We note, however, that the authorities have maintained a number of policy measures that have not provided the needed flexibility in their economic management in the past, and that their economic program for the coming fiscal year appears to be premised on very optimistic assumptions. For example, in the area of fiscal policy, while the program calls for a substantial increase in development expenditures, this is not matched by a corresponding improvement in tax effort through new tax measures. The optimistic assumption is that government revenues will increase mainly through improvement in tax administration.

In the area of monetary policy, the retention of selective credit controls does not appear to be consistent with improving financial intermediation and encouraging private sector domestic savings. The optimistic assumption is that efficient use of financial resources can contain monetary expansion to noninflationary levels, notwithstanding that the annualized rate of monetary expansion for the first quarter has exceeded substantially the 20 percent target set for the year as a whole.

The other optimistic assumption is that external assistance in the form of foreign aid will continue to finance the widening current account imbalance resulting from higher imports and that it is not yet necessary to adjust the exchange rate to generate higher export revenues. We note that, in the past, Executive Directors and the staff have called attention to the unsustainability of these policy measures.

We would advise the Sudanese authorities to take advantage of the vast experience of the staff in dealing with countries that have faced external debt problems similar to Sudan's and to be more responsive to the staff's assessment of external developments. We would also note that a comprehensive and credible economic adjustment program formulated in consultation with the Fund could help mobilize international assistance for the elimination of the country's arrears.

With regard to Sudan's overdue obligations to the Fund, we are aware of the extremely difficult position that Sudan is in at present and we appreciate Sudan's effort to keep current in the SDR Department and to maintain an active policy dialogue with the Fund. We are confident that Sudan is aware of the adverse impact of its overdue obligations on Fund members and would urge Sudan to settle its overdue obligations with the Fund promptly. We therefore support the proposed adoption by the Executive Board of the draft decision on Sudan's overdue obligations.

Mr. Grosche made the following statement:

By now we have, unfortunately, become all too familiar with the tremendous problems Sudan is facing. The staff and previous speakers have made it clear that years of drought, civil unrest, a large number of refugees, and inappropriate policies have had devastating effects on the country. Recent developments have brought some relief to the most immediate problem of feeding the people. However, we cannot draw too much comfort from this welcome improvement, since it can be attributed largely to the recent improvement in weather conditions (which we hope will last) and to the generous external assistance that became available in spite of the deterioration in Sudan's financial relations with the outside world.

The legacy of previous governments' inability to tackle the structural and financial imbalances has left the Sudanese economy in a state of disarray that can be overcome only through a protracted, determined, and comprehensive adjustment effort. Against this background, the Economic Salvation Program launched by the new Government is a most welcome indication of a change in the economic policy approach. Nevertheless, the staff paper leaves no doubt, that the policies announced for FY 1987 fall substantially short of what is required to put the economy back on a sustainable path of recovery.

The staff's estimates for the first half of the fiscal year point to a continued deterioration. Those estimates confirm our assessment that the authorities' targets are not likely to be met. It appears from the Article IV discussions that, despite their good intentions, the authorities may not have been fully aware of the dimensions of Sudan's economic problems and of the strength of policies required to effectively tackle them.

Perhaps they still had hopes for a "quick fix" solution in combining some, albeit insufficient, adjustment measures with unilateral nonpayment of debt and the expectation of continued large aid inflows. If that were the case, I would only underscore the clear warning given by the staff that the external imbalance is in fact one of the most serious problems confronting the authorities, and that there is an inherent contradiction in following such an approach. In fact, to give in to the temptation of unilaterally limiting debt service payments would place additional serious strains on Sudan's relations with external creditors and would jeopardize the expected additional inflows of external assistance.

The authorities would thus be well advised to follow the staff's recommendation to recognize the existence of a large financing gap and seek to cover it by a combination of realistic and credible policies, normalization of external financial relations, and a substantial amount of external assistance.

It goes without saying, of course, that in the context of such a strategy, the Fund has to be given top priority. Only the rapid elimination of arrears to the Fund will ensure that this institution can eventually play a more important role in supporting Sudan's adjustment efforts.

In giving the authorities the benefit of the doubt--and there are many welcome indications from the authorities to warrant this--I would like to support the staff's suggestion that the best use of time could be made now by concentrating on FY 1988 and putting every effort into preparing and implementing a strong and comprehensive program which includes major fiscal and monetary policy initiatives, wide ranging structural reforms, liberalization of prices and interest rates, and the adoption of a flexible and realistic exchange rate policy.

This list is certainly not exhaustive. The staff has provided a much more detailed list of policies and measures that could form the basis for the kind of comprehensive and consistent adjustment program urgently needed now in Sudan, and I can fully endorse those recommendations.

The next move is up to the Sudanese authorities, and I sincerely hope that the opportunity will not be lost again as has happened in previous years. Finally, I would like to lend my support to the proposed decisions, both on the Article IV consultation and on the review of overdue obligations.

The Executive Directors agreed to continue their discussion at 3:00 p.m.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/20 (2/2/87) and EBM/87/21 (2/4/87).

3. THE GAMBIA - TECHNICAL ASSISTANCE

In response to a request from the authorities of the Central Bank of The Gambia for technical assistance in the area of balance of payments accounting, the Executive Board approves the proposal set forth in EBD/87/28 (1/29/87).

Adopted February 3, 1987

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/17 (1/30/87) and EBAP/87/18 (2/2/87) is approved.

APPROVED: September 14, 1987

JOSEPH W. LANG, JR.
Acting Secretary