

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/149

10:00 a.m., November 17, 1989

M. Camdessus, Chairman

Executive Directors

T. C. Dawson

E. T. El Kogali

E. A. Evans

R. Filosa

M. Finaish

M. Fogelholm

G. Grosche

J. E. Ismael

B. Jalan

A. Kafka

Y. A. Nimatallah

K. Yamazaki

Alternate Executive Directors

C. Enoch

G. C. Noonan

Zhang Z.

B. S. Newman, Temporary

H. S. Binay, Temporary

R. J. Lombardo

M. A. Fernández Ordóñez

C. Schioppa, Temporary

A. M. Othman

O. Kabbaj

L. M. Piantini

J.-F. Cirelli

C. V. Santos

M. Al-Jasser

G. P. G. Hogeweg

S. Yoshikuni

L. Van Houtven, Secretary and Counsellor

B. J. Owen, Assistant

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Also Present

Exchange and Trade Relations Department: S. Kanesa-Thasan; N. Kirmani.
Fiscal Affairs Department: K. Nashashibi. IMF Institute: A. A. Abubakr,
S. Alsuwaidaa, A. Saber, Participants. Legal Department: J. K. Oh.
Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy
Director; S. El-Khoury, H. P. G. Handy, S. H. Hitti, M. F. Melhem,
S. von Post, C. A. Yandle, M. Yaqub. Research Department: G. Hacche.
Secretary's Department: A. Tahari. Western Hemisphere Department:
L. K. Ebrill. Personal Assistant to the Managing Director:
H. G. O. Simpson. Advisors to Executive Directors: M. B. Chatah,
M. Eran, A. Gronn, S. M. Hassan, Z. Iqbal, A. Napky, F. A. Quirós,
A. Raza, R. Wenzel. Assistants to Executive Directors: S. K. Fayyad,
J. Gold, M. Hepp, K. Ichikawa, A. Iljas, M. E. F. Jones, J.-P. Schoder,
M. J. Shaffrey.

1. SAUDI ARABIA - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Saudi Arabia (SM/89/145, 7/19/89). They also had before them a background paper on recent economic developments in Saudi Arabia (SM/89/142, 7/21/89).

The Director of the Middle Eastern Department indicated that the staff had estimated that the budget deficit for 1989 would be somewhat larger than that projected by the authorities. However, recent data covering the first six months of 1989, indicated that revenues had been about SRls 6 1/2 billion higher than the budgeted level, while expenditures had been only about SRls 2 billion higher than in the original budget. If those trends continued for the second half of the year, the estimates of the authorities might well be achieved.

On the balance of payments, the staff's projections for 1989 of an average increase in oil prices of about 20 percent remained valid, but the volume of oil exports was likely to be somewhat higher than expected, the Director added. That factor, coupled with the expectation that imports might be slightly lower than the staff had projected, should serve to reduce the current account deficit in 1989 to about \$1-2 billion, from between \$3-4 billion.

Finally, as indicated in the staff report, the Saudi authorities had been in the process of revising their GDP estimates for 1988, the Director of the Middle Eastern Department stated. Based on the updated information provided to the staff, the revisions had apparently been completed, but the detailed figures were not yet available. Non-oil GDP was estimated to have increased by about 1.5 percent in real terms instead of the decline of 1.1 percent shown in the staff report. The overall growth rate estimated for 1988--including the oil sector--was 6 percent.

Mr. Nimatallah made the following statement:

The closing of the 1980s will conclude an unusual decade in the economic history of Saudi Arabia. In one decade, it had to adjust twice, once to the boom in oil revenues, and the other time to their sharp and sudden decline. In adjusting the economy to the boom, the authorities seized the opportunity to transform the economy at an unprecedented speed into a modern one with improved human capital and adequate networks of infrastructure. By 1981, Saudi Arabia was well placed to play its international role effectively and responsibly. The second adjustment occurred when oil revenues declined steeply. The authorities again took the opportunity, while adjusting the economy to manageable levels, to transform it from one dependent on one major source of exports and income and dominated by the public sector, to an economy that is much more diversified, with

a resilient private sector playing a leading role. As a matter of fact, today, only two of the largest 100 corporations in Saudi Arabia are public sector corporations.

In my judgment, this is a case that should make the Fund proud, as one of its members has managed its economic affairs so well by adopting the appropriate policies domestically and internationally, in two difficult situations, thereby contributing to the smooth functioning of the international economic system.

Preparations for the adjustment to the sharp fall in oil revenues had actually begun way before the fall started in 1983. During the boom years, my authorities had decided to put aside resources that could have been spent easily at the time as reserves for a "rainy day." They also insulated the private sector by providing the specialized lending institutions with adequate capital. The former minimized the need for the public sector to borrow to finance budget deficits, and the latter minimized disruptions to borrowing by the private sector to finance business.

These two farsighted precautionary measures have made the severe adjustment over the last five years much more orderly and gradual. But, despite gradualism in adjustment, the government budget of 1988 reached less than one half of that of 1982. There is no need to describe here how much the various sectors of the economy have suffered owing to the sharp decline in government expenditure. After all, that is the meaning of adjustment, i.e., to bring the economy down to sustainable levels where it can function within its means. What is remarkable, however, is that the economy continued to be open and free of any controls and to enjoy competition throughout its severe adjustment. And that certainly has helped in keeping the rate of inflation very low.

Today, the economy has resumed growth and shows many signs of strength. Provisional estimates just received from Riyadh reveal that in 1988, GDP, in real terms, had grown by about 6 percent. The agricultural sector took the lead by growing at 13 percent. Indications point to an economy that is even more buoyant in 1989.

In the meantime, while macroeconomic adjustment has been implemented, structural changes in the economy have been taking place to diversify it. With an appropriate exchange rate policy in place, non-oil exports have grown remarkably fast, and reached double their level in 1986. Private sector activities contributed about 50 percent to GDP in 1988, compared with less than 20 percent in the early 1980s. The Government is determined to reduce its economic role and increase that of the

private sector. Basic incentives are there to encourage private sector activities, e.g., adequate infrastructure, adequate financing, appropriate policies of no controls, and no inflation, leading to stable exchange and financial markets.

Thus, expanding the regional and international markets for our non-oil exports has been given a first priority. Saudi Arabia's trading partners are asked to help our efforts at diversifying the economy. We keep our economy wide open for their exports, and it is only fair and makes for good business for them to open their markets to our exports. My authorities are very concerned about the very high tariffs and discriminatory taxes imposed on imported crude oil by certain industrial countries to subsidize other forms of energy, such as coal. We hope that this blatant discrimination against oil as a source of energy will soon be stopped.

In the first half of 1989, government revenues increased by SRls 6.5 billion above budget estimates, while expenditure increased by about SRls 2 billion. If this picture continues for the rest of 1989 and the early 1990s, it is hoped that the fiscal deficit will be reduced and eventually eliminated faster than had been expected.

With adequate infrastructure now in place, peace restored to the Gulf area, and with economic relations among the members of the Cooperation Council for the Arab States of the Gulf (GCC) strengthened to widen investment opportunities, private capital, which has been seeking investment abroad, is returning home. Banks have also gained more confidence to resume lending to the private sector as profitability improves and better legal relations with clients are secured. All in all, the private sector seems to be poised to take an expanding share in income generation over the coming years.

Saudi Arabia will continue to play its international role effectively. Its oil policy will continue to support stability of oil markets and prices. Saudi Arabia's record on foreign aid is well known, and there is no need to state it again. My Government continues its support to developing countries through its arm for development assistance, the Saudi Fund for Development. Saudi Arabia's support to international organizations, particularly the Fund and the World Bank, continues to be strong. My authorities are convinced that these organizations are indispensable to the world economy, in general, and to the promotion of adjustment and growth, in particular, and therefore should be strongly supported.

Finally, my authorities value these consultations with the Fund, and therefore are grateful to the Board, management,

and the staff for their professional conduct of the Article IV consultations with Saudi Arabia over the years.

Extending his remarks, Mr. Nimatallah commented that his authorities were optimistic that revenue might exceed the original budget estimates for 1989 by as much as SRls 12 billion, or double the estimate of about SRls 6 billion that he had mentioned in his opening statement. If that increase in revenue materialized, the reduction in the budget deficit could be speeded up. The external sector should also improve, with every possibility of a decline in the current account deficit. His authorities believed that the surplus on the trade account would be about \$7 billion, but that the balance of payments as a whole might be in equilibrium in 1989.

Expenditure was being kept steady, Mr. Nimatallah remarked. There had been little increase, if any, in investment spending. In addition, there had been no increase in salaries and wages since 1982, a policy that had been made possible by the good inflation performance. At the beginning of the period of adjustment, negative inflation might even have contributed to an increase in real income, at least for government employees. Later, inflation had picked up by about 2 percent, but there still seemed to be no reason to increase wages and salaries. The outcome could therefore be a faster reduction in the fiscal deficit than was expected.

In response to a question by the Chairman, Mr. Nimatallah said that the current account deficit, which was currently estimated at about \$3 billion, was expected to disappear by the end of 1989 or early in 1990. As for the budget deficit, which had been estimated at about 9 percent of GDP, his authorities considered that it might fall to close to 5-6 percent of GDP. Preliminary estimates indicated an increase in revenue of up to 10 percent above the original estimate. The test would come on the side of expenditure, which might edge up a little but which had so far been kept in line, apart from a small increase on the investment side. As he had mentioned, salaries, wages, and other expenditures were not increasing.

Mr. Finaish made the following statement:

The major policy questions facing the Saudi authorities have not changed in any significant way since the Board discussed the previous Article IV consultation report in mid-1988 (EBM/88/93, 6/15/88). Indeed, since the early part of the decade when Saudi Arabia's oil revenues began to decline rapidly, the basic challenge has been one of balancing two important objectives--to contain the loss of foreign exchange reserves through macroeconomic adjustment, while at the same time maintaining the drive toward the diversification and expansion of the non-oil sector. This challenge has been particularly difficult in light of the large degree of uncer-

tainty about the prospects of fiscal and external revenues, as well as the authorities' clear--and I should add, farsighted--decision not to resort to restrictions or controls as a means of adjustment.

The record of the past few years leaves no doubt that the authorities are succeeding in meeting this challenge. As Mr. Nimatallah reminds us, financial adjustment has been quite substantial, with fiscal expenditures declining by more than 50 percent between 1981 and 1988. Yet, despite the inevitable impact on domestic demand and on non-oil economic activity, the economy appears to be much more diversified than it was a decade ago, and, from all indications, the private sector is well poised to take advantage of a more efficient and more competitive economy. This reflects the authorities' emphasis not only on the strength of adjustment but on the quality of adjustment as well.

Having said this, however, it should be clear that the adjustment process in Saudi Arabia is not over yet. The difficult choices which have faced the authorities in recent years are still there; and despite the relative stability of oil prices in the recent period, economic management continues to be complicated by uncertainties about the medium-term--and possibly even the short-term--outlook of the oil market.

Let me offer a few comments on recent economic management and some of the policy issues raised in the staff papers.

Given the structure of the Saudi economy, fiscal policy is undoubtedly the central instrument for adjustment. As I mentioned earlier, the fiscal adjustment through expenditure cuts over the past seven or eight years has been quite impressive. Fiscal performance in 1988 was particularly strong, with total expenditures declining by 27 percent compared with 1987. Also noteworthy is the fact that large cuts were made in virtually all categories of expenditures. This tight fiscal policy appears to be continuing in 1989. Although we have noted the differences between the authorities' and the staff's projections of the likely fiscal outcome for the year, the more recent information provided in Mr. Nimatallah's statement seems to suggest that the deficit may turn out to be significantly less than the authorities themselves had projected. That would certainly be a welcome development. But the question remains whether the authorities should move more aggressively on the domestic revenue front. This seems to be the staff's advice, which the authorities do not totally disagree with, although they have expressed reservations regarding the introduction of domestic taxes. Obviously, domestic taxes are not an objective in themselves, and to the extent that it can be achieved, it could be argued that a viable deficit reduction path through

expenditure restraint would be better than imposing new taxes. I would agree with the staff, however, that there may be scope for further increases in utility rates and in fees for government services, not only for fiscal purposes but also to improve resource allocation. Scope may also exist for an adjustment in import tariffs if further fiscal adjustment were to become necessary.

Also on public sector finances, let me say that we welcome the elimination of budgetary transfers to the specialized credit institutions as well as the measures to limit the support which had been provided selectively to certain activities. This step will not only strengthen the fiscal position but will also help the non-oil sector to increase its efficiency and competitiveness.

The financing of the budget deficit is obviously not an issue in itself, at least not in the short term, given that the government bonds are likely to be absorbed by commercial banks and autonomous government institutions (AGIs) without a significant impact on domestic liquidity. However, the staff's analysis of the potential medium-term implications of continued bond financing on the scale currently projected confirms the importance of avoiding excessive accumulation of domestic debt. It also shows the importance of capital repatriation to achieving the authorities' objective of limiting the impact of deficit financing on foreign exchange reserves or on the cost of domestic borrowing. In general, the staff's analysis points to the need for special vigilance in the conduct of monetary policy in the period ahead.

While still in the monetary area, I noted the staff's reference on page 4 of the report to the unusually high rate of credit expansion to the private sector in 1988. Given the relatively subdued rate of economic activity, and the fact that the demand for credit came primarily from the nonbank finance houses, the staff suggests speculation as a possible explanation. It would be useful if the staff could elaborate on the reasons behind this apparent speculation against the riyal.

Turning to the external sector, in our view, the authorities' management of the exchange rate during the recent years of adjustment has been properly balanced between the need for flexibility and the advantages of stability. The balance of payments data presented on page 11 show a clear downward trend in the current account deficit through 1988. This trend is projected to continue in 1989, with the deficit estimated to amount to only about one third of its level in 1985. One of the important factors which will influence the overall balance in

1989 is the extent to which the sale of government bonds will generate capital reflows. I wonder whether the staff has any information on capital movements so far this year.

Clearly, the question of capital flows is important not only for 1989 but for the medium term as well, given the likely developments in the fiscal and current accounts. But the medium-term outlook of the current account will continue to depend crucially on developments in the international oil market. Another important factor in the medium-term and longer-term balance of payments outlook of Saudi Arabia is its access to export markets for its fledgling industries, particularly petrochemicals. In this connection, my authorities fully share the concerns about the impediments to petrochemical exports of Saudi Arabia and other oil countries in the region, particularly to the European Communities (EC). Let me also associate myself with the concern regarding the high protection accorded to non-oil energy sources by a number of industrial countries. Indeed, Saudi Arabia's call for free trade assumes special credibility given its own policy of maintaining an open market.

In conclusion, let me commend the Saudi authorities for continuing to play a constructive role on the regional level, both within and outside the Cooperation Council for the Arab States of the Gulf (GCC). As an important member of the international financial community, Saudi Arabia has also continued to play a unique role in assisting other developing countries. Its record of external assistance speaks for itself. And, finally, as a major oil exporter, Saudi Arabia has played a constructive role in promoting orderly and stable conditions in the world oil market. In this connection I can only agree with the authorities' call, on page 6 of the staff report, for effective cooperation to ensure that the burden of adjustment to changing supply and demand conditions is shared in an equitable manner among all market participants.

Mr. Ismael made the following statement:

I would like to congratulate the Saudi Arabian authorities for the success of their efforts to diversify the economy, thereby reducing Saudi Arabia's dependence on the oil sector, as clearly reflected by the impressive growth of non-oil exports and the increasing role of the private sector. Nonetheless, the continued depletion of official foreign asset holdings, together with the uncertainties associated with the oil market, have left the authorities with no other choice but to further consolidate and broaden their adjustment efforts. The staff's medium-term outlook for the balance of payments and the government budget point in the same direction.

I note with satisfaction that policy implementation over the past year has been broadly consistent with the Board's recommendations at the time of the 1988 Article IV consultation. As I generally concur with the thrust of the staff appraisal in the present report, I will confine my comments to a few issues in two major areas: public finance and the external sector. I believe that sustainable progress in these two areas is essential to further enhance the role of the private sector and intensify economic diversification away from the oil sector, as envisaged under the Fifth Development Plan.

Fiscal policy has been, and will continue to be, the linchpin of the authorities' adjustment policies, in particular, in light of the important need attached by the authorities to containing the loss of official foreign asset holdings. I believe that these holdings should encompass those of the Saudi Arabian Monetary Agency (SAMA) and the AGIs, as suggested by the staff. I note, in this regard, that the authorities' policy in 1988--to shift the mode of deficit financing from a drawdown of government deposits with SAMA to the sale of government bonds to the AGIs and the commercial banks--has helped to contain the decline in SAMA's reserves.

This strategy, however, has resulted in a substantial reduction in the reserves of the AGIs; at the same time, it is also expected to result in a significant increase in government expenditures over the next several years, as service charges on public debt are projected to increase in line with the rapid accumulation of the debt, thereby making efforts to contain the budgetary deficit more difficult. I, therefore, agree with the staff that bond financing operations should be regarded as providing temporary relief, and that they need to be directed more toward tapping large foreign assets from the commercial banks and the nonbank private sector rather than from the AGIs. More important, the authorities need to intensify their efforts to introduce a comprehensive fiscal reform over the medium term.

I commend the authorities for making considerable strides in adjusting government expenditures to a sharp decline in oil revenues over the last several years, except of course in 1987, when the fiscal stance was deliberately relaxed to stimulate economic activity. I note that fiscal restraint has been subsequently re-established, and that the budget for 1989 envisages a continuation of restrained fiscal policies. Nevertheless, I believe that the expenditure priorities, especially with regard to subsidies and project outlays, need to be further sharpened. I welcome, in this respect, the authorities' readiness to take additional steps in this area, if necessary. At the same time, efforts should be directed toward broadening and developing a domestic revenue base, including, for example, the introduction of income and general consumption taxes. I

also believe that these efforts need to be strengthened by the adoption of a more realistic pricing policy with regard to public services. This, together with the subsidy reduction referred to earlier, would improve considerably the efficiency of resource allocation, thereby contributing to the strengthening of the non-oil sector over the medium term.

With regard to the external sector, I am encouraged to note that the current account of the balance of payments is expected to improve substantially in 1989. A large part of the expected improvement will arise from the projected increase in oil exports; however, the rising trend of non-oil exports will be an important contributory factor. Further improvement in this area would, inevitably, require continued efforts to broaden the export base through improving efficiency, and maintaining the external competitiveness of the economy.

The authorities' exchange rate policy over the past few years has been broadly consistent with this objective, and their intention to maintain a flexible exchange policy is welcome. I commend the authorities for their adherence to a generally free trade and exchange system, and I welcome their intention to seek full membership of the GATT.

Finally, on international oil policy, I note the important role of Saudi Arabia, and support its efforts and commitment to seek stability of the international oil market and prices. In this connection, I agree with Mr. Nimatallah that discrimination against oil as a source of energy by certain industrial countries should be discontinued.

Mr. Hogeweg made the following statement:

Without doubt, Saudi Arabia has managed its economy extremely well in turbulent times. The boom in oil revenues in the early 1980s has been wisely used to build an infrastructure as a basis for the diversification of the economy, as well as to build up large net foreign assets. The sharp decline in oil revenues has induced sharp cuts in government expenditure, while the authorities tried to maintain private sector activity by increasing efficiency and allowing a real effective depreciation of the exchange rate. Substantial drawdowns of net foreign assets have allowed the adjustment process to be gradual in the sense that Saudi Arabia could afford sizable overall deficits in the balance of payments.

The staff's medium term scenario clearly shows the need for further adjustment and in that light I would like to make some remarks on the financing of the budget and on exchange rate policy.

I understand that the aims of the adjustment effort are to contain the loss of foreign reserves and at the same time to foster continued growth and diversification of the non-oil sector. In this connection, the report goes into some detail in describing the financing of the remaining, still very large, budget deficit. First, government deposits with SAMA were drawn down. Subsequently, and since direct lending by SAMA to the Government is rightly precluded, bonds were issued. These bonds were in part taken up by the banks which financed them by reducing their claims on SAMA. Most of the bonds were purchased by autonomous government institutions, which financed them by selling their foreign assets to SAMA. I think it is important to recognize clearly that the monetary effects of bond financing in this way are very similar to drawing down government balances with SAMA or direct lending by SAMA to the Government. It is essentially a form of monetary financing which contributes to deficits in the balance of payments. The foreign assets of SAMA are preserved by drawing down foreign assets by AGIs and banks. In this process intergovernmental claims--namely, bonds in the portfolio of AGIs, rapidly build up.

It is important to look through these financing transactions to the simple national accounting identity--that the country will have a deficit on the current account as long as the government deficit exceeds the savings surplus of the private sector. It is equally important to recognize that liquidity creation in excess of money demand induces outflows of liquidity, namely, an overall deficit in the balance of payments, with the loss of net foreign assets as its counterpart. The only way to reconcile the two objectives of Saudi Arabia's adjustment effort--containing the loss of foreign reserves and promoting diversification of the non-oil sector and bearing in mind that the second aim precludes lower investments--is to increase national savings, which, of course, means lowering consumption. The introduction of taxation might indeed be a very advisable instrument to accomplish that objective. In the case of Saudi Arabia, this would amount to a true sort of structural adjustment. Looking at the problem in this way, it struck me that the report gives very little information on private sector savings behavior. Maybe the staff could shed some light on this issue.

Turning to the exchange rate, I was somewhat surprised that the staff attaches the label "flexible" to Saudi exchange rate policy. I get the impression that there is in practice very little difference from the exchange rate policy of Morocco, which has nominally fixed its exchange rate for a number of years to a basket in which the U.S. dollar has a large weight, so that, given a low inflation rate, the fall in the dollar over the past few years was reflected in a gradual net effective depreciation. However, in Morocco's case, (EBM/89/147 and

EBM/89/148, 11/15/89) the staff did not regard the exchange rate policy as flexible. On the contrary, in their view, a "much more active" exchange rate policy was needed. Some coordination in the practice of labeling similar arrangements might be useful.

Flexible exchange rate policy in Saudi Arabia seems to consist of the recognition that a sharp dollar rise might necessitate some action on the exchange rate. I note with satisfaction that the staff in its appraisal has qualified its welcome to such flexibility by placing it in the context of other considerations, including the avoidance of exchange rate instability, to which the authorities rightly attach importance. In the previous year's appraisal, this qualification was not yet made. I would go even further and repeat a remark this chair made in June 1988: the macroeconomic imbalance stemming from the still large fiscal deficit and the way it is financed does not necessarily indicate a lack of competitiveness.

Mr. Grosche observed that Saudi Arabia's adjustment strategy, aimed at scaling back public expenditure while at the same time supporting and expanding the private sector, was paying off nicely. Growth of 6 percent in 1988 and, as Mr. Nimatallah expected, even higher growth in 1989 at relatively stable prices was no small achievement, considering the huge task that had had to be accomplished after the sharp drop in oil prices. However, that task was not yet finished, and further adjustments were called for. The staff report and Mr. Nimatallah's statement made him confident that the authorities would live up to the challenge. It was particularly encouraging to note from the staff report that policy implementation since the Board had last discussed Saudi Arabia had been broadly consistent with the Board's conclusions and recommendations.

The recommendations for the current year should, Mr. Grosche considered, concentrate again on the budget deficit. That deficit would stay at high levels, although he had noted with satisfaction from Mr. Nimatallah's remarks that it was coming down faster than had previously been expected. Developments should continue to be favorable if oil revenues increased strongly in the years ahead, as expected. However, assumptions on oil prices were fraught with uncertainty, although he hoped that the authorities' policies, aimed at promoting orderly and stable conditions in the world oil markets, were successful. Nevertheless, they should continue to err on the cautious side and should keep domestic absorption at levels that could be sustained without depleting foreign assets too fast or piling up excessive public debt, thereby burdening future budgets with a rising share of interest expenditure.

Fiscal efforts should aim at both expenditure and revenue, Mr. Grosche continued. On the latter, he fully shared the staff's carefully worded advice "to broaden the revenue base." He interpreted that to mean that the authorities should not preclude the introduction of

a comprehensive system of direct taxes. After all, with the strengthening of the private sector, that source of fiscal revenue should not go untapped, and it would also contribute to a more balanced adjustment. He understood, however, that the authorities had some reservations with respect to tax reform, but he was not sure that he fully grasped the rationale of their position. Maybe the staff or Mr. Nimatallah could offer some additional comments on that point.

As for expenditures, priority should be given to a further streamlining of subsidies, Mr. Grosche noted. Such action could not only yield budgetary savings but would also strengthen the international competitiveness of the private sector and help dispel protectionist sentiments. He wished to add that while he fully agreed with Mr. Nimatallah that every effort should be made to keep markets open so as to exploit the potential benefits of international trade to the fullest extent possible, it had to be recognized that the market for crude oil was not a perfect one. Sudden supply shortages and price hikes had provided good arguments to favor reduced dependence on imported energy and to subsidize other forms of energy. He hoped that with continued stable conditions on the oil market, the arguments of those that wanted to phase out subsidies, particularly for coal, would prove strong and would lead to a reduction in subsidies.

In other policy areas, he fully shared the staff's recommendations, Mr. Grosche remarked. By way of emphasis, he commended the authorities for their commitment to open markets, appropriate exchange rates, and their reliance on price signals and market forces. That commitment, together with demonstrated skillfulness in economic management, boded well for the continuation of an orderly adjustment process and the country's prosperity.

Finally, Mr. Grosche commented that the statistics in Appendix III to the staff report left him unsure that the currentness and coverage of data lived up to Saudi Arabia's role in the world economy and its rank in the institution as the sixth largest member. Speaking of Saudi Arabia's role in the institution, however, he wished once again to express his authorities' deep appreciation for the commitment to the Fund that the authorities had demonstrated in the past and continued to display, even though the reduced amount of its outstanding credit to the Fund could have led the authorities to take a somewhat more distant view. He hoped that Saudi Arabia would continue to support the institution.

Mr. Fogelholm noted that in the 1980s, the Saudi Arabian economy had undergone a major adjustment process necessitated by the sharp fall in petroleum revenues. The authorities were indeed to be commended for having actively promoted that process and for having been able to implement it in an orderly manner. Even though much remained to be done, the results attained to date were impressive, not least being the diversification of the economy. He was also pleased to note that policy implementation since the Board's previous discussion on Saudi Arabia had been broadly in line with the Board's recommendations.

The fiscal deficit had been reduced significantly in the past year, and he was impressed by the determined execution of expenditure cuts, particularly the halving of subsidies, Mr. Fogelholm continued. The staff forecast of the deficit for the current year indicated a further substantial fall, albeit at a slower pace than the estimates in the budget, owing to both higher project expenditures and a renewed increase in subsidies. The latest information from Mr. Nimatallah and the staff indicated that stronger than expected developments in both government revenues and expenditures for 1989 implied that the staff forecast for the current year and beyond--as shown in Table 1 of SM/89/145--were too pessimistic. That was, of course, a most welcome development.

Nevertheless, there was no scope for relaxing the adjustment effort yet, Mr. Fogelholm added. The economy was still heavily dependent upon petroleum revenues, and the room for policy flexibility was limited and most sensitive to oil price developments. The Government's deposits with the Saudi Arabian Monetary Authority had been drawn down, and continued use of foreign reserves to finance current account deficits was clearly not an appropriate policy for the long term. That had to be said regardless of the fact that Saudi Arabia was currently in a most comfortable net foreign asset position and could easily finance external deficits in the short run.

Fiscal reforms should therefore be continued, both on the expenditure and on the revenue sides of the budget, Mr. Fogelholm considered. Subsidies should be cut further and efforts to improve the quality and composition of government spending strengthened. He also believed that the authorities would be well advised to broaden the revenue base of the budget, for instance, by increasing utility rates and fees for government services, as proposed by the staff. Nor would he, a priori, exclude the introduction of either a property tax or a consumption tax; like Mr. Grosche, he believed that such measures would facilitate a balanced adjustment process.

In addition, Mr. Fogelholm considered that the authorities should consider easing the restrictions currently imposed on the nonbank private sector relating to investment in government bonds. The result would be both to promote the development of the domestic capital market and, hopefully, to contribute to private capital inflows. Together with deeper and more efficiently functioning domestic financial markets, such action would, of course, over time improve resource allocation and enhance the productivity of the economy.

Finally, Mr. Fogelholm said that he commended Saudi Arabia for its large official development assistance and supported the authorities' policy of fostering stability in oil markets. Also, he was in full agreement with Mr. Nimatallah regarding the necessity and usefulness of keeping all markets open for exports from all countries.

Mr. Fernández Ordóñez observed from the outset that he wished to underscore that over the past twelve months, the Saudi authorities had

implemented most of the conclusions and recommendations made by the Executive Board at the time of the 1988 Article IV consultation. He joined others in giving full recognition to the authorities' adherence to the Board's advice.

The fiscal cuts had been really impressive, Mr. Fernández Ordóñez noted, and the reduction of budgetary expenditures in nominal terms to only 47 percent of their 1982 level was an enormous achievement. Saudi Arabia was an outstanding example for other countries that needed to implement much smaller budgetary reductions. Nevertheless, as the staff had pointed out, the figure for the overall deficit for 1989 of 13 percent of GDP continued to be high. That was why he welcomed the information provided by the Director of the Middle Eastern Department and Mr. Nimatallah on the faster than expected correction of the fiscal deficit. The figure of 5-6 percent of GDP for the year that had been mentioned was very satisfactory.

On macroeconomic policies, he fully shared the staff's appraisal, Mr. Fernández Ordóñez remarked. However, on structural policies, he wished to note that the staff report scarcely dealt with them at all, compared with staff reports for other Article IV consultations that were full of analysis and suggestions on structural issues. Comment was difficult in the absence of information; the best that could be done was to make some guesses about the structural policies needed in Saudi Arabia. Mr. Nimatallah had given two examples--privatization and trade. The process of privatization, which seemed from the figures provided to be spectacular, deserved deeper follow-up. The question of trade should also be studied in more detail. The staff indicated that the authorities had resisted pressures from the private sector for increases in protectionism, but mention was also made in the staff report of certain protectionist measures, such as subsidies on specific domestically produced commodities and capital, government procurement, as well as some protective tariffs. He wondered what possibility there was of Saudi Arabia joining the GATT.

The employment situation might also benefit from structural analysis, Mr. Fernández Ordóñez considered. It was shocking to learn that in a country of 12.5 million people, only 1.5 million nationals had jobs. Without a careful analysis, it was difficult to know what measures were needed, but it was likely that labor market rigidities were one explanation for the enormous number of unemployed people. Incidentally, in attempting to study the problem of unemployment, he had noticed that the latest employment data were three years old, and even then, did not permit a breakdown between, for example, male and female workers.

He was therefore led to mention what appeared to be a certain "under-development" in Saudi statistics, Mr. Fernández Ordóñez said. He had also noted that no data from Saudi Arabia were published in the Fund's Govern-ment Financial Statistics. In his view, the upgrading of Saudi Arabia's statistical base would improve not only the Fund's surveillance task but would permit the Saudi authorities to better design economic policies.

He did not wish to conclude his remarks without commending Saudi Arabia for its crucial role in promoting stable conditions in the world oil market, Mr. Fernández Ordóñez remarked. In that connection, Mr. Nimatallah had raised the question of what he called discriminatory taxes on imported crude oil. While that question deserved careful consideration, it must be discussed in the global framework of international taxation of energy. That issue had been studied thoughtfully by the Fund in the recent paper on tax harmonization, which would give the Board an opportunity to take up that important matter.

Finally, Mr. Fernández Ordóñez said that he begged to disagree with Mr. Nimatallah's view that the Saudi Arabian record on foreign aid did not need to be stated again. He wished to restate his recognition to the Saudi authorities for that record. Even though the absolute amount of aid had been reduced in recent years, development aid must always be judged in relative terms, and Saudi Arabia continued to be the largest aid donor in relation to GDP, and, in consequence, continued to be an example for other countries in the world to follow.

Mr. Jalan noted that as pointed out by the staff, and highlighted by Mr. Nimatallah, Saudi Arabia exemplified a country that had had to adjust twice during a decade to sudden, sharp changes in the external economic environment. He agreed with Mr. Nimatallah that it was a matter of pride not only for his country but for the entire Fund membership that Saudi Arabia had successfully met those challenges. He doubted whether a better example of structural adjustment could be found.

The two most impressive aspects of Saudi Arabia's adjustment were the tremendous successes achieved in increasing the share of agriculture and manufacturing in GDP, and the fiscal adjustment, Mr. Jalan observed. It was striking that agricultural output had more than doubled from 1982 to 1988, and that the manufacturing sector had also shown substantial growth, thereby helping to increase the share of non-oil exports in total. Likewise, the sharp cutback in expenditure, even in nominal terms, could not have been an easy task in an economy which had enjoyed high rates of growth of consumption and expenditure during the boom years. The fiscal position was expected to improve further in 1989, helped by efforts to raise revenue and to keep expenditures under strict control. He had been glad to note from Mr. Nimatallah's statement that the increase in revenue during the year so far had been even larger than budgeted.

In view of the efforts made by Saudi Arabia to reduce expenditure and raise revenue, he was content to leave it to the authorities to decide the mix of taxes, and to determine whether an income tax was appropriate or not, Mr. Jalan added. His own experience, and that of other countries, was certainly that an income tax was perhaps the most equitable and least harmful form of taxation. However, it had to be recognized that societies differed in culture and tradition, and as long as overall policies were sound and sustainable, the choice of taxes and subsidies that best served the purposes of the society should be left to the authorities.

The large fiscal deficits had been financed by drawing down official foreign assets, and, since 1988, by the issue of bonds, Mr. Jalan noted. As such, the deficits had not generated any inflationary pressure, and the performance of the economy on the price front had also been quite remarkable.

The staff considered that bond financing of fiscal deficits should be a temporary expedient, Mr. Jalan observed. He was not sure why such financing should be considered undesirable as long as the resources were used productively for investment. The focus should be on the use of resources rather than on whether they were raised by the government or the private sector. At the same time, he was rather intrigued by the authorities' view that the scheme for the purchase of bonds by the Saudi Arabian Monetary Authority from commercial banks did not constitute deficit financing. Normally, such purchases should create high-powered money and thus add to the liquidity in the economy. Comments by Mr. Nimatallah would be helpful. It would also be useful to know whether there was any obligation on the part of the commercial banks to subscribe fully to government bond issues, or whether they had complete freedom on that account.

He shared the staff's concern about data problems and noted that the authorities were seeking Fund assistance in improving the data base, Mr. Jalan said. He encouraged the Fund to respond to such requests.

Finally, the Saudi authorities were to be commended for providing large amounts of highly concessional assistance to a number of developing countries. It was noteworthy that despite a decline in income, that assistance had increased significantly in relation to total current account receipts. He hoped that that record would continue.

Mr. Yamazaki made the following statement:

Like other oil-exporting countries, Saudi Arabia has been faced with the difficult policy challenges brought about by the sharp decline in oil prices since the beginning of the 1980s. In addition, in adjusting its economy to lower oil prices, the authorities have had limited room for maneuver owing to the unique role of Saudi Arabia in stabilizing oil prices. Against this background, we continue to commend the authorities for their efforts aimed at diversifying the economy, particularly through rationalizing the public sector and enhancing the role of the private sector, while at the same time paying due attention to the effect of their economic policy on the world oil situation.

Having said this, although the recent increase in oil prices is providing some relief, the authorities are encouraged to take this opportunity to strengthen the pace of economic adjustment in order to cope with the uncertain oil situation in the future. With this in mind, let me make a few observations.

First, I broadly agree with the two policy objectives the authorities have in mind, namely, to expand the private sector's role in the economy and to keep the loss of SAMA's foreign assets within manageable bounds. It might be argued that in view of the high level of foreign assets, a somewhat large drawdown of reserves could be tolerated if it would help diversify the economy. In my view, however, there is a clear risk, once the authorities formally decide to resort to reserve drawdown, of creating an excessive demand for protection and subsidization from the various sectors of the economy, which would not be helpful and might even be counterproductive to the revitalization of the private sector. Indeed, as the staff has rightly pointed out, the authorities have wisely resisted such pressures and opted to broaden the adjustment policy, which I believe was facilitated by the authorities' adherence to protecting reserves.

Second, in order to simultaneously achieve the two objectives, a combination of flexible exchange rate policy and fiscal restraint is essential. In this connection, I commend the authorities' efforts aimed at reducing the budget deficit. The uncertainty surrounding the world oil market underscores the need to increase the pace of fiscal restraint. In this connection, we would attach particular importance to reducing subsidies. At the same time, however, we continue to think that revenue-raising measures, including, *inter alia*, broadening of the income tax base and the introduction of a consumption tax, as suggested by the staff at the time of the 1988 Article IV consultation, should be seriously considered.

Third, on the financing of the budget deficit, we welcome the smooth implementation of the bond sales operation. On the other hand, the true benefits of the introduction of the government bond scheme seem to be somewhat obscured. According to page 40 of the background paper, most of the bond issue was purchased by the autonomous government institutions, which, in turn, financed the bond purchase by the sale of foreign assets to SAMA. Accordingly, the bond sale did not have any significant impact on the net foreign asset position of the public sector, nor did it lead to a significant increase in the commercial banks' claims on the public sector. In this connection, the staff is right in saying that the bond scheme has not contributed to stimulating private capital inflows, thereby conserving the public sector's foreign assets. The question that arises, however, is whether use of the bond scheme to increase the net foreign assets of SAMA would imply that the fiscal deficit is financed by central bank credit and, if so, whether that would not undermine price stability in the long run. I recall that on the occasion of the 1988 Article IV consultation, the staff provided an in-depth analysis of the different effects of bond financing, depending on the sector

that purchased bonds. I would appreciate it if the staff could elaborate on this point again with particular emphasis on the monetary aggregates. In sum, while we appreciate the introduction of the bond financing scheme inasmuch as it provides flexibility in public debt management, we also think that its implications for monetary policy should be carefully examined. Also, I fully agree with the staff that bond financing should not replace efforts toward fiscal consolidation.

Finally, on external policy, I generally support the authorities' commitment to free trade as evidenced by their attempts to reduce trade barriers. We particularly welcome the fact that the authorities are considering full membership in the GATT, and I would like to know if they have any timetable in mind. That being said, the external sector is still heavily dependent on oil exports and is therefore vulnerable to external developments. As I stressed at the outset, the recent increase in oil prices does not provide room for complacency. Rather, it should be interpreted as a good opportunity to strengthen and consolidate adjustment efforts aimed at making the economy more industrialized and less dependent on the oil sector. In this connection, I am much encouraged by Mr. Nimatallah's statement in which he clearly underscored the determination of the Saudi authorities to adhere to the adjustment process.

Last, but not least, I wish to associate myself with previous speakers in commending the positive contribution that the Saudi authorities have so far extended to the developing countries as well as to this institution.

Mr. Kafka commended the Saudi authorities for their exemplary performance. They had, as in the past, acted with bold determination, adopting far-reaching measures in various areas to deal with the severe impact on the economy of the fall in oil prices which followed the sharp upward price adjustment in the 1970s. He had been pleased to learn from Mr. Nimatallah's statement that the rate of growth of GDP had increased by 6 percent in 1988 and was expected to accelerate further.

The medium-term outlook pointed to the need for continued deepening of structural reforms and for keeping in place strict macroeconomic policies, Mr. Kafka added. The staff projection of a rapid increase in public debt called, in particular, for the maintenance of a prudent fiscal policy, including the broadening of the revenue base, as mentioned by several Directors. But insofar as the productivity of Saudi Arabian investments exceeded the interest rate on reserves, he agreed with Mr. Jalan that it was not the borrowing but the use of the borrowed funds that was relevant.

The Saudi authorities were to be commended for their firm commitment to resist pressures for trade restrictions, in spite of the sharp fall in

export revenues, Mr. Kafka stated. He supported Mr. Nimatallah's request to Saudi Arabia's trading partners to assist the country's efforts by avoiding any kind of discriminatory treatment specifically addressed to Saudi Arabia's exports. The Saudi Arabian authorities were wise to seek full membership of the GATT.

Finally, Mr. Kafka said that he wished to thank the Saudi authorities for maintaining a high level of concessional economic aid in relation to GDP, channeled both through bilateral and multilateral institutions, in order to assist developing countries in their endeavors to grow.

Mr. Cirelli said that he wished to join others in commending the Saudi Arabian authorities for the ability they had displayed in responding adequately to a "rainy day," namely, the sharp decline in their main source of revenue. The authorities must also be congratulated for the considerable progress Saudi Arabia had made in past years toward the development and diversification of its oil-based economy. Economic developments in the country were closely linked to oil market movements, which were characterized by great uncertainty. It was against that background that the authorities had followed a successful adjustment path. In spite of a more favorable oil price in 1989, compared with previous years, they had actively pursued the adjustment process they had embarked upon.

He fully endorsed the staff appraisal, Mr. Cirelli added. The 1989 fiscal stance seemed adequate, and the authorities had been able to maintain the prudent policy of fiscal restraint implemented in 1988. However, there was little room left for maneuver in that area, given the need to maintain the level of infrastructure developed in the past. Indeed, the Government's efforts to cut back the large budget deficit had been based principally on substantial expenditure cuts. The determination of the authorities was praiseworthy, but the staff's projections showed that the efforts made would not be sufficient to regain a balanced fiscal position in the years ahead, since the budget deficit would remain high, at about 13.5 percent of GDP. The authorities were still reluctant to increase revenue, even if that would permit a more balanced adjustment. The introduction of new taxes did seem warranted, given the low level of taxation, and he wondered whether Mr. Nimatallah could be more specific about the reservations of his authorities toward moving in that direction. It would also be helpful to have information from the staff on the level and distribution of income in Saudi Arabia as well as on the development of national savings. In spite of the latest positive fiscal outcome for the year, as provided by Mr. Nimatallah and the staff, it was worrying to note that there would be no major improvement in the budgetary situation in the coming few years, even though the projections in that area had to be looked at cautiously since they were very sensitive to variations in oil export revenues.

As for the financing of the deficit, the authorities were issuing bonds in order to maintain Saudi Arabia's foreign assets and avoid a

drawdown in reserves, Mr. Cirelli observed. Under that policy, financing the budget deficit would not seem to present too many difficulties. However, as the staff had stressed, the authorities had to be prudent, especially in avoiding any monetization of the deficit through a SAMA facility--a point of the utmost importance. An improvement in the competitiveness of government securities, as indicated by the staff, would also be needed, at least to permit capital inflows. However, the authorities should take a cautious attitude to an increase in public debt, which would impose a heavier burden on interest expenditure by the Government. Since 1988, they had tried to widen the government bond market by allowing banks to broker bonds. He asked the staff or Mr. Nimatallah to comment on the limited success of the sale of broker bonds through mutual funds.

On the external side, the authorities must be commended for having dramatically increased non-oil exports and for having kept their economy open and free of any controls at a difficult time, Mr. Cirelli considered. Their commitment to pursuing a liberal economic policy by relying on price signals and market prices was also laudable. The persistence of a current account deficit would not endanger Saudi Arabia's financial position in the short run, given its high level of reserves, but there would be a need to tap commercial banks' foreign assets.

Finally, Mr. Cirelli said that he shared the staff's view on exchange rate policy. Also, as usual, but with sincerity, he wished to give their due to the authorities for their performance in maintaining a high level of foreign aid, reflecting the important role of Saudi Arabia in the international community.

Mr. El Kogali made the following statement:

At the outset, let me express my support for Mr. Nimatallah's judgment that Saudi Arabia has managed its economic affairs in an impressive way, evidenced by the prudent manner in which oil wealth was used to transform the economy over a record short period into a modern state with a highly developed infrastructure and high standard of living. When the oil market collapsed, the authorities were able to adjust to the sharp loss in revenues while maintaining Saudi Arabia's support of multilateral organizations and the developing countries, as well as protecting the standard of living of its population.

The objective of economic policy in Saudi Arabia in recent years has been to contain the negative impact on the economy of adverse developments in the world oil market by adjusting domestic absorption to lower oil revenues, minimizing the depletion of official foreign assets, and diversifying production and the export base to reduce the vulnerability of the economy. The challenge facing the authorities has been how to accomplish these goals while avoiding a major withdrawal of stimulus from the domestic economy. Commendable progress has been made, and so far the authorities have been able to maintain

a reasonable balance. Their quick response in making deep cuts in government expenditure has helped to prevent the development of large domestic imbalances, and prudent use of the sizable foreign assets accumulated over the years has facilitated a soft landing for the economy, while maintaining external reserves at acceptable levels.

Fiscal restraint has been the major vehicle of the authorities' adjustment. Despite occasional relaxations to avoid pushing the domestic economy into a severe recession, the authorities deserve to be commended for achieving sustained fiscal discipline. In 1988, total expenditures declined by 27 percent compared with the year before. However, the staff estimates indicate that 1989 may witness a relative relaxation of expenditure restraint and that despite an expected increase in budgetary oil revenues of more than 38 percent, the budget deficit is estimated to remain at a high level of 13 percent of GDP. The authorities' emphasis on close monitoring of budgetary performance and their readiness to take additional steps to curb expenditure growth, if needed, and the additional information provided by Mr. Nimatallah, are reassuring.

While commending the authorities for their strong fiscal adjustment and encouraging them to persevere with prudent financial policies, it is not clear to me how much further they can reduce expenditure, and to what extent expenditure cuts can remain the main tool of adjustment in the face of uncertain developments in world oil markets, at least not without seriously damaging the diversification effort, hampering the productive activities of the private sector, and setting in motion a major recession in the domestic economy. The question is whether it is not time for the revenue side to play a more active role, lessening the burden of adjustment on expenditure by the introduction of a major tax system and a broadening of the non-oil revenue base. In the absence of direct taxes, non-oil revenues from customs duties and fees and charges for government services represent less than 9 percent of GDP. I am aware that the Saudi citizens pay the Zakat, a tax on wealth, at a flat rate, which may have certain implications for the introduction of an income tax. An alternative to direct taxes could be a system of partial cost recovery for services such as education and health in the form of fees or charges. The staff or Mr. Nimatallah may perhaps enlighten us on the authorities' views in this regard.

A second point is related to the mode of financing government expenditure. The introduction of debt financing, to avoid further depletion of the Government's deposits with SAMA is a wise move. However, I note that the bulk of the bonds issued to date is being held by autonomous government institutions, financed by a drawdown of their foreign assets. Only 20 percent

of the bonds is held by commercial banks while the nonbanking private sector has not participated in the bond market. A relevant question is to what extent this structure of bond holding is consistent with the projected large increase in borrowing and how the staff envisages that such borrowing will evolve.

A related point is the projected accelerated reliance of the Government on debt financing over the medium term. Table 1 on page 9 of the staff report forecasts that by 1993, the ratio of debt to GDP will reach well beyond 73 percent. I understand that all or most of this projected increase in borrowing will be undertaken by the Government. I wonder what proportion of this debt will be financed from domestic sources and what the implications might be for private sector activities. Would it not be advisable to moderate the pace of borrowing by broadening the revenue base? The staff may wish to comment on these points.

The medium-term projections once again highlight the vulnerability of the economy of Saudi Arabia to developments in world oil prices and re-emphasize the need for continued adjustment efforts. Mr. Nimatallah informs us that remarkable progress has been made. Non-oil exports have increased and the role of the private sector has been enhanced while the economy has resumed growth. I also notice, from the basic data in Appendix II to the staff report, the steep rise in the share of agriculture in GDP from 5.8 percent in 1984 to almost 10 percent in 1988, which is other evidence of the efforts being made to broaden the productive base of the economy. All these encouraging signs reflect the benefits of adjustment and call for its maintenance. I am confident that the authorities will continue their prudent economic and financial policies. As indicated by Mr. Nimatallah in his statement, it is important to note that Saudi Arabia's exports face mounting trade barriers on the part of a number of its trade partners. The diversification effort will proceed satisfactorily only if these trade partners open up their markets in the same way that the Saudi markets are open to their exports.

Saudi Arabia also offers good opportunities for direct private foreign investment. The well-developed infrastructure, the stability of economic policies, and the encouragement offered by the authorities to private investment, together with the absence of any restrictions on economic activities and international transfers, create a conducive environment for direct foreign investment. Such foreign investments will also help to improve the efficiency of the Saudi private sector in the form of new technology and good management.

My final point is on the commendable record of Saudi Arabia in the provision of aid and development assistance to developing

countries. Saudi Arabia remains the largest aid donor in relation to GDP, with development assistance of 7 percent of current revenues in 1988. A number of countries in my constituency benefit from Saudi assistance and commend the authorities not only for maintaining a high level of assistance but also for its quality. The performance of Saudi Arabia should encourage other donors to increase their ODA contribution.

Mr. Newman made the following statement:

I would like to join the staff and other Directors in commending the Saudi authorities for the prudent and effective policies they have pursued to achieve a difficult second adjustment. The success of this effort was in part due to the authorities' willingness to lay aside a portion of the resources obtained during the period of very high oil prices for, as Mr. Nimatallah says, a "rainy day." The current financial situation appears to be improving much more rapidly than had been projected initially. While it is still too early to say definitively, the Saudi authorities may now be facing the more attractive choices of the first adjustment period, although on a much smaller scale. It will be important for Saudi Arabia to follow the prudent course of the earlier period in light of the uncertainties existing in the oil markets.

It now appears that the improvement in the oil market will result in an increase in oil revenues this year that exceeds the initial projections in the budget. Thus, a continuation of the trends in the first half of the year would result in government revenues about 10 percent above budget levels, and roughly 50 percent greater than in 1988. This development provides an opportunity to reduce significantly the budget deficit, possibly by more than the originally targeted level of 9 percent of GDP. Such a reduction in the Government's financing requirement would enable the authorities to rebuild precautionary balances that have been drawn down substantially in recent years. We therefore welcome Mr. Nimatallah's indication that the authorities will maintain a cautious approach to expenditures.

Furthermore, the easing of recent financial constraints also provides an opportunity to initiate further efforts to diversify the sources of government financing in order to avoid placing an undue burden on any one channel in the future. We therefore welcome the authorities' intention to improve the bond scheme by making it more attractive to private investors. Further development of the domestic financial market will also be increasingly important as the private sector expands in order to avoid renewed pressures for special financing arrangements by the Government. Finally, while expenditure restraint is the

preferred approach, consideration should also be given to steps to broaden the revenue base such as those suggested by the staff as a means of reducing future financing pressures.

Economic activity appears to have picked up sharply with the improvement in oil markets and the increase in government expenditures. A resumption of activity in the non-oil private sector also should facilitate further reductions in government support. The authorities' intention to maintain their market-oriented approach in the new development strategy is welcomed. In this regard, the substantial reduction in budgetary subsidies in 1988, including the elimination of transfers to the specialized credit institutions and elimination of the barley subsidy, should be extended as a means of encouraging a viable, self-sustaining private sector. It will also be important to continue to resist pressures for direct and indirect trade protection. In this context, we would be interested in knowing whether a decision on GATT membership will be part of the new development strategy.

Finally, the increase in oil export revenues is likely to result in greater improvement in the external position than initially expected, possibly leading to elimination of the current account deficit as early as this year and almost certainly next year if the oil market remains firm and a cautious budget policy is pursued. The medium-term projections developed by the staff suggest, however, that even a very modest decline in real oil prices would alter the situation dramatically and result in a substantial increase in financing requirements. In view of the uncertainties in the oil markets, some precautionary steps taken now could obviate the need for more unpleasant choices later. In addition to rebuilding the foreign asset position, the authorities will need to monitor the exchange rate closely and to pursue a flexible approach in responding to market developments to avoid damaging the emerging private sector.

Mr. Binay made the following statement:

Given the remarkable adjustment of Saudi Arabia's economy, I can be brief. In the early 1980s, the Saudi authorities launched a farsighted development strategy aimed at taking the fullest advantage of the boom in oil revenues. The main feature of this strategy was to prepare the economy for private-sector driven diversification by improving its infrastructure and creating human capital, and by investing in highly capital-intensive oil- and gas-based industries as a future source of revenue.

It was foreseen that a well-balanced incomes policy would be essential to avoid potential discrepancies between rural and urban areas, and this foresight led to the sound decision to give high priority to the restructuring of the agricultural sector. A crucial positive externality was created by this policy's success in using cash crop incentives to encourage the agricultural sector's movement toward adoption of the same market mechanisms on which the later industrial strategies and production incentives will be based.

Since the downturn in oil prices, the authorities have accelerated the pace of their adjustment toward new market realities. Faced with a trade-off between maintaining official reserves and continuing the improvement of human capital and the creation of long-run sustainable revenues, the authorities decided to accept some erosion of reserves by applying slower-acting traditional measures to increase public revenues, instead of seeking a sharper adjustment of the economy by curbing public spending. They reasoned that the latter course would have greatly increased the eventual cost of ongoing projects and ended the dynamic transformation of their society.

The present challenge for the Saudi economy and the Saudi authorities is to redouble the effort to establish a link between domestic financial resources and private investment in sectors of comparative advantage without directly intervening. Since Saudi Arabia's competitive position in petrochemicals is well established, since sufficient expertise can be found locally or acquired by promoting joint ventures, and since the nature of the production technology is not particularly affected by economies of scale, the encouragement of downstream petrochemical industries appears quite promising. The recent relaxation by some industrial countries of their restrictions on Saudi petrochemical exports, and Saudi Arabia's relative proximity to several reviving economies, are clearly advantages to be exploited. In the light of the correlation between investment opportunities and national savings, establishment of the needed link between domestic financial resources and local investment could be aided by reinvigorating the stock market; the resulting correlation of national savings with investment opportunities would also help to avoid volatility in the national savings rate, as this chair has pointed out on several occasions. Other ways of promoting the development of downstream industries via market mechanisms are to speed up the elimination of distortions and increase the availability of domestic financial instruments.

To summarize, at the present stage of Saudi Arabia's development, success in stimulating export-oriented industries, especially small- and medium-scale ones, will be a major step forward. The diversification of industry seems to be the only possible substitute for Saudi Arabia's nonrenewable natural

resources in sustaining future prosperity. We believe that Saudi Arabia possesses sufficient resources and expertise to accomplish this task sooner than we all expect.

Finally, my authorities desire once more to express their appreciation for the generosity shown by the Saudi authorities in their assistance to the developing countries.

Mr. Noonan made the following statement:

I wish to associate my chair with the commendations by other Directors of the Saudi authorities on the substantial progress they have made to date in adjusting their economy to the continuing weakness and uncertainty of the oil market. The adjustment has been substantial by any measure. In undertaking this adjustment, Saudi Arabia has had the good fortune to have considerable reserves, which permitted the authorities to determine the pace of adjustment and provided a safety margin for some deviation from their original targets. I do not mean to imply that the adjustment has thereby been made easier; Mr. Nimatallah points out in his statement that, by definition, adjustment is painful. My point is that the adjustment process in Saudi Arabia is a rather special case and not directly comparable with that in many of the other countries the Board discusses.

The overall objective of the Saudi Arabian authorities since 1986 has been the growth and diversification of the non-oil sector together with the achievement of a more sustainable balance on the external account. In appraising developments within the non-oil sector, the staff pointed to the depression of private sector activity resulting from the large reduction in domestic absorption. That helps to explain the low or negative growth in the aggregate non-oil sector since 1983, although the latest GDP estimates for 1988 that have just been announced point to a real increase of 1 1/2 percent in 1988.

As to where, and to what extent, growth and diversification are taking place within the non-oil sector, I note that the staff states on page 4 of its report that in 1988, "there were indications of what may be the beginnings of a process of structural change...." On page 16, the staff adopts a more positive note about the future in projecting growth in the non-oil sector of 1 1/2 percent to 2 percent a year over the medium term, and the preliminary 1988 GDP data would appear to support that projection. However, from reading Mr. Nimatallah's statement, one is left with the impression that Saudi Arabia has already come much further than the progress identified by the

staff. Could the staff and Mr. Nimatallah comment on what appears to be a difference in perception of how far the non-oil economy has come and how much further it has to go?

Our own study of the staff papers revealed only two sub-sectors in the non-oil sector that have recorded any significant growth since 1986. These are the agricultural sector and, to the extent that it is in the non-oil sector, petroleum refining. The latter would seem to be a natural development, but I have to share the staff's doubts as to the sustainability of the growth in agriculture. That growth has been based on nonrenewable water resources and has involved considerable economic costs. The authorities' concern to reduce the country's dependence on food imports is legitimate but it is not reasonable for Saudi Arabia to become, in 1988, the sixth largest exporter of wheat in the world.

Turning to the means adopted by the Saudi Arabian authorities to achieve their overall policy objective, the staff appraisal identifies the leading role played in the adjustment process by deep cuts in Government expenditures. These cuts have led to a reduction in the budget deficit from 25 percent of GDP in 1987 to less than 9 percent, according to the authorities' latest forecast for 1989. This forecast outturn is lower than originally expected because revenue was higher than first estimated, largely as the result of a firmer oil market. The assumption that a firm oil market will continue would be a vulnerable assumption. Even if the market proves robust, the deficit will still remain substantial and would not be sustainable in the longer term.

We note that the financing of this year's budget deficit is to rely exclusively on bond sales. We sympathize with the authorities' desire not to deplete further SAMA's assets and can see how financing the deficit through bonds could impose added discipline on the system. Nevertheless, we agree with the staff that such financing should be regarded as no other than a temporary palliative; it is not an alternative to reducing the deficit. If that alternative view were to be taken, Saudi Arabia would soon find itself saddled with quite a large public debt. We are all aware that the growth of the debt-service burden in relation to revenue resources can compound the complexity of fiscal management within a short number of years and lead to very serious problems.

In our view, further steps should be taken at this stage to reduce the fiscal imbalances, both on the expenditure side and the revenue side. On the expenditure side, we would urge the authorities to continue with their efforts to reduce, or at least contain, subsidies, including the subsidies outside the budget for the agricultural sector, which are referred to on

page 16 of the background paper (SM/89/142). These are stated to have increased. We are also struck by the changing ratio of current expenditure to salaries and wages on the one hand, and to supplies and services on the other (Table 1, SM/89/145). We wonder whether the growing proportion of wages and salaries in current expenditure, excluding subsidies and debt-service payments--and despite the stability of pay rates--may reflect a failure to reduce staff numbers corresponding to the reduction in overall expenditure provisions.

Concern should be expressed about the low participation rate in primary education, which represents an important investment in the future of Saudi Arabia and a prerequisite for training programs. I am sure that if sufficient priority is given to basic education, the participation rate can be improved notwithstanding further fiscal retrenchment.

We would also like to associate ourselves with other Directors in recognizing Saudi Arabia's continuing substantial assistance to developing countries, notwithstanding major cuts in overall government expenditures. On the revenue side, we also agree with other Directors and with the staff that the authorities should give favorable consideration to broadening the tax base. That could be the most effective way of reducing the remaining fiscal imbalances; it would also make for a more robust fiscal position in the event of any future fall in oil revenues.

To conclude, I feel that the authorities are to be commended on their exemplary record in regard to monetary policy. Despite substantial fiscal imbalances over the past several years, the rate of inflation has remained extremely low. Similarly, in light of the substantial growth of non-oil imports in the past year, the level of the exchange rate appears to us to be appropriate.

Mr. Evans said that he agreed with the staff and with Mr. Nimatallah that the Saudi authorities had handled well their considerable adjustment task of the 1980s. Nevertheless, significant problems remained, centered on fiscal policy. The improvements expected in 1989 were to be welcomed, although it must be noted that they primarily reflected short-term developments, leaving a structural fiscal problem intact. If the budget deficit were to remain as large as projected by the staff, some 13 percent of GDP over an indefinite period, the authorities would need to institute the reform of domestic capital markets to ensure noninflationary financing. That would appear to require a change in the authorities' attitude to the cost of borrowing. Mr. Hogeweg's excellent analysis suggested that the staff could provide greater assistance to the Saudi authorities on that issue.

More fundamentally, of course, the fiscal deficit itself should be tackled, Mr. Evans considered. Given the degree of expenditure restraint already achieved, revenue enhancement would seem to be the most fruitful method of accomplishing further fiscal adjustment, notwithstanding the authorities' reservations regarding the introduction of domestic taxes. But more could be done in respect of expenditure. In particular, while spending on subsidies had declined somewhat, the staff saw no prospects for further declines. Table 38 of the background paper indicated that the only subsidies in which major cuts had not been made were those for wheat and social relief payments. Leaving the latter aside, the continuation of substantial subsidies to wheat growers, who were paid three times the world price, was a matter of considerable concern. Not surprisingly, there was a substantial excess of production over domestic consumption, with the surplus being exported. Consequently, as Mr. Noonan had noted, Saudi Arabia had become the world's sixth largest wheat exporter and, to achieve that distinction, had rapidly increased its use of nonrenewable water resources. Clearly, wheat was a product in which Saudi Arabia had no comparative advantage--there were insufficient "rainy days," to use Mr. Nimatallah's metaphor--and its production involved high economic costs. It was to be hoped that the authorities' stated commitment to pursue liberal economic policies through reliance on price signals and market forces would extend to the early phasing out of wheat subsidies. Mr. Nimatallah was, of course, justified in his criticism of the effects of protectionism on his country's exports; but an equally valid case could be made in respect of Saudi Arabia's wheat exports.

In concluding, Mr. Evans said that he joined previous speakers in commending the Saudi authorities for the considerable contribution they were continuing to make to global economic development.

Mr. Lombardo made the following statement:

Saudi Arabia's adjustment to the changing conditions in oil markets during the decade of the 1980s has been commendable; in fact, it is particularly remarkable, considering the dramatic fluctuations in petroleum prices during the last 20 years. In this context, Saudi Arabia has adopted a cautious and prudent policy stance, in the domestic, as well as on the external front, where it was able to play an important role in the international financial community. The progress made in the development and diversification of its oil-based economy, creating a modern infrastructure, has also been impressive.

Therefore, I wish to concentrate my comments on three issues that have caught my attention: fiscal policy in a medium-term perspective; trade policies and the issue of protectionism; and official development assistance.

Regarding the medium term, the staff report presents the projections discussed with the authorities, which assumed budget

deficits in the range of 13 to 14 percent of GDP for forthcoming years, consistent with the stance of fiscal restraint re-established in 1988. As indicated by the Director of the Middle Eastern Department and Mr. Nimatallah, the result would be a much lower deficit for 1989. Nevertheless, the deficits assumed in the staff report would lead to a rapid accumulation of public debt, to reach about 70 percent of GDP by 1993, with a consequent increase in service charges that would represent about 12 percent of total expenditures at the end of the period. This deficit would be expected to be financed through bond sales which, in our view, implies several problems.

The first one is the amount of the deficit which, independent of the financing, would generate either a reduction in reserves, or a high debt burden for the public sector, calling for a further tightening in fiscal policy. Given the objective of promoting private activities, the room for tax measures would appear limited, requiring additional expenditure restraint. In this regard, public expenditures of well over 50 percent of GDP in recent years should permit some margin for maneuver.

The option of financing the deficit through bond sales is also limited by the impossibility so far to place government bonds outside the banking system. In this respect, the restriction on bond sales to nonresidents seemed to be a prudent measure. An enhancement of the instrument would be appropriate, in order to achieve a broader participation and the development of a secondary market. However, we share the staff's view that the result should not be to put additional pressure on the cost of domestic borrowing and consequently on the burden of public sector debt. Furthermore, from the point of view of credit flows in the economy, there is the risk of crowding out of the private sector, which could endanger the objective of promoting private sector activities in the economy.

All these limitations lead to the conclusion that the assumed level of fiscal deficit is not sustainable in the medium term, and could be inconsistent with the prudent economic management adopted by the Saudi Arabian authorities so far. In this regard, we share the staff's position on the desirability of pursuing fiscal reform over the medium term.

To turn to the issue of trade policies, we have noted the authorities' interest in emphasizing bilateral and regional trading arrangements, like the trade accord with the European Community concluded in June 1988. In this regard, we hope that the most-favored-nation treatment and a free trade agreement can be reached not only on a bilateral or a regional basis, but on a broader, multilateral level. We note the importance attached

by the authorities to the completion of the negotiations of the Uruguay Round, and we encourage Saudi Arabia to become a full member of the GATT.

Finally, let me conclude by commending the Saudi Arabian authorities for their generous economic assistance to developing countries. We encourage them to maintain--as a minimum--the level programmed for 1989 in the coming years.

Mr. Enoch made the following statement:

The year 1988 was another difficult one for the Saudi economy; the sharp decline in oil prices was obviously very unhelpful to the authorities' sustained and committed efforts to deal with their twin deficits. It is to their credit that they have persisted with their adjustment strategy through this period.

On the external side, the prospects for the current account this year and beyond are improved by firmer oil prices and the price stability projected by the staff. However, while the updated developments reported by the Director of the Middle Eastern Department indicate a further improvement, prospects do remain extremely vulnerable to the inherent instability of oil prices, and will continue to be so despite the sustained upward trend in other forms of exports.

Moreover, a significant part of the balance of trade improvement is projected in the staff report to be offset by a deterioration in the balance of services and private transfers. Particularly noticeable is the reversal this year in the declining trend in government overseas payments. Would the staff have any detailed information on what is behind this? I would also be interested to know why other service payments are expected to rise again after their sharp contraction in recent years.

The financing of the deficit was achieved by a rundown last year in the foreign asset holdings of both the autonomous government institutions and SAMA. Clearly, such a rundown cannot continue indefinitely. In 1988, SAMA's foreign assets were largely maintained by purchases from the AGIs, which have sold their assets to SAMA in order to purchase government bonds. But as the staff report recognizes, this does nothing to preserve total public sector holdings of foreign assets. Regarding these sales, I found it a little surprising that while the staff report states that the AGIs purchased 75 percent of the bonds issued--financed largely by sales of foreign assets to SAMA--it reports also that the sale of such assets by AGIs

amounted to only \$5 billion, compared with \$11.3 billion of bonds purchased. Presumably, the difference is accounted for by continued growth in the AGI balance sheets.

The sale of bonds in 1988 was a major innovation, which had become increasingly necessary as successive deficits drained deposit holdings with SAMA. Welcome as these new debt instruments are, they should not be considered as a panacea for budgetary difficulties. The staff analysis of the medium-term outlook places appropriate emphasis on bonds as a temporary expedient. The most important task is to reduce the fiscal deficit further, and in this respect I was disappointed that Table 1 of SM/89/145 does not reveal more action to generate non-oil revenue.

On the expenditure side, I note that Table 1 indicates a sharp reduction in spending in 1988. However, I also note the staff's expectation that 1989 spending budgets are likely to be exceeded by not insignificant margins, although Mr. Nimatallah was rather more optimistic in his statement and his additional remarks. As for the sources of the reduction in spending, project expenditure seems to bear the main brunt. The background paper reports that this is in part the result of delaying project implementation, but also reflects payment normalization after the settlement of payments arrears in 1987. Another contributor to restraint is the lower level of subsidy payments; but I was disturbed to learn from the discussion of the agricultural sector in the background paper that not only have various indirect subsidies been available, but there have also been increased subsidies "outside the budget." I would welcome further comment from staff as to what these subsidies are and how they are financed.

Whatever the mechanics of the budget, Table 1 shows that the fiscal deficit is expected to be unchanged as a proportion of GDP through 1993, and financing is projected to depend entirely on bond sales. I have a few comments in this respect, in line with points already made by several other Directors. First, Table 1 shows, if these projections are realized, how rapidly total debt will accumulate, from nothing in 1987 to 73 percent of GDP in 1993. Second, these projections of the deficit are highly vulnerable to adverse developments, so the Saudi authorities need to have additional, contingent policies in mind in case the outturn is substantially less favorable. Third, the projections assume that these volumes of debt can be sold. Yet 75 percent of bond sales in 1988 were to the AGIs, and the staff report notes that efforts to place bonds more widely have met with only limited success. If the rate of acquisition of bonds by AGIs has been maintained in 1989, then by the end of the year they will hold SRls 64 billion's worth of

bonds, which compares with their balance sheet of SRIs 124 billion at end-1987. The information given to the Board today suggests that hopefully the rate of accumulation this year will be somewhat slower than this. In any case, there must be some doubt as to whether AGIs can continue to run down foreign assets at the recent pace. I understand that the General Organization for Social Insurance in particular has considerable foreign liabilities in the form of commitments to pensioners overseas or former workers entitled to contribution refunds.

It also seems that the mechanism of deficit financing might be somewhat artificial. The authorities began to issue bonds because of a legal restriction on borrowing from SAMA. As Mr. Hogeweg and Mr. Yamazaki have already noted, however, if the AGIs are purchasing bonds with the local currency proceeds of sales of foreign assets to SAMA, this would seem to amount to the same thing. I see in the background paper that the staff recognizes that the monetary implications of the deficit financing are unclear, but it seems that sales to the AGIs do have a monetary impact. I would welcome further staff comment on this.

Judging by the initial experience with bond sales, the authorities may have to take further steps to make bonds more attractive, including higher yields. However, the rising debt-service burden will contribute to the deficit. I am not clear whether the staff has allowed for this in its projections.

Should domestic financing prove insufficient, the Saudi authorities clearly could turn to the international markets. I understand that the Public Investment Fund recently raised \$600 million from banks overseas, and would be interested to hear whether the staff or Mr. Nimatallah see significant scope for borrowing by other Saudi agencies.

Increasing the attractiveness and liquidity of bonds should be part and parcel of an increasingly active capital market, and I welcome the report in the background paper on recent economic developments that, as part of the shift of emphasis to private sector activity, venture-capital firms and a more active stock market are to be encouraged. These should serve to facilitate private capital inflows. The overall encouragement to the private sector envisaged in the Fifth Development Plan is very welcome, but I note that the authorities intend to continue support to the private sector, albeit more selectively than hitherto. In view of the fiscal position and the authorities' expressed desire to allow market forces to operate, I would have thought it appropriate to reduce such support considerably further.

An important factor in a more liberal economy is a strong banking system. The authorities have fortunately pursued this

objective with considerable rigor, through the activities of the Banking Disputes Council and SAMA's work in encouraging banks to strengthen their balance sheets.

I agree fully with the staff in commending the authorities for the way in which they have made immense adjustments in the face of massive external shocks. I also agree with the staff's assessment that there is no scope for any relaxation of their efforts.

Mr. Schioppa made the following statement:

Both the staff and Mr. Nimatallah duly underline the adjustment challenges faced by Saudi Arabia in the 1980s and the several positive results that the authorities have achieved in the process of restructuring the economy in the last few years. We can certainly share this overall positive assessment.

However, this is certainly not the time to slow down the adjustment efforts since the Saudi economy remains, in a way, fragile, with some problems yet to be solved that require careful attention on the part of the authorities. The outlook for the Saudi economy shows, in fact, an external deficit persisting over the medium term and a relatively high overall budget deficit. Moreover, and I would say, quite naturally, the economy remains highly dependent on its oil exports. These elements call for the authorities to continue to pursue wise diversification efforts and additional budget restraint. The timely adoption and the correct implementation of adjustment policies on the part of the authorities in the past warrants the expectation that the remaining problems the authorities are facing will be effectively and forcefully addressed.

Since I broadly share the analysis and comments in the staff appraisal, I will focus my attention on a few policy areas which, as I said, deserve careful attention.

The fiscal budget remains one area on which attention should be focused in order to reduce domestic absorption and limit external imbalances. During past years, the cuts in government expenditure have been profound and have played a central role in the process of adjustment. Yet, the overall budget deficit has been 19.0 percent of GDP in 1988, versus an estimate of 13.6 percent, and appears to remain about 13 percent for the next five years. If the estimate proves correct, public debt will increase to 70 percent of GDP by 1994. Some further reduction of the fiscal deficit in the coming years is therefore necessary, and should be brought about both by cutting expenditures and by strengthening and broadening the revenue side of the budget. In this respect, I fully share the staff's

point of view that the relatively favorable medium-term prospects for oil prices give the authorities a favorable opportunity for implementing a wide-ranging fiscal reform.

As far as the financing of the budget deficit is concerned, it is clear that it does not constitute a problem for the time being. In the medium term, a small budget deficit might even favor the development of an active domestic bond market, which, in turn, could enhance monetary policy in the near future. But, in order to facilitate the management of public debt in the medium term, I believe that nonbank residents should be encouraged to hold government bonds. In fact, an undue concentration of government bonds in the banks' portfolios could act as a serious constraint on the authorities, since, in circumstances which would call for an increase in interest rates, the authorities might feel obliged to refrain from such increases for fear of causing excessive losses to banks. In this regard, I note the authorities' concern that a wider participation on the part of nonbanks in the market for government bonds might require an increase in interest rates, thus aggravating the budget through a higher cost of borrowing. Of course, I do share the authorities' concern. Nevertheless, one should not forget that, in the medium term, the other alternative available to the Government for the purpose of funding its deficit is to borrow in the international capital market. But, even in this case, an increased cost of borrowing would be difficult to avoid in the face of an increasing demand for funds on the part of Saudi Arabia. In fact, the yield required by international investors would grow in line with the stock of debt. Moreover, the benefits of a well-developed domestic capital market would not materialize.

The other area which deserves careful monitoring is certainly the development of the non-oil sectors of the economy. While I am glad to learn that a number of positive results have been achieved in agriculture and industry, thanks to past policies, I believe that further economies in direct and indirect subsidies might be necessary. I think that, if implemented timely, such reduction might give incentive to the private sector to achieve higher levels of productivity, both in the primary and in the secondary sector. In this respect, I note that the new development plan duly takes into account the goal of developing a more efficient and self-reliant private sector.

Before concluding, I would like to commend the authorities for their continuous commitment to stabilizing the oil price.

Mr. Zhang said that he too wished to join previous speakers in commending the Saudi Arabian authorities for the success they had achieved

in undertaking economic adjustment in recent years since the slump in oil prices. It was encouraging to note that the authorities would continue to implement adjustment measures and make further efforts of fiscal and financial reform.

As for the medium-term outlook for Saudi Arabian economic development, Mr. Zhang said that he concurred with the staff in its analysis and recommendations. Budget deficits were expected to remain relatively high in the medium term, despite an improved outlook for oil revenues and the anticipated maintenance of expenditure restraints. It was very important, therefore, that the fiscal deficit be tackled by means of fundamental measures.

In recent years, Saudi Arabia had achieved rapid development and diversification of the non-oil economy, Mr. Zhang observed. The authorities had decided on a series of policies and measures to improve efficiency, productivity, and competitiveness. He was in full agreement with the view expressed by Mr. Nimatallah in his statement on the development of Saudi Arabia's trade. It was indeed crucial for the international community to improve the environment for international trade and take steps to stem protectionist pressures.

The Saudi Arabian authorities were also to be commended for generously providing concessional economic assistance to other developing countries. The authorities had also stated that, in the coming years, their official development assistance would be maintained at approximately the same level as for 1989.

Mr. Santos made the following statement:

Like previous speakers, we commend the Saudi authorities for their resolve in implementing their program of economic and financial adjustment which, over the past five years, has enabled the country to cope with a severe loss in export revenue without major disruptions to the economy. Above all, this adjustment has been achieved in an environment of relative price stability and without recourse to controls. This, in itself, is quite remarkable, given the magnitude of the adjustment. Furthermore, and as noted by Mr. Nimatallah in his statement, the authorities have also implemented important structural measures which have increased the contribution of the non-oil sector to total output as well as encouraged the participation of the private sector in the economy. These are indeed major achievements which should help the economy to adjust faster to lower oil revenues. We note also that, although there was an improvement in revenue in 1988 and in the first part of 1989, the adjustment efforts have been maintained and even intensified in certain areas. As a result, internal and external imbalances have been further reduced and the economy is estimated to have registered a 6 percent increase in real output in 1988 with a further expansion expected in 1989.

After these general remarks, and since I can concur with the staff's appraisal, let me just add some brief comments on the fiscal and external sectors.

In the fiscal sector, we welcome the continued improvement in the budgetary situation in 1988 as well as the favorable outlook projected for 1989. This performance, brought about mainly by substantial and broad-based cuts in expenditures, indicates the significant progress made in controlling outlays, especially subsidies. Nevertheless, as the staff indicates, for the medium term, the fiscal outlook could turn out to be less favorable if no additional measures are taken. In the circumstances, and given the instability of the oil market and the limited scope for further reduction in expenditure, we would encourage the authorities to maintain their vigorous efforts to control expenditure and to consider additional revenue-raising measures. In this context, information provided earlier this morning by Mr. Nimatallah and the staff on fiscal performance during the first half of 1989 can only augur well for the future.

In the external sector, we note that larger export earnings will reduce further the current account deficit, which, as announced by Mr. Nimatallah, is expected to be brought close to balance as early as the end of 1989. While a strengthening in the price of oil is mainly responsible for this outcome, we are pleased to note the increasing contribution of the non-oil sector to this development, which also reflects the successful efforts of the authorities at diversifying the economy. The recent relaxation of a number of restrictions by Saudi Arabia's trading partners on some of its exports is welcome and should help to improve further the external sector position. But, as stated by the staff, there are still other impediments to Saudi Arabia's exports in many industrial countries. The diversification of the Saudi economy can only succeed if industrial countries' markets remain open to Saudi Arabia's exports. On exchange rates, the flexible exchange rate policy followed by the authorities has been appropriate and consistent with their macroeconomic objectives.

The medium-term outlook highlights the necessity for the Saudi authorities to continue with the adjustment efforts. In view of the uncertainty of the oil market, we fully agree with the staff on the need "for considerable caution in policy formulation as well as continued flexibility and pragmatism in implementation."

Finally, I wish to associate myself with other Directors in commending the Saudi authorities for maintaining their high level of financial assistance to other developing countries, and their role in supporting the international monetary system.

Mr. Kabbaj made the following statement:

In facing the rather sharp drop in oil revenues, the Saudi Arabian authorities have been undertaking appropriate adjustment measures to overcome the economic and financial difficulties described by Mr. Nimatallah in his statement. Indeed, the authorities have implemented in a timely fashion a policy of sustained fiscal restraint that controlled budgetary expenditures and broadened the tax base so as to expand revenues from domestic sources. In fact, the authorities' prudent reserve management policy has successfully mitigated the adverse impacts on the economy of falling oil revenues. The authorities deserve to be commended for all these adjustment efforts.

Since we are in broad agreement with the staff appraisal and with the thrust of Mr. Nimatallah's statement, my comments will be brief. Indeed, Saudi Arabia continues to face considerable challenges in the future in coping with the drawdowns of SAMA's foreign assets and to diversify the economy so as to depend less on oil revenues. To achieve these objectives, needless to say the implementation of appropriate fiscal and monetary policies is crucial.

A policy of fiscal restraint should be continued in order to achieve the authorities' objective of attaining internal balance. It also seems advisable, if feasible, to further broaden the tax base so as to reduce the fiscal deficit, which is anticipated to account for about 13 percent of GDP in 1989 as noted in the staff report. In this respect, the recent measures implemented are definitely steps in the right direction. The further streamlining and rationalizing of expenditures could also be complementary factors in containing the deficit.

To ensure the achievement of internal and external objectives, it is vital that the authorities continue to consolidate the monetary instruments already put in place. In this regard, it is interesting to note the willingness of the authorities to further enhance the bond scheme. We welcome this step, which is in the right direction and which would encourage private sector saving and develop the domestic capital market. Furthermore, the bond scheme in addition to an appropriate exchange rate, could ease pressures on SAMA's reserves, facilitate the financing of the budget deficit, and improve the balance of payments position. Accordingly, the monetary authorities are to be commended for prudent reserve management and a flexible exchange rate policy which could enhance the competitiveness of the economy.

During the past few years, we noted the efforts of the Saudi Arabian authorities to develop the non-oil sector so as to diversify the economy and to boost non-oil exports. These

efforts are aimed at lessening dependence on oil revenues and promoting the private sector. Further developments in this area should be encouraged with a view to consolidating the existing gains and improving efficiency, productivity, and competitiveness in the economy.

Moreover, the authorities, while protecting the infant industries, are obviously committed to a market-based economy. In this respect, it is important to note that Saudi Arabia continues to maintain its economy open, despite the restrictive trade policies of some of its partners. Even in the labor market where there is some unemployment among nationals, Saudi Arabia has maintained its liberal policies concerning the use of foreign manpower.

Finally, we would like to commend the authorities for preserving their high level of foreign aid policy and for their cooperation with the Fund and the international financial community at large.

The Director of the Middle Eastern Department said that because the riyal was tied to the U.S. dollar, which had appreciated during 1988, the expectation of a depreciation of the riyal had led to speculation against the currency and to a sharp increase in nonbank financing during the year. The evidence for such speculation, which had gathered momentum for a while, could be seen in the increase in interest rates on riyals compared with U.S. dollar interest rates.

As for capital movements, the only information available to the staff related to the bond issue of about SRls 25 billion in 1989, the Director added. Whereas in the course of 1988, the bonds had been purchased mainly by the AGIs, and not on a net basis by the banking system, there were some data to indicate that the banking system was participating more actively in purchasing bonds in 1989. To the extent that the banking sector sold foreign exchange to purchase bonds, a capital inflow resulted. The Government was in fact anxious to have private sector participation in the bond market, and had actually encouraged banks to engage in activities of a mutual-fund type for that purpose.

Data on private sector savings were not disaggregated by the private and public sector, the Director commented. Much more work on statistics needed to be done and, given the importance of the Saudi Arabian economy, the staff hoped to be able to present more detailed statistics on major variables to the Board in the years ahead.

There was no income tax in Saudi Arabia, the Director observed. The reluctance of Saudi Arabia to impose direct taxes had been discussed with the authorities on a number of occasions. In the recent past, the authorities had announced their intention to introduce some form of direct

taxation, which had however not been well received and the measure had had to be repealed. Cultural factors certainly had to be taken into account when the staff recommended different forms of taxation to a government.

Mr. Nimatallah recalled that he had referred to the tax issue on a previous occasion when he had explained that the Government's oil revenue was viewed as a tax because the oil and the revenue from its sale belonged to the people. The Government managed the people's resources, and it was only when citizens demanded a level of services that could not be supported by oil revenue that the Government would reach the point of having to consider imposing direct income taxation. Meanwhile, the payment to the Government of revenue from oil sales represented the payment of income taxes.

The Director of the Middle Eastern Department said that subsidies that were not reflected in the budget included free land and water for agriculture; subsidized land leases for industry; low domestic fuel prices, especially for agriculture and industry; and interest-free loans for agriculture, industry, and housing. In discussing Saudi Arabia's method of financing its budget deficit, it was necessary to keep in mind the major policy objective of the Government, namely, preserving the reserves of SAMA, given the vulnerability of foreign exchange receipts to developments in the oil sector. As shown in the staff scenario, if receipts were to fall during the period 1989-93 by 15 percent a year, rather than remaining constant in real terms as projected, the overall deficit would be about \$40 billion, or slightly below the current level of foreign exchange reserves.

In 1988, the Government, for the first time, had resorted to borrowing, the Director said. The foreign asset holdings of AGIs, including the social security fund and the pension fund, were considered to be official foreign assets. To the extent that the AGIs financed the purchase of bonds by selling foreign exchange, there was a decline in official foreign assets but not a decline in SAMA's reserves. Commercial bank holdings of foreign exchange were not considered part of official reserves, although if banks sold foreign exchange to buy riyal-denominated bonds--which they had begun to do in 1989--their holdings of foreign assets would decline, and liquidity would be injected into the economy. For that reason, the staff had emphasized in the consultation discussions in both the previous and current year that it was necessary to tackle the fundamental problem of the budget deficit. It was true, as had been mentioned by Mr. Jalan, that it was really a matter of the composition of the expenditure leading to the budget deficit. Also, Saudi Arabia had the option of investing its resources abroad or domestically. Saudi Arabia had chosen domestic investment, which might well be a desirable course of action, but it would lead to a budget deficit. If the investment was productive, the borrowing and the reduction in reserves would be of less concern.

The staff's appraisal of the medium-term outlook for Saudi Arabia should not be viewed as pessimistic, the Director commented. Indeed, it should be revised to reflect more favorable developments in 1989, but that

revision could not be made until the data and the reasons for the deviations from the staff's projections, which had been made only a few months previously, had been analyzed by the staff.

It was not surprising that external service payments had declined significantly in the balance of payments in 1988, the Director explained, since total government expenditures had declined by 27 percent. In addition to the overall fiscal retrenchment evident in that year, the decline also partly reflected the authorities' efforts to rationalize and reduce the maintenance costs of government projects, which were leading to considerable savings. Moreover, there had been a shift from foreign to domestic providers of services as more domestic companies were established and others expanded, partly as a result of various government incentives. As for the increase in other service payments in the balance of payments for the period 1989-93, it was noted that that was projected from a low base, as such payments had declined in recent years, reflecting the stagnation of non-oil GDP, the decline in imports, and the related reduction in freight and insurance payments. The latter factors would not operate in the years ahead; imports were expected to rise and non-oil GDP was expected to grow, thereby contributing to the moderate growth in service payments.

The borrowing undertaken by the Public Investment Fund during 1989, amounting to the equivalent of \$660 million, was a foreign exchange liability of the Government but not a foreign liability, because the loan had been floated and subscribed to by Saudi banks, the Director explained. In response to a question by the Chairman, he commented that the action, the reasons for which were not clear to the staff, had been taken after the completion of the consultation discussions. There was considerable scope for other Saudi agencies to borrow, if they wished to do so. Saudi Arabia's creditworthiness was quite high, and it had no foreign debt to speak of.

The structural changes that were taking place in the Saudi Arabian economy had come about largely as a result of the sharp decline in imports, the Director of the Middle Eastern Department explained. In the late 1970s and early 1980s, a significant proportion of non-oil income had been generated by the services sector, related to the boom in imports. The services sector was no longer basically associated with trade, but had diversified and acquired both a broader base and a higher level of sophistication, especially in the areas of financial and maintenance services. In addition, there had been a shift in non-oil GDP from services, or nontradables, to tradable goods.

Mr. Nimatallah said that he wished to respond to four points that had been made by Directors, whose comments he would convey to his authorities.

First, it was only a question of time before Saudi Arabia became a contracting party to the GATT, Mr. Nimatallah remarked. The matter was before the Council of Ministers, and he understood that the Minister

responsible was keen for Saudi Arabia to become a full member. Meanwhile, Saudi Arabia had an observer--who was also an active participant--at the GATT.

When the Government had first decided to borrow domestically, it had done so for productive purposes, Mr. Nimatallah explained. The reason was twofold: to avoid the problems attendant on borrowing, such as inflation, and interest payments. Therefore, the bonds had been issued as development bonds, with the objective of balancing the return on development with the remuneration paid on the amounts borrowed. It seemed useful to give investors, particularly AGIs which used to invest their resources abroad, the opportunity to divert their resources to productive, domestic investment. However, he agreed with those who had stated that borrowing must be a temporary arrangement and that the fiscal deficit must be brought down as fast as possible.

As for taxes, Mr. Nimatallah said that he wished to emphasize the efforts of his authorities to enhance revenue. The increase in non-oil revenues by 11 percent in 1988 was impressive, especially as it was derived from user fees. As he had already mentioned, oil revenue, which was increasing fast, was considered to be an income tax because oil resources--and even foreign reserves--belonged to the people. There would be a reluctance to impose taxes as long as the country had external assets and reserves. The outlook for 1989 looked good, and that for the following year or two should be even better. If it came to the point of having to decide whether people would accept further cuts in services and increases in utility rates and other fees, should external resources no longer be available in sufficient quantities to maintain them at the level existing at the time, the issue of introducing direct taxation of some kind would have to be discussed. It was not that Saudi Arabia was opposed to income or direct taxes; rather, it was attempting to delay the consideration of such taxation until it was needed, and so far, it had not seemed necessary. He did not think that the Government would resort to external borrowing.

As for subsidies, he hoped that the proposal made by former President Reagan, for a 10-year program of reducing agricultural subsidies, would go into effect one day, Mr. Nimatallah stated. It was not equitable for so many countries to subsidize their agricultural sectors and at the same time to accuse each other, in the name of fair trade, of not being willing to reduce or eliminate subsidies. He recognized that by its nature, the agricultural sector was a harsh one for those working in it; but at the same time, there were limits to the extent of subsidization. Countries should globally accept their responsibility for such subsidies, or should collectively work to reduce or to eliminate them. A global undertaking to eliminate excessive subsidies would contribute to the structural adjustment efforts of developing countries, promote sustained growth of their economies, enhance their export capacity, and thus help them to tackle their debt problems.

The Chairman made the following summing up:

The Executive Directors generally endorsed the staff appraisal and the adjustment strategy implemented by Saudi Arabia in recent years in response to protracted weakness and uncertainty in the world oil market. They commended the authorities for the magnitude of the adjustment that had been accomplished and for the method that had been followed, noting also the steadfastness of the authorities in adhering to their policy reforms and their resistance to pressures for increased support and protection. The recovery of economic activity in 1988 and 1989 in a climate of price stability was an illustration of the success of the adjustment efforts, and Directors welcomed the indications that the external current account deficit and the fiscal deficit for 1989 may remain well below the forecast levels.

While the outlook for the world oil market appeared favorable to Saudi Arabia at this time, there would be little latitude for any relaxation of the current adjustment efforts, in the view of most Directors. Indeed, they encouraged the Saudi authorities to build on the progress in adjustment and structural reform realized so far through a consolidation and broadening of the existing strategy, which focuses on fiscal restraint while strengthening the medium-term prospects for economic diversification through the private sector as envisaged in the next development plan.

Directors endorsed the thrust of the 1989 budget. They noted, however, that while the projected budgetary deficits over the medium term were expected to decline from the levels of the past few years, they would remain relatively high and their financing carried the risks of crowding out the private sector and of encumbering future budgets with burgeoning debt-service costs.

For these reasons, Directors attached great importance to the pursuit of fiscal reforms over the medium term. In this regard, Directors strongly encouraged the authorities to make further progress in reducing budgetary subsidies, and to strengthen efforts to improve the quality and composition of government spending. In addition, most Directors were of the view that fiscal reform should also encompass measures to broaden the revenue base. While noting the traditional reluctance of the Saudi authorities to broaden the tax base, Directors encouraged the authorities to consider forms of income and consumption taxes, in addition to raising utility rates and fees for public services.

In order to meet the projected external and fiscal financing requirements while minimizing, as intended by the authorities, the further drawdown of official foreign assets, the authorities will need to tap the foreign assets of commercial banks and the nonbank private sector. To this end, Directors encouraged the authorities to improve the attractiveness of government securities and to pursue policies aimed at assuring adequate incentives and at maintaining the confidence of the private sector. A few Directors drew the attention of the authorities to the monetary character of some of the present methods of deficit financing and to the projected rapid pace of increase in the public debt which they regarded as worrisome.

Several Directors believed that Saudi Arabia's position in the world economy called for a strengthening of its statistical base, including improved currentness. In the same vein, it was suggested that future staff reports could usefully give more emphasis to structural problems and reforms such as the labor market, agricultural and industrial policies, and the program of privatization.

Directors generally welcomed Saudi Arabia's oil policy which will continue to support stability of oil markets and prices, and they praised warmly its generous development assistance. Several Directors emphasized the importance of unrestricted access for Saudi Arabian exports to foreign markets.

Directors felt that Saudi Arabia's exchange rate policy over the past few years had been generally consistent with the need to adjust to lower export earnings, with the emphasis on the development of the non-oil sector, the rationalization of resource allocation, and the avoidance of exchange rate instability.

The next Article IV consultation with Saudi Arabia is expected to be held on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/148 (11/15/89) and EBM/89/149 (11/17/89).

2. COMPENSATORY AND CONTINGENCY FINANCING FACILITY - AMENDMENT

The Fund decides that in paragraphs 28, 41, and 47 of Decision No. 8955-(88/126), as amended, "December 1, 1989" shall be replaced by "January 15, 1990." (SM/89/234, 11/13/89)

Decision No. 9293-(89/149), adopted
November 16, 1989

3. ZIMBABWE - 1989 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure IV of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1989 Article IV consultation with Zimbabwe to not later than December 8, 1989. (EBD/89/351, 11/13/89).

Decision No. 9294-(89/149), adopted
November 15, 1989

4. RELATIONS WITH GATT - CONSULTATIONS WITH CONTRACTING PARTIES - FUND GUIDANCE

The Executive Board approves the recommendation by the Committee on Liaison with the CONTRACTING PARTIES to the GATT with regard to the guidance statement for the Fund representative attending the GATT consultation with Israel during the week of November 20, 1989, as set forth in EBD/89/298, Supplement 1 (11/13/89).

Decision No. 9295-(89/149), adopted
November 16, 1989

5. BURKINA FASO - TECHNICAL ASSISTANCE

In response to a request from the Burkinabe authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/89/352 (11/13/89).

Adopted November 16, 1989

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 89/47 and 89/48 are approved. (EBD/89/349, 11/10/89)

Adopted November 16, 1989

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/89/268 (11/14/89) and EBAP/89/271 (11/15/89), and by an Advisor to Executive Director as set forth in EBAP/89/268 (11/14/89) is approved.

APPROVED: July 5, 1990

LEO VAN HOUTVEN
Secretary