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Minutes of Executive Board Meeting 88/149

10:00 a.m., September 16, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	
	C. Enoch
	Shao Z., Temporary
	D. C. Templeman, Temporary
	E. L. Walker, Temporary
J. de Groote	J. Prader
	M. Hepp, Temporary
	A. M. Othman
G. Grosche	B. Goos
	A. Iljas, Temporary
	J. E. Zeas, Temporary
	D. McCormack
	J. Gold, Temporary
	K. Kpetigo, Temporary
	I. A. Al-Assaf
G. Ortiz	L. Filardo
	C. Noriega, Temporary
	M. Fogelholm
	M. Pétursson, Temporary
	G. Pineau, Temporary
	G. P. J. Hogeweg
C. R. Rye	
G. Salehkhou	
	V. K. Malhotra, Temporary
	S. Yoshikuni
	T. Morita, Temporary
	S. Rebecchini, Temporary

C. Brachet, Acting Secretary
L. Collier, Assistant

<u>Also Present</u>

IBRD: E.-C. Hwa, Latin America and the Caribbean Regional Office; P. Nouvel, Europe, Middle East and North Africa Regional Office. Asian Department: K. Bartholdy. European Department: P. B. de Fontenay, Deputy Director; P. Beaugrand, G. Bélanger, L. Hansen, R. G. Manison, J. Somogyi. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; P. A. Acquah, E. Brau, A. Leipold, M. H. Rodlauer. Fiscal Affairs Department: T. Ter-Minassian, Deputy Director; A. Cheasty. Legal Department: J. W. Head, J. V. Surr. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; E. DeCarli, L. A. Cardemil, R. A. Elson, G. R. LeFort. Advisors to Executive Directors: K. Kapetanović, K.-H. Kleine, P. D. Péroz, P. Péterfalvy. Assistants to Executive Directors: J. R. N. Almeida, R. Comotto, C. L. Haynes, J. Heywood, M. A. Khylberg, W. K. Parmena, S. Rouai, C. C. A. van den Berg, R. Wenzel.

1. HUNGARY - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report (EBS/88/174, 8/18/88) for the first review under the stand-by arrangement for Hungary approved on May 16, 1988.

The staff representative from the European Department stated that all the performance criteria for end-June had been met and the corresponding purchase had been made.

Mr. de Groote made the following statement:

> The Hungarian program is on track. This is a matter of satisfaction not only for my Hungarian authorities but undoubtedly also for my colleagues in this Board, who had expressed legitimate concern during the period of uncertainty before the new program was set into operation under the Fund's guidance.
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> The staff report indicates clearly that there is good reason to believe that Hungary's performance will remain satisfactory in the future. An important contribution to further progress will be made by the implementation of the new commercial legislation--Law of Association. After nationwide debate, this Law will shortly be introduced in Parliament, where it will be discussed in October. The envisaged reform of company ownership and corporate taxation will give equal treatment to the state, cooperative, and private sectors. Individuals will have the freedom to set up joint stock companies or limited liability companies and to acquire shares in state companies, which will be transformed into joint stock companies.
>
> Along the route to further liberalization of the economy, added steps will have to be taken in the area of import liberalization. In spite of the progress already achieved, the transmission mechanism to the outside world remains weak: my Hungarian authorities are convinced that the productivity gap vis-à-vis Western Europe can be overcome only by increasing competition from imports.
>
> A strong consensus among all segments of public opinion is needed to achieve the complete transformation of the Hungarian economy into a full market system and to keep Hungary at the forefront of the reform movement among socialist countries. My Hungarian authorities fully realize the difficulty of achieving and maintaining such a consensus when some of the least popular aspects of the liberalization movement become apparent, such as unemployment and corrective price increases after the further elimination of subsidies.
>
> The necessary relationship between the consolidation of a decentralized economic decision-making process nationwide and

new advances on the political front in the democratization process is fully perceived in Hungary; the lesson is drawn from the experience in some neighboring countries, where economic reform seems to have met the obstacle of insufficient popular support because the process of political democratization is seen as too uncertain. The political and social mechanisms necessary to sustain the consensus needed to achieve full liberalization of the economy will therefore be set in place. Freedom of the press, the right to create independent trade unions, a system of genuine political pluralism, and parliamentary democracy will be essential components of this transformation.

Given the prospect of rapid further progress toward economic decentralization and of a stronger political basis to support this transformation, my Hungarian authorities, the Board, and management will have to assess whether there would be scope for stronger and more prolonged forms of cooperation between Hungary and the Fund.

Mr. Templeman made the following statement:

Hungary's performance under the current stand-by arrangement seems to be proceeding quite well, with all performance criteria met and with encouraging progress being made in the reform of the economy. We strongly urge the authorities to remain in firm compliance with their commitments through the remainder of the stand-by arrangement period. We particularly welcome the inclusion, as formal performance criteria, of commitments with regard to the new Law of Association and the reform of the wage system prior to release of the fourth tranche.

While continued careful macroeconomic policy management will be crucial to meet overall economic aims, we strongly endorse the staff report's emphasis on resolute and concurrent implementation of an array of structural reforms. In 1988, the introduction of the value-added tax, the new personal income tax, and the April price decontrol measure represent important steps in the three-year economic stabilization and reform effort now under way. Next year, the introduction of a new system of wage determination, the new Law of Association, the second round of price decontrols, adoption of a new system of corporate taxation, the integration of banking services offered to households and enterprises, and the gradual participation of commercial banks in the exchange market should all contribute importantly toward a more market-oriented and more efficient system for the allocation of resources.

The major current threat to the stable macroeconomic environment within which these reforms are being introduced consists of an incipient overheating of the economy owing to faster than anticipated business investment, some wage pressures, and the continued high liquidity preference of the household sector. Therefore, emphasis on achieving the quarterly targets for net household savings is fully warranted. The promptness with which the authorities have responded to indications that these end-June and end-September targets might not be met is commendable and essential. The increase in deposit interest rates, the creation of medium-term certificates of deposit with competitive yields, and increases in lending rates on credit to households are steps in the right direction. It also appears that some fundamental reforms of housing finance will be needed if a sufficient share of household savings is to be allocated toward productive business investment. No doubt, this is a sensitive matter, but staff suggestions to introduce more transparency in housing subsidization through direct budgetary expenditures and to concentrate on a more narrowly targeted part of the housing market seem well worth consideration.

The combination of financial market reforms and the new Law of Association should help to mobilize savings and increase the efficiency of investment. Specifically, the integration of banking services offered to the household and enterprise sectors and the gradual participation of the banks in the exchange market should contribute to development of a modern system of financial intermediation. Moreover, the broadening of corporate forms and types of ownership of business enterprises should help to create a nondiscriminatory environment for investment by all types of enterprises. We particularly welcome the increased role for private and foreign enterprises, including the possibility of full foreign ownership of enterprises, as a means to ensure greater competition and efficiency in the Hungarian economy.

We note the marked deceleration this year in the growth of credit and broad money aggregates. This is important in light of the considerable rise in prices expected this year and the danger of increasing inflationary expectations. We recognize that the introduction of the value-added tax and some cuts in price subsidization account for a considerable part of the anticipated rise in the inflation rate this year. But it is especially important to exercise careful control over global demand through market-oriented, demand-management policies as the reliance on direct controls is reduced. In fact, the continued liberalization of price controls and the new liberalization of the system of wage determination next year will make effective use of market-related monetary and fiscal policies even more crucial for the containment of overall demand.

Good progress has been made in the past couple of years in somewhat reducing the size of the General Government and in reducing the government deficit. But the overshooting of expenditures in the first half of 1988 warranted the actions taken in July to reduce some subsidy and transfer payments and to increase excise taxes and raise the price of gasoline. Continued resistance to pressures for government assistance to noncompetitive enterprises this year and the broad review of government expenditure priorities and the introduction of the new corporation tax next year will be important elements in the current implementation of prudent fiscal policy and in the creation over the longer term of a smaller but more efficient fiscal structure.

Hungarian performance with regard to current account adjustment seems to be proceeding on track this year. The real effective exchange rate depreciation of 25 percent since early 1985 appears to be helping exports, and continued exchange rate flexibility will be important in preserving Hungary's competitive position. Also important will be the achievement of a faster pace of trade liberalization than has occurred to date. Over the medium term, it should be possible for Hungary to balance its current account by 1990 and reduce its ratio of debt to GDP and its debt service ratio through 1993, while keeping its gross borrowing requirements below the excessively high levels of 1985-87. Of course, success in maintaining Hungary's external creditworthiness is likely to depend as much on the assessment of external creditors of Hungary's overall macroeconomic and structural reform efforts as on narrower balance of payments and debt ratios.

Finally, Mr. de Groote mentioned the interest of the Hungarian authorities in a longer-term arrangement with the Fund. While we cannot take a firm position at this time, if Hungary continues to perform well under this stand-by arrangement and is prepared to adopt an intensified program of economic reform, building forcefully on what has been accomplished--for example, by introducing substantial import liberalization--then a longer-term arrangement might be appropriate.

Mr. Enoch made the following statement:

As Mr. de Groote has noted, the Hungarian authorities have shown a laudably firm commitment to macroeconomic control and progressive structural reform in the early months of their three-year program. While the authorities benefited from a number of helpful external factors in the first half of 1988, they have also responded quickly and effectively to several unforeseen developments of a less helpful nature. Overall, performance against program objectives has been very satisfactory.

Nevertheless, within this generally satisfactory performance, a number of worrying features deserve comment. It is now clear that the buoyancy of demand seen toward the end of 1987 has carried through to the first half of 1988. In particular, there has been a substantial increase in fixed investment, fueled by a relatively strong enterprise liquidity position. The staff suggests that this investment boom is probably consistent with the desired shift in activity in favor of the more profitable sectors of the economy. I would be grateful for more information about this. Prima facie, a "restructuring" of activity should not necessarily require a considerable and unforeseen expansion in aggregate investment. Perhaps the effect is due to delays in restructuring the less profitable sectors; for example, there have been delays in restructuring the coal industry.

The authorities have now taken a number of welcome measures designed to slow down the rate of capital formation and to prevent overheating. The staff also refers in this context to a programmed tightening of credit conditions. This is somewhat puzzling because the recent surge in enterprise investment has apparently been financed mainly by own resources rather than by credit. Moreover, the staff also points out that the revised financial program permits a larger expansion of credit to enterprises than originally envisaged in the second half of 1988.

While overall monetary conditions have been broadly satisfactory in the first part of 1988, the low level of net household financial savings is a cause for concern; given the unexpected increase in investment demand, it is particularly important that private consumption should not grow more quickly than projected. The recent increase in deposit rates and the introduction of certificates of deposit are therefore extremely welcome, as is the tightening of household credit conditions. I am not clear, however, how the tightening of credit conditions will affect the buoyant demand for low-cost housing loans, which has presumably contributed to the increase in aggregate investment. As we have argued before, it is important to ensure that housing subsidies are channeled explicitly through the budget rather than through the banking sector, particularly given the impending integration of that sector.

The authorities also had to act swiftly to staunch a deteriorating fiscal position in the middle of the year caused, among other things, by higher enterprise subsidies and lower than anticipated income tax receipts. The steps taken by the authorities to keep the fiscal position on track are a particularly encouraging signal of their commitment to the program. Recently, however, the Deputy Finance Minister expressed a more pessimistic view; on September 6 he stated that the planned fiscal deficit of about Ft 10 billion was likely to be considerably exceeded this year. I would be interested in the staff's comments.

Improved terms of trade, lower debt service payments, and favorable demand conditions in external markets have contributed to an improved current account performance in the first half of 1988, despite the impact on imports of higher investment and the carry-over effect of imports in late 1987. The program target of a $500 million current account deficit for 1988 seems to be within reach. Indeed, if exogenous factors remain favorable on balance over the remaining months of the year, the authorities may be able to achieve an even lower deficit, provided that competitiveness is carefully monitored. This would be a particularly welcome development given the current and projected low level of reserves, and the need over the medium term to improve Hungary's external debt position.

Looking ahead to the structural program for 1989, it is clear that the authorities have set themselves a heavy and ambitious agenda of crucial reforms. This underlines the need for the authorities to maintain their firm grip on the macroeconomic environment so as to provide the best possible backdrop for the reform program.

A key theme of the proposed structural measures is the need for greater decentralization and liberalization throughout the economy, but in particular in the process of wage determination and in the legal and economic framework for business activity. These reforms are, of course, closely linked. The more commercial the business environment, the more powerful the incentives for wage differentiation. I hope that the new rights and opportunities envisaged under the proposed commercial legislation will be seized with enthusiasm. Apparently each enterprise can decide whether to transform itself into a new-style corporation. I would be interested to know what incentives will exist for state enterprises and cooperatives to convert, for example, into limited liability joint-stock companies. The mechanics of conversion will also be extremely interesting. It will clearly be important for the authorities to develop the existing somewhat rudimentary stock market to facilitate the raising of equity capital on a significant scale. It is commendable, too, that the authorities intend to make it easier for foreign investors to participate in the new business ventures.

I welcome the authorities' intention to remain in close contact with the staff over the coming months as they formulate concrete proposals in several other important areas. The preliminary plans to reduce subsidies to weak industries, to generally scale down the extent of government intervention in economic activity, and to introduce more equitable corporate taxation legislation will be an essential accompaniment to the new legal framework for business activity.

Similarly, the importance of accelerating the process of trade liberalization cannot be overstressed. This will provide an additional spur to improve allocative and productive efficiency and will no doubt reinforce Hungary's increasing links with the European Communities (EC).

In sum, the authorities have made good progress toward designing and implementing a major structural adjustment program that will touch every aspect of Hungary's economy. The success or failure of this economic revolution will depend upon the authorities' continued commitment to the reform process and to appropriate macroeconomic policies. Given their performance so far, the authorities deserve the continuing support of this institution, and I can therefore strongly support the proposed decision.

Mr. Rye made the following statement:

In May (EBM/88/78, 5/16/88), this chair wondered whether Hungary's planned measures went far enough, and we could reach a positive conclusion only with some hesitation. Such hesitation is, I am glad to say, no longer warranted.

Certainly, the authorities are tackling--or have in train the processes for tackling--all the key areas. The changes in wage determination, commercial legislation, and banking and fiscal reform are all in the right direction. One might have hoped, perhaps, for a more vigorous approach to trade liberalization, but if the authorities carry out their announced intentions for 1989, that will represent a significant step forward.

Progress in wage differentiation in 1988 was limited because of the overriding priority given to incomes policy considerations. This seems to have been the right decision against the background of a rather high inflation rate, which it was important not to build into the ongoing wage structure. But it is necessary also to keep up the momentum toward a more flexible wage system, and I note with satisfaction that the further reforms planned for January 1, 1989 are a performance criterion under the program. I would be interested in having any further information from the staff or Mr. de Groote on the implications of the intriguing footnote in the staff report concerning the "Wage Club."

Perhaps it is through commercial legislation that Hungary has set in train what are potentially the most fundamental reforms. It is remarkable to witness the beginnings of the transformation of a centrally planned economy through the wide variety of corporate forms that will be allowed and the raising of equity capital, including capital from the public at large. I wonder, like Mr. Enoch, what incentives there may be for managers of state enterprises and cooperatives to pursue these innovations vigorously and how soon they will take hold in practice. I imagine this may be dependent, to a large degree, on continuing public support for the whole liberalization process.

On banking reform, I agree with the crucial importance of rationalizing housing finance. I note the concern of the authorities about ensuring a sufficient flow of funds for housing loans, but to judge from experience in the admittedly very different environment of countries like Australia and New Zealand, liberalization in this area can be a lot less troublesome than previously feared. Lending for housing will always be an attractive proposition for banks--provided, of course, that interest rates are appropriately free--since homeowners are a stable part of the community, and equity in housing is a most secure asset.

While I have concentrated on the structural reforms, it is, as the staff states, of "equal importance" that "an appropriate demand-management framework" be maintained. So far under this program, the authorities have done well in this regard. In particular, they seem to have acted judiciously and firmly to combat fiscal slippage and to get the budget back on track. Now they have met all end-June performance criteria. It is vital that they continue to ensure that macroeconomic policies remain appropriate to changing circumstances.

This is a most gratifying report. Major changes in the Hungarian economy have been set in train, and we hope that the authorities will be able to maintain the spirit, as well as the letter, of the planned liberalization--to pursue, in the staff's words, "the establishment of a market environment which promotes effective competition and an efficient allocation of resources." We all watch with interest as the twin processes of economic and political liberalization go forward hand in hand. In these endeavors, the Hungarian authorities deserve our encouragement and support, and I am glad to support the proposed decision.

Mr. Grosche commented that it was encouraging that the program with Hungary was broadly on track. It had not been easy for the authorities to achieve those results, and some slippages had occurred in the implementation of the program. Expenditure had been higher than expected, and the greater than envisaged recourse to central bank financing of the budget was a cause for concern. The authorities had reacted promptly, however, and had taken the appropriate corrective actions. In particular, he welcomed the measures taken to restrain investment spending and the intention to tighten domestic credit for the remainder of 1988. Such actions should bring investment to more sustainable levels.

The staff was right in cautioning against excessive expenditures that would appear to yield only short-term growth effects while deepening imbalances in the medium run, Mr. Grosche continued. To restrain both investment and consumption, the establishment of adequate interest rates would be essential. The authorities had taken the first steps in that direction, but more remained to be done, and the authorities would be well advised to adopt the staff's recommendations as soon as possible. Doing so would make an important contribution toward more efficient resource utilization, and it would also strengthen the ability of the private sector to compete with the state sector, particularly if the latter no longer benefited from subsidies and other forms of preferential treatment.

On the external side, the better than expected outcome appeared to be more the result of a favorable external environment than of a stronger competitive position, Mr. Grosche commented. Indeed, external competitiveness had deteriorated with the depreciation of the dollar, and he wondered whether the depreciation of the forint in mid-July had been sufficient. In any case, the authorities should monitor developments closely and not preclude further, and especially early, action on the exchange rate. The flexible exchange rate policy would help to generate sufficient export savings to service external debt and to finance high-technology imports so as to bolster the restructuring of the economy. In that connection, he encouraged the authorities to press ahead with the liberalization of imports, thereby greatly enhancing domestic competition and resource allocation and keeping price pressures in check.

The Hungarian economy was undergoing a difficult period, but the steps already taken had been in the right direction and should encourage the authorities to continue their efforts, Mr. Grosche noted. A number of measures were not easy to implement owing to the burden they placed on certain segments of the population, at least in the short run, and efforts to explain what was being done and to reach a strong consensus among all parties concerned were extremely important. Mr. de Groote's statement was encouraging; the new attempts at consensus-making boded well for the future of reform in Hungary, and he was ready to consider favorably further support by the Fund. He supported the proposed decision.

Mr. Pineau made the following statement:

> The Fund-supported program adopted by the Hungarian authorities has been unfolding satisfactorily. Naturally, some strains were registered, but they never reached the point beyond which the program would have been threatened. Most of the

difficulties faced by the authorities were predictable and were, in fact, touched upon by the Board at the time of the adoption of the stand-by arrangement. This awareness of the obstacles that lie ahead should reinforce the authorities' determination to carry through their ambitious medium-term program.

The Hungarian authorities have to operate under domestic and external constraints. On the domestic side, it was clear at the program's start that the burden of the stabilization process would be borne by the household sector. However, the shift in favor of the corporate sector should not go too far, and in particular the continued buoyancy of capital formation should be better monitored, so as to avoid a serious misallocation of resources. Given the significant strengthening of the corporate sector's financial position, partly as a result of the recent tax reform, it would seem advisable to cut back subsidies further.

Another way of ensuring that the enterprises' investment decisions are well founded is to tighten monetary conditions. The modification of the program's targets in this area is most welcome, and further steps should be considered, in particular a more intensive use of interest rates.

The authorities should display more decisiveness in their conduct of interest rate policy. The maintenance of positive real interest rates is essential with regard to not only the investment decisions of enterprises but also the behavior of household savings. In the face of mounting inflationary pressures, the persistence of a strong preference for liquidity and the fact that the savings target has been missed are unambiguous signs that the present level of interest rates is inadequate.

A firm monetary stance is all the more appropriate as two significant structural reforms are about to be introduced. The new legislation on wages contains many positive features, among which the call for more differentiation is essential. Nonetheless, a cautious approach is needed if higher wages, granted in sectors with good performances, are not to generate a demonstration effect elsewhere in the economy. In this respect, the reform of commercial legislation appears to be an indispensable supplement, to the extent that it aims at enhancing competition and financial discipline within the corporate sector.

On the external side, recent developments are encouraging. The current account target for 1988 should be met, and Hungary is still able to raise new financing in the international market on rather favorable terms, but this situation should not promote complacency. Specifically, the authorities must keep the exchange rate under close scrutiny and be prepared to adjust it without delay, should a less favorable trend in the terms of trade emerge.

More fundamentally, it seems advisable to follow a more rapid path of external adjustment, in view of the need for import liberalization. This major step, which should be considered an integral part of the comprehensive structural adjustment program currently being carried out, requires a firmer restoration of external viability. Consequently, greater emphasis should be placed on a more sustained recovery of exports to create room for the necessary development of imports.

My authorities are confident that the current stand-by arrangement will continue to be carried out with the required determination to lay the basis for further and more far-reaching structural changes. From this perspective, a longer-term arrangement would deserve serious consideration by the Fund in the coming months.

Ms. Gold made the following statement:

I would like to congratulate the authorities for the favorable developments since approval of the stand-by arrangement in May. Instead of the projected small decline in investment, Hungary has had a minor investment boom, relatively higher consumer demand than initially projected, significant terms of trade gains, and a considerably stronger than expected performance with regard to both exports and imports. Although these positive developments have been accompanied by some less desirable factors, the authorities have responded in an effective and timely manner, and the ambitious liberalization and reform program is being implemented according to plan.

As we are in general agreement with the staff report and support the proposed decision, I will comment only on the quantitative financial performance criteria and external policies. The less positive developments since the approval of the program are related primarily to the acceleration of the inflation rate--by 3-4 percent--and significant slippages in the state budget deficit in the second quarter. The acceleration in inflation appears to be evidence of some overheating of the economy, which in part was a result of the stimulative fiscal stance. However, the slippages in the budget deficit did not prevent compliance with the quantitative performance criteria. The budget's greater recourse to bank financing was offset by lower refinancing credits to the State Development Institution (SDI) so that the joint ceiling on bank credit to the budget and SDI is expected to be met. Perhaps the staff could comment on whether separate performance criteria--one for bank credit to the budget and one for SDI--would be more appropriate to prevent further fiscal slippages.

Corrective measures have now been taken on the fiscal side and, as a result, the deficit target for the year as a whole is expected to be met. We are also assured by the authorities' seeming willingness to take further action if any new slippages develop. In light of the excess demand evidenced through the second quarter of the year, some additional measures beyond those required to meet the end-of-the-year budget target may be warranted.

We agree with the staff's downward revision of the ceiling on the net domestic assets of the banking system. According to the staff report, the reason for this revision is to take into account the enterprises' lower demand for financial assets. We wonder, however, whether the higher than expected inflation rate would not also justify some further tightening of monetary conditions, including an increase in real interest rates.

With regard to external policies, we commend the authorities on the timely devaluation of the exchange rate in July and urge them to continue to follow a flexible strategy to maintain external competitiveness. We are also pleased to note that the authorities are in the initial stages of preparing an import liberalization plan to begin in 1989, particularly since the absence of such a plan in the program was of serious concern to us in May. Like other Directors, we encourage the authorities to give this task the high priority it deserves, and to bring the work to as early a conclusion as possible. While import liberalization may initially increase pressures on the external account, it will, in the medium term, facilitate the authorities' overall efforts to modernize the economy, increase efficiency, and improve Hungary's competitive position.

Mr. Shao noted that under the current Fund stand-by arrangement, the Hungarian authorities had devoted their efforts to economic reform, and the resulting performance had been satisfactory. To further improve Hungary's economic situation, the Government intended, under a new three-year economic program, to focus on promoting effective competition and the efficient allocation of resources. Owing to the Government's economic policies, progress had been made on several economic fronts: the external payments position had improved; the high level of external debt had eased; and the structural reforms in the banking, fiscal, and trade sectors were proceeding, although some difficulties and uncertainties remained.

The authorities should be highly commended not only for their determination but also for their courage in pioneering a novel economic reform, Mr. Shao commented. Many obstacles to the ongoing economic restructuring could be expected. With that in mind, Fund financial support should be considered while acknowledging the unique characteristics of Hungary's economic reform. With regard to the review under the stand-by arrangement, he could go along with the staff's appraisal and he supported the proposed decision.

Mr. Rebecchini said that he was pleased to note that the Hungarian program was on track and that reforms had proceeded on schedule. Even more important, where weaknesses had emerged--such as the fiscal deficit--the authorities had been able to implement corrective measures. Those developments boded well for the future of the Hungarian economy.

Careful attention should continue to be given to price and wage increases, Mr. Rebecchini remarked. As his chair had indicated at the time of the discussion of the Hungarian program (EBM/88/77 and EBM/88/78, 5/16/88), inflation was a major risk in an extensive program of structural reforms because of the broad adjustment that the whole system of relative prices would have to undergo. The projected inflation outcome for 1988 of about 18-19 percent was a substantial achievement, although it fell somewhat short of the regional 15 percent target, especially as it embodied the once-for-all increase resulting from the abolition of consumer subsidies and the introduction of the value-added tax. Furthermore, upward pressure on prices should be expected in the coming years, and monetary policy would have to play a leading role in controlling those developments. To contain the burden on the monetary sector, a somewhat more rapid process of fiscal consolidation should also be envisaged. Room for maneuver could be found in further cuts in the enterprises' subsidies within the framework of the reform of budgetary expenditures.

The authorities should take advantage of the favorable external environment and the successful macroeconomic stabilization efforts to date to step up the implementation of structural reforms, Mr. Rebecchini continued. The objective should be to reach as soon as possible a critical mass of reforms by which the process would become irreversible. To do so was particularly important in light of the remarks made earlier by Mr. de Groote regarding the need to overcome one of the major obstacles to reforms--insufficient popular support. Priority should be given to those reform measures that could develop stronger sympathy for the stabilization process so as to reduce or minimize the adjustment cost and strains on the population. In that respect, he highlighted the importance attached to the completion of the budget reform, not only because of its structural implications but also because it could yield a significant improvement in terms of the fiscal stance and could support fiscal consolidation.

Another important area of reform was trade liberalization, which could usefully complement and integrate the process of external adjustment, Mr. Rebecchini noted. Further efforts in addition to the significant improvements achieved thus far were certainly necessary to consolidate Hungary's reform process. The Fund should stand ready to consider extending financial assistance in the most appropriate form, particularly if further progress was promptly undertaken in key structural areas. He supported the proposed decision.

Mr. Pétursson made the following statement:

I basically agree with the staff's assessment and support the proposed decision. However, despite the impressive achievements under the first phase of the Government's three-year stabilization program, there are certain issues that cause concern. It is encouraging that the program targets have been met, although a greater than forecast inflationary tendency appears to persist in the economy. This is most evident in the excessive rise in nominal wages, the strong household credit demand, and the growing liquidity preference of households. In the enterprise sector, however, investment activity has been beyond targets.

I welcome the measures that have been implemented to counteract overheating in the economy. The higher interest rates and fiscal tightening introduced in June and July were appropriate measures in this respect. However, to contain the still existing expansionary pressure, the authorities should stand ready to introduce additional stabilization measures.

The staff believes that the measures introduced since the beginning of June to bolster household savings and raise the cost of credit will be sufficient to ensure that the end-year net household savings target is met. In this connection, I note that deposit rates on housing accounts have also been raised. However, demand for low-cost housing loans was buoyant in the first half of 1988, and credit extended to the household sector exceeded forecasts. In light of the expansive investment activity, I would have expected that measures to curb the demand for housing credit would have been both appropriate and necessary. Improvements in this area are an inherent part of the wide-ranging banking reform, and perhaps the staff could comment on the prospects for early progress.

With regard to the medium-term framework of the stabilization program, first, it is encouraging that the current account deficit has been reduced in accordance with targets and that elimination of the deficit by 1990 still seems possible. Nevertheless, I agree with the staff that Hungary's external position will remain vulnerable to domestic policy slippages and adverse exogenous developments. In view of the strengthened external position, however, the authorities could give higher priority to trade liberalization. In the medium-term scenario for the balance of payments, exports are projected to grow at a rate of 5-6 percent annually, while imports will be kept at a level substantially below that of exports until 1992. Moreover, close to one third of Hungary's total exports are to developed market economies, exposing the export sector to competition. A program to liberalize imports and simplify administrative practices relating to exports is now in the initial stages of preparation. This is particularly welcome, and I encourage the authorities to move in that direction even more decisively than indicated in the staff report. Increased competition from abroad would be a useful complement to domestic policy measures directed toward enhancing efficiency in industry; competition would also help to expedite enterprise reform.

My second point regarding the medium-term prospects also concerns the enterprise sector, but from a different angle. When the stand-by arrangement was approved, this chair particularly welcomed Hungary's timely tax reforms, namely, the introduction of the value-added tax and personal income taxation. As part of a comprehensive tax restructuring, I now urge the authorities to implement decisively the proposed new corporate tax law, which will provide a uniform system of taxation for all forms of enterprises. This is particularly appropriate in conjunction with the forthcoming new legislation on enterprise ownership and the establishment of new enterprises. An equitable and consistent operating environment for all business activities also promotes efficient allocation of resources and effective competition.

Mr. Hogeweg observed that only relatively little time had elapsed since the Board had approved the stand-by arrangement in support of Hungary's program, which in itself was only the first phase of the Government's three-year stabilization and economic reform program. Accordingly, a relatively large portion of the staff report was devoted to the future and the preparation of further far-reaching measures. He supported the proposed decision and agreed with the staff appraisal. Evidently, the staff's good advice had fallen onto fertile soil with, he was confident, the prospect of long-lasting results. However, one factor of overriding importance, of which the Hungarian authorities were undoubtedly aware, was the appropriate demand-management framework.

Hungary needed external support for its efforts, Mr. Hogeweg continued. It could not afford to lose the confidence of the financial markets, and developments in the external balance seemed crucial in that respect. Excess domestic demand could easily jeopardize the external targets. In the longer run, as the market orientation became firmer, the external accounts would attain a stronger basis.

Another aspect of ensuring implementation of the initiated reforms was the maintenance of social consensus in the face of unpopular early consequences, Mr. Hogeweg noted. Apparently Hungary was relatively well placed in that respect, in view of the steps announced by Mr. de Groote.

The neighboring socialist countries would look closely at Hungary's progress, and he too looked forward to observing developments in Hungary during the remainder of the present stand-by arrangement and any subsequent arrangement.

Mr. Morita said that he broadly shared the staff's views. He welcomed the fact that progress so far was broadly in line with the program's objectives. Although stronger than projected domestic demand, caused by higher investment spending of the enterprises owing to excessive liquidity, was a worrisome aspect, corrective measures had been taken, and he welcomed the authorities' quick response. Nonetheless, caution was still warranted as the enterprise reform was still under way and considerable uncertainty remained. Furthermore, the authorities' tax reform program aimed to reduce the burden for enterprises and to shift it to the household sector. He hoped that the authorities would continue to monitor developments in that area closely and to be flexible in taking additional corrective measures if needed.

Similar considerations applied to wage differentiation, Mr. Morita continued. Although his chair had emphasized the need for that policy, the enterprises' excess liquidity might make that aim damaging to the economy. Therefore, it would be wise to rely on direct control measures when necessary, and he could endorse the retention of the incomes policy safeguard.

Slow but steady progress had been made in structural reform, Mr. Morita noted. However, a gradual and piecemeal approach would not be helpful in the case of Hungary, and measures should be front-loaded to the extent possible. Slow progress in household savings was also a cause of concern. He welcomed the recent increase in deposit interest rates, but other attractive financial instruments should be introduced and the auction of treasury bills should be accelerated. Furthermore, he wondered whether there was scope for further front-loading of trade liberalization if the favorable external conditions continued.

While progress had been achieved in structural reform, much remained to be done, Mr. Morita stated. Early in 1989, some important, welcome steps would be taken, but to make those measures effective, prudent demand-management policy must be continued. He supported the proposed decision.

Mr. Noriega made the following statement:

> The overall positive picture of Hungary's recent economic developments reflects the commitment of the authorities to the measures and objectives stated in their three-year economic program and supported by the current stand-by arrangement. Furthermore, the fact that neither the medium-term projections nor the major targets for the second semester of 1988 have been

substantially modified attests to the consistency and coherence of the program. This is particularly meritorious if seen in the context of an economy in a state of transition.

We agree with the thrust of the staff's appraisal and with some of the views expressed by previous speakers, in particular those regarding the swiftness with which the authorities reacted to a fiscal deterioration during the second quarter of this year, and, as expressed by Mr. Templeman, the chance that an overheating of the economy may pose a threat to the stabilization process. The latter, as well as other possible threats, should not minimize the importance of Hungary's having complied with the program's performance criteria. Mr. de Groote's words also augur further progress. Therefore, we can support the proposed decision.

Two issues seem critical for sustaining the positive results achieved so far. First, it is worrisome that although in 1988 national savings are expected to increase significantly, even if not substantially, investment might remain stable, although at a somewhat higher level than originally projected. While it was envisaged that foreign savings would be lower in 1988 than in 1987 and that the domestic effort would rely primarily on the correction of the fiscal deficit, it is significant that growth projections are supported essentially by an increase in domestic savings to finance a growing ratio of investment. It is therefore of paramount importance that a stimulus to private savings be provided now as the scope for further reduction of the fiscal deficit is limited. Moreover, it is expected that the bulk of future investment will take place in the private sector.

In this connection, therefore, the deterioration observed in the intermediation by financial institutions is indeed a source of concern, not only because it reflects the fact that the stimulus to private savings was not working as planned, but also because the stimulus might have been responsible for investment by enterprises in sectors whose profitability at current relative prices might be impaired later when the economy operates in a more open environment. This last point, moreover, assumes that low real interest rates were responsible for more investment and not, as the staff states, that the decline in financial holdings helped finance stronger fixed investment spending and limited the enterprises' need for credit from the banking system. I interpret these developments as a self-financing scheme, given the fact that the banks were curtailing credit while offering low interest rates. The future allocation of investment to its most profitable alternative will thus require a flexible interest rate policy and a gradual phasing out of quantitative credit restrictions.

Second, I wish to emphasize the view of the staff that price liberalization and trade liberalization need to reinforce each other. A delay in trade liberalization runs the risk that, in the process of domestic price liberalization, some distortions typical of a closed economy may be aggravated with perverse effects for overall economic efficiency. I wonder to what extent the authorities will set domestic prices at the level expected to prevail when the economy is opened; in this way, by avoiding some undesirable volatility that may discourage longer-term investment, more rapid progress toward efficiency may be achieved.

With respect to short-term considerations--namely, the concern expressed in the staff report regarding the still vigorous private investment--excessive domestic demand may impair the external account targets, but investment demand seems to be an extremely elusive component in growth-oriented adjustment programs. Therefore, it seems important to consider how to redirect investment rather than to curtail it, as we have learned from painful experience about the difficulties of restarting the process of investment. I would appreciate further comment by the staff on this issue.

Finally, I commend the authorities for the progress in the reorientation of the economy, even though a cautious policy stance will remain crucial for some time in the future.

The staff representative from the European Department said that data were incomplete, but evidence indicated that the investment that had taken place in Hungary was consistent with the intended restructuring of industry. Investment had been particularly strong in manufacturing and food processing, although some restructuring was also needed in the latter sector, as well as in the services sector--including the banking system. The staff was encouraged by the fact that investment had been financed from the enterprises' own resources, using their profits rather than credit from the banking system or subsidization from the budget. Also, investment had not occurred in some sectors, in particular coal and metallurgy, that were targeted as inefficient and where programs were under way for significant restructuring.

It had been asked whether the tightening of credit conditions was sufficient to achieve the targeted slowdown in investment, since it had been financed from enterprises' own resources, the staff representative recalled. The authorities had no intention of reversing that investment, which for the most part was efficient. The intention was to bring the program back on track for the second half of the year. Although there were clear demarcations in the accounts between credit for working capital and that for other objectives, money was fungible. Therefore cuts in working capital credit--the largest component of credit extended by the banking system--would cause enterprises to use other resources, thus limiting funds for other purposes. Although the targets for credit had been reduced, the staff allowed a somewhat faster than programmed expansion for the second half of the year, mainly to ensure that the favorable crop of the first half of the year would be harvested and exported. Export performance might be stronger than expected, depending on transportation capacity and prices on the world market, and a certain amount of credit would be needed to facilitate that process.

The statement by the Deputy Finance Minister about the likelihood of the fiscal deficit being significantly higher than planned was somewhat baffling and had triggered a review of the budget by the authorities, the staff representative commented. The statement was puzzling because an extra margin of security had been built into the targets. Increased prices for energy would raise revenue by Ft 3-4 billion to help meet the deficit target of Ft 10.4 billion. The authorities had assured the staff that additional measures would be taken promptly if the review indicated slippages. Meanwhile, developments would be monitored carefully.

The staff realized that putting in place a legal framework such as the Law of Association, while important, was only the first step in replacing a law dating from 1875 that was inconsistent with present realities, the staff representative noted. The new Law provided important guarantees to businesses that they would be fairly treated. It must be recalled that not many years previously, enterprises in Hungary had been subject to confiscation of all available funds, which constituted a form of taxation in some cases. The Law provided for significant liberalization of the operations of private enterprises and cooperatives. In fact, the initial impact of the Law of Association would be felt by small and medium-sized enterprises, as individuals would have the opportunity to form limited as well as unlimited liability companies. The Law, by raising the limitation on the size of private companies to 500 employees, provided substantial scope for the private sector and also allowed new methods of financing.

The conversion of state enterprises into joint stock companies involved prerequisites that were considered important by the Hungarian authorities, and the Fund staff would work closely with them on that issue, the staff representative remarked. The World Bank staff was also involved. One basic issue was the valuation and form of holdings of state shares. The foremost requirement would be the publication of audited accounts for the information of investors and the preparation of appropriate instruments and institutional arrangements. The authorities hoped to receive technical assistance from foreign experts in those areas. As to incentives, the authorities intended to establish a financial framework that would force enterprises to raise capital on the emerging capital market to finance their short-term and longer-term needs rather than provide official incentives to make the enterprises change. Appropriate credit and subsidy policies would have a key role to play in that respect.

A joint ceiling for bank credit to the budget and the State Development Institution (SDI) had been set because SDI was an extension of the budget, the staff representative explained. In fact, SDI carried out many functions that had previously been performed first by the budget and then by a state development bank, which had received funds direct from the budget to finance large investment projects that were part of international agreements. The separation of SDI and budget activities was in many ways arbitrary; for example, one activity of SDI--beyond those major projects--was equity participation in firms, while the budget included subsidy contributions to enterprises for capital purposes. With a joint ceiling, the staff was better able to monitor the overall claims of the state sector on available resources. A separate end-year ceiling for the budget deficit had been specified because the annual deficit figure was central to political decision making, and the ceiling focused attention on current spending under the budget, particularly subsidies to enterprises.

During the initial negotiations, a lot of pressure had been applied by the authorities to allow for a larger deficit in order to provide a higher level of current subsidies to enterprises and, in particular, to allow resources to be raised outside the banking system through the issue of treasury bills, the staff representative continued. By focusing specifically on meeting the annual target for the budget deficit, some assurance was provided that if additional resources became available to the economy during the course of the year, they would be channeled to more productive uses rather than to finance higher budget spending, including subsidies to enterprises.

It had been suggested that further tightening of the monetary program might result in a lower rate of inflation, the staff representative recalled. The adjustment of the value-added tax at the beginning of the year accounted for 8 percent of the measured increase in the consumer price index. The problem arose because a certain level of inflation, within reasonable limits, had to be in place for the required readjustment of relative prices to occur. In earlier negotiations with the authorities in 1983-84, regarding two earlier stand-by arrangements, the staff had pressed for a somewhat higher target for the rate of inflation than the Hungarian authorities were willing to allow; the authorities' reluctance on that point, however, had limited the amount of reform and readjustment of relative prices that could be included at that time.

Housing credit was a difficult social and political issue, and the overall size of the subsidies would have to be addressed in the context of both the use of savings and a sustainable budget position, the staff representative from the European Department remarked. Steps in that direction were expected as part of the banking reform scheduled to take place at the beginning of 1989. The size of subsidies that the budget could afford would be addressed more explicitly because the subsidies on both new and old loans had been taken out of the banking system and set out in the budget, allowing a better determination of the real cost of subsidization of housing. The staff hoped that as part of the continuation of the program, a strong reorientation of investment would take place in response to improved incentives, including through the import liberalization process. It was also hoped that better progress would be made in liquidating the loss-making enterprises, for which the initiative had currently been shifted to the banking system. Those enterprises were able at present to pay current interest out of the subsidies, but if a substantial subsidy reduction program were set in place, as intended by the authorities, the issue of releasing the resources currently absorbed by the loss-making enterprises would have to be addressed.

Mr. de Groote said that the good results under the program thus far would strengthen his authorities' resolve. The Hungarian authorities would take advantage of present circumstances to step up reforms, and they were fully aware of the underlying political requirements.

One of the major problems was the danger of additional inflationary pressures once the market-oriented price mechanisms were set in motion, Mr. de Groote observed. Obviously, demand-management policy would have to be considered to avoid the risks accompanying such price movements. But only the implementation of fundamental reforms could provide an increase in supply, as the best way in the long term to avoid inflationary pressures was to improve the availability of goods and services. For that reason, a link existed between the immediate target of fighting the inflationary consequences of the process on the one hand and the commercial legislation and import liberalization measures on the other. All those measures formed a comprehensive approach that could increase supply through a higher degree of economic activity and a greater openness to the world. The Deputy Managing Director would be visiting Hungary shortly, and he would see the favorable situation regarding the provision of goods and services. He looked forward to future Board discussions on the further steps needed to transform Hungary into a full-fledged market economy.

The Acting Chairman observed that the present discussion provided useful background for his meeting with the Hungarian authorities, who would be interested in the Board's suggestions regarding areas where further action was required, namely, trade liberalization, the reduction of subsidies, financial reform, and the rationalization of housing finance.

The Executive Board then took the following decision:

1. Hungary has consulted with the Fund in accordance with paragraph 4.d of the stand-by arrangement for Hungary (EBS/88/47, Sup. 1, 5/12/88), and paragraph 11 of the letter dated February 10, 1988 from the Deputy Chairman of the Council of Ministers of the Hungarian People's Republic and the First Deputy President of the National Bank of Hungary, in order to review developments under the program, including interest rate and exchange rate policies, and to establish suitable performance criteria.

2. The letter dated July 27, 1988 from the President of the National Bank of Hungary with attached table shall be annexed to the stand-by arrangement for Hungary, and the letters with attached

tables dated February 10, 1988 and May 9, 1988 shall be read as modified and supplemented by the letter dated July 27, 1988 with attached table.

3. Paragraph 4.a of the stand-by arrangement for Hungary is amended to read:

"a. during any period in which the data at the end of the preceding period indicate that:

(1) the limit on net domestic assets of the banking system specified in paragraph 5 of the annexed letter dated July 27, 1988 and its attached table is not observed; or

(2) the limit on recourse to credit by the State Government and the State Development Institution specified in paragraph 3 of the annexed letter dated July 27, 1988 and in its attached table is not observed; or

(3) the limit on the state budget deficit (annual) specified in the table attached to the letter dated February 10, 1988 is not observed; or

(4) the intention regarding the reform of the wage determination process specified in the last five sentences of paragraph 6.a of the annexed letter dated July 27, 1988 is not carried out; or

(5) the intention regarding the new commercial legislation specified in the last two sentences of paragraph 6.b of the annexed letter dated July 27, 1988 is not carried out; or"

4. The Fund decides that the first review contemplated in paragraph 4.d of the stand-by arrangement for Hungary is completed, and that Hungary may proceed to make purchases under the stand-by arrangement.

Decision No. 8985-(88/149), adopted
September 16, 1988

2. VENEZUELA - 1988 MIDYEAR ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 midyear Article IV consultation with Venezuela (SM/88/165, 8/3/88).

Mrs. Filardo made the following statement:

Because Executive Directors have challenged the effectiveness of the enhanced surveillance procedure each time the Board has discussed Article IV consultations with Venezuela, my authorities consider it useful to provide some observations regarding the practicality of the exercise, as Venezuela is one of the few countries under enhanced surveillance. This mechanism, established by the Fund in September 1985, was a response to commercial banks' request to those debtor countries, not requiring Fund resources, for a restructuring of their debt. Thus, the purpose was to assess the country's creditworthiness, as credit agencies do with companies and nations, or ability to support their securities or bond issues in the financial markets.

With certain reservations concerning the commercial banks' possible dilution of responsibility in the monitoring process under the multiyear restructuring agreement (MYRA), the Board's decision was taken with the intention of "helping members make progress toward addressing their debt problems and improving their relationship with creditors in an orderly manner and in a broad framework." Nevertheless, on the occasion of its approval, most Directors stressed that under no circumstances should this mechanism be a substitute for a stand-by or extended arrangement. Thus, the main conditions behind this procedure were that for those countries with a good record of adjustment and in a position to formulate an adequate quantified policy program in the framework of consultations with the Fund, enhanced surveillance would serve the purpose of helping countries to normalize their market relations and to facilitate the resumption of voluntary or spontaneous financing.

It is, therefore, worthwhile considering whether, in the context of the evolution of the debt strategy, progress has been made toward voluntary lending at the conclusion of or during an arrangement with the Fund, especially for a country under a surveillance mechanism. In my authorities' view, a successful program would imply access to capital markets on the basis of actual financial operations without the application of pressure from governments or multilateral institutions. It is evident from different sources of information contained in the various staff papers on debt issues that for the 15 heavily indebted countries--except Venezuela--the only lending that has occurred was the result of refinancing, restructuring, or arrears accumulation.

In the case of Venezuela, in spite of substantial amortization of ($16.2 billion) and interest payments ($21.8 billion) on public and private foreign debt since 1982, which reduced long-term debt from $37.6 billion to $29.7 billion in 1988, only trade credit lines and a few bond issues, at a very high cost, were forthcoming. Paradoxically, in spite of being the sole country paying principal and interest regularly during the past six years, the lending terms have been the worst compared with those for other nations in arrears or making only interest payments. Thus the concept of creditworthiness has become totally misinterpreted; therefore, one wonders what it really means to be creditworthy in the present financial environment.

The problem for Venezuela is how to gain normal access to financial markets when the discount on its debt has been about 50 percent in the secondary market, notwithstanding its good record in honoring external debt obligations and in adopting from 1983 to 1985 one of the strongest adjustment programs compared with other indebted countries. The most evident conclusion is that the process of obtaining voluntary lending is too slow and too costly; therefore it cannot possibly constitute a satisfactory solution for those countries wanting to grow out of debt, especially those affected by external shocks.

Regarding the usefulness of the surveillance exercise in relation to the orientation of economic policies under the management of my authorities, they have found the mechanism extremely constructive and beneficial. The dialogue with the staff has been continuous and intense, especially during this year when the country experienced an external shock stemming from the reduction of oil prices and the increase in interest rates. These shocks, as well as the constraints to raising new money in the financial market, have seriously affected the target for international reserves in the Quantified Economic Program for 1988. Because this is an election year, my authorities considered it politically very delicate to reopen negotiations with commercial banks and to modify the interest rate structure and the exchange rate system. Thus they deemed it necessary to enhance the dialogue with the staff in order to adopt alternative steps while preparing more comprehensive measures. The multiple exchange rate system is a complicated mechanism for imposing taxes and providing subsidies; on average, the real effective exchange rate has been at the level prevailing in 1970. The authorities have seriously restructured government expenditure, eliminating or postponing lower-priority projects and restraining wages. In this regard, my authorities do not share the staff's view that one of the sources of inflation during 1987 was the increase in salaries. Venezuela is one of the few countries in the world without indexation schemes. The increase of salaries by 23 percent at the beginning of 1987 partially compensated for the substantial decline of the past years. Moreover, at the end of 1987, the consumer price index rose by 40 percent, and it is expected to rise by a further 20 percent in 1988. Besides, no salary increase has been programmed for the near future; on the contrary, the Government has managed to discourage such an increase in spite of trade union pressures. In my authorities' view, the main cause of inflation during 1987 was the overdevaluation of the bolívar by nearly 100 percent at the end of 1986.

Fortunately, Venezuela has had sufficiently high international reserves to cushion the external shocks, although my authorities are of the view that, given the country's narrow export base and its dependence on oil income, maintaining high net foreign assets has been and continues to be one of its main objectives. Meanwhile, the Government will enforce a comprehensive economic program conducive to the diversification of nontraditional exports, which have doubled since 1982.

During the past five years, although the authorities did not follow a market-oriented approach, they have implemented serious adjustment measures despite the stagnation of economic activity in the previous six years. Fiscal, monetary, and wage policies were severely restrained, and the bolívar was devalued. As the staff has recognized in the report, these measures led to considerable improvement in the public finances and the external sector during the period 1983-85, allowing the country to reduce its external debt. Nevertheless, this improvement was made possible by a substantial reduction in investment and imports, which are fundamental for the promotion of economic growth. Thus, during 1986, the Government considered it essential to redress its policies in order to implement a growth-oriented program. On that occasion, when the negotiations for the multiyear rescheduling arrangement were ending, one of the worst oil shocks occurred, reducing foreign revenues by 50 percent. Thus the negotiations continued until 1987. With certain modifications in the maturity terms, a contingency clause was agreed that allowed the authorities to reopen debt negotiations if deemed necessary. The sharp reduction of oil income in that year seriously affected both the balance of payments and public finances. To this end, the bolívar was devalued by nearly 100 percent at the end of 1986.

In 1987 the fiscal deficit, although widened in relation to 1986, was 5.6 percent, 0.7 percent below the projected figure in the Quantified Economic Program; the reduction in international reserves amounted to $1 billion, compared with $1.5 billion programmed, and the current account deficit was $0.8 billion lower than its level in 1986. Furthermore, money supply and domestic credit declined strongly in real terms. Real GDP increased by 3 percent, and unemployment declined by 1 percent. Thus, except for the inflation rate--which reached 40 percent--in my authorities' view the economic results during 1987 were relatively satisfactory.

The economic program for 1988 was also framed in a medium-term perspective where the main goals were to fight inflation and to preserve economic growth. In this regard, the most important targets discussed and endorsed by the staff were a reduction of inflation from 40 percent to 17 percent; an increase in real GDP growth of about 3 percent; and a limit to the loss of international reserves of \$1 3/4 billion. To achieve these targets, the Government intends to restrain fiscal, wage, and monetary policies and to gradually unify the exchange rate. Unfortunately, during this year Venezuela has faced a renewed external shock emerging from the reduction of oil prices from \$16.54 to \$13.70 a barrel and the increase in foreign interest rates. Although the authorities are projecting an average oil price of \$14.15 for 1988, in their view the oil market's situation and prospects are very pessimistic. Net interest payments are estimated to increase, possibly by more than \$0.5 billion as a result of higher foreign interest rates and costly short-term credit lines. These two elements, in addition to the debt service during 1988--which amounts to \$5 billion, or 47 percent of total exports and 10 percent of GDP--and the stringency of the financial market, have imposed tremendous pressure on international reserves, which have fallen sharply in view of the authorities' commitment to honor their debt.

In view of those constraints, the authorities decided to further restrain fiscal policy and aimed at reaching a deficit of 4 percent of GDP--as recommended by the staff--to avoid increases in salaries, to liberalize foreign investment, and to transfer imports amounting to \$1 billion from an exchange rate of Bs 1 = \$7.50 to Bs 1 = \$14.50. On the monetary front, although recognizing the urgency of having a more market-oriented system, the authorities have introduced gradual interest rate flexibility by allowing the private and public sectors to issue long-term bonds at market-determined yields. To cover the financing gap, the authorities have resorted to various balance of payments operations with the Bank for International Settlements (BIS) and some central banks and have renewed the dialogue with commercial banks. Nevertheless, the question remains whether the oil market will stabilize or whether it will continue to deteriorate.

Meanwhile, the Government expects that except for net international assets, the targets of the 1988 Quantified Economic Program will be met. In this regard, the authorities consider that the most important achievements are the reduction of inflation from 40 percent in 1987 to 20 percent in 1988, the growth of real GDP by 3 percent and the reduction of unemployment to 9 percent.

During 1988 one of the main tasks undertaken by the Government and the staff has been the discussion of the medium-term scenarios and the most appropriate set of policies to be implemented in the future. For this purpose, the staff conducted discussions on four different occasions at both technical and political levels, and the authorities expect another mission at the end of October.

In view of the transition period Venezuela is experiencing, owing to the change in Administration next February, the Government has formed a team at a technical and political level made up of officials from the Government and advisors to the main presidential candidates. The purpose of the team is to reach a consensus for the implementation of a medium-term comprehensive economic program that would include demand and supply economic measures and determine the targets of the financing program for 1989. The main question remaining is whether the new Administration will adopt a shock or a gradual approach.

To strengthen the economic program, my authorities have requested the World Bank to undertake an exhaustive evaluation of various sectors where further structural reforms could be initiated in the next five years. The sectors under review are public finance, investment, subsidies, the tax system, and debt management; trade and industrial policies; the financial system; and social areas such as education, health, and nutrition. The report is expected to be finished at the end of October, which, together with the medium-term scenario and policies under discussion with the Fund staff, will constitute a basic set of recommendations for future actions to be implemented by the new Government.

My authorities agree with the staff that Venezuela must undertake a comprehensive economic program that should envisage structural reforms. Thus, they expect that the modernization of Venezuela will continue to take place with the new Administration.

Mr. Zeas made the following statement:

As we stated during the discussion of the staff report for the 1987 Article IV consultation with Venezuela (EBM/88/2, 1/6/88), and as further elaborated in this staff report and by Mrs. Filardo, the country has made important adjustment efforts under very difficult circumstances. The sharp drop in oil prices between 1982 and 1987 represented more than $26 billion in forgone export revenue during this period. Approximately one half of the loss in oil revenue was reflected in the cumulative deficit of the balance of payments; this amount also included $5 billion of net foreign debt repayments, and the balance reflected other adjustments made by the country. Thus, while imports reached $14 billion in 1982, they declined to an annual average of $7.6 billion in the next five years; public investment was curtailed; and per capita income, which had reached the equivalent of $4,200 in 1982, was recorded as $2,800 in 1987.

Real wages deteriorated substantially between 1983 and 1986. The 1987 average wage increase--about 23 percent--partially restored this deterioration but it did not take into account the price increases that took place in 1987. Wage restraint helped to keep inflation under control, except in 1987 when prices rose sharply, led by the sharp devaluation of the bolivar from Bs 7.50 to Bs 14.50 per US$1 for most transactions. All in all, the average annual rate of price increase for 1983-88 was kept at about 17 percent.

For 1988, the balance of payments deficit is projected at $3.8 billion--although we have some doubts about the magnitude of the projected deficit, because for the first seven months of the year the loss of net international reserves amounted to only $1.3 billion. In any event, if Venezuela were to finance the projected deficit with a loss of international reserves, the stock of net reserves at the end of 1988, including gold valued at only $300 an ounce, would still represent nearly nine months of this year's imports. This would not be a highly negative result considering that oil prices weakened again in 1988 while interest rates increased by an additional 1 percentage point. In this regard, we note that a decline of $1 a barrel in the price of oil reduces export earnings by $0.5 billion a year, and a 1 percentage point increase in interest rates represents an additional outflow of $0.4 billion a year.

In addition to the sharp fall in oil prices, the authorities had to face price speculation and some capital flight related to the understandable negative expectations that were raised by the external shocks. The authorities reacted by controlling temporarily the prices of some essential commodities. We welcome the reductions in the list of controlled prices and in the list of imports that were kept at a preferential exchange rate.

With respect to fiscal policy, while additional deficit reduction is needed, the 1987 actual deficit of 5.6 percent of GDP and the 1988 projected deficit include the equivalent of 2 percentage points of GDP corresponding to central bank exchange losses, which could be reduced by unifying the exchange rate system and moving transactions from the Bs 4.30 and Bs 7.50 exchange rates to Bs 14.50 = US$1--the Central Bank still applies the rate of Bs 4.30 = US$1 for private sector debt repayments. Furthermore, we support the authorities' intentions and the staff's recommendations to reduce customs duty exemptions, introduce a temporary import surcharge, and gradually adjust gasoline prices and electricity rates.

An important effort carried out by the authorities so far has been through the adjustment of the exchange rate. The intervention rate was depreciated in nominal terms from

Bs 4.30 = US$1 to Bs 14.50 = US$1, or an annual average of 27 percent between 1983 and 1988, compared with an annual average inflation rate of 17 percent. This depreciation was motivated mainly by the sharp deterioration in oil prices that turned the 1983-85 average current account surplus of $3.5 billion into a deficit of $2.1 billion in 1986. This deficit was reduced, however, to $1.3 billion in 1987.

While we encourage the authorities to reorganize the exchange system and unify the exchange rate at the intervention rate, we do not believe that the free market exchange rate--Bs 30 = US$1--for capital transactions, tourism, and some imports reflects the underlying strength, or weakness, of the external sector. The free market rate reflects speculative capital movements and a disequilibrium inherent in the way this market is organized. As mentioned earlier, the unification of all current account transactions at an appropriate floating intervention rate would seem desirable, leaving the free exchange market for capital transactions only.

Venezuela has an outstanding record of amortization of external debt. During the last debt renegotiation, the commercial banks pledged to reopen debt negotiations, including the provision of additional fresh financing in case there was a weakening of oil prices. Thus, the authorities sought to tap the capital market with very modest amounts of bonds--$100 million--and at generous terms--five years' maturity and 11 1/8 percent interest. Venezuela's excellent record of payments notwithstanding, efforts by the authorities during 1987-88 have had a rather weak response from the banks so far, compelling the authorities to seek short-term financing. This is not a desirable option.

The problem of voluntary lending and creditworthiness in the face of external shocks is well described by Mrs. Filardo. The debt service envisaged for 1988--$5 billion or close to 45 percent of exports of goods and services--the weakening of oil export prices, and the increases in interest rates are the main causes of the projected overall deficit in the balance of payments. Given the present constraints of the financial markets, and as the staff's medium-term projections point in the direction of an unfinanced gap of between $2 billion and $4 billion a year, depending on which scenario is adopted, the authorities should seek long-term financing from the international development agencies and a new refinancing agreement with the commercial banks that would postpone amortization payments becoming due in the next five to seven years and would reduce spreads and interest costs to amounts consistent with the country's capacity to pay. The projections presented in the report show that, even with optimum policy measures, Venezuela will achieve only a moderate rate of growth of less than

3.2 percent on average a year and that the debt service ratio--with interest rates declining slightly after 1989, according to World Economic Outlook projections--will average 44 percent of exports of goods and services in the next five years. This is a very difficult prospect to face. Therefore, a long-term foreign debt refinancing agreement would be a timely and more realistic option than additional short- or medium-term indebtedness.

We welcome the approval of a debt-equity swap mechanism, and we support the authorities' medium-term plans to undertake further structural reforms in a framework of financial discipline. Of course, these policy initiatives will have to be addressed by the new Administration after it has taken office.

Mrs. Hepp made the following statement:

Since 1986, the Venezuelan authorities have adopted a series of measures to induce the recovery of economic growth while facing a sharp deterioration in the external position owing to the fall in oil export prices. During the period 1986-88, Venezuela has been successful in restoring positive rates of growth while reducing the rate of unemployment and maintaining the nominal level of external debt. At the same time, the costs have been reflected in a temporary increase in the rate of inflation and in the deterioration in the consolidated public balance. The shift from a surplus to a deficit position in the external current account, related to the fall in petroleum exports, was financed by the reduction in international reserves.

As mentioned by Mrs. Filardo, 1988 represents a transition period, with discussions focusing on the measures to be implemented in the next period. We welcome the authorities' initiative in requesting the assistance of the World Bank to evaluate the structural measures required in several important areas of the economy. I would appreciate further information on these reforms from the staff or the World Bank representative. These proposals, together with the policies and recommendations that will be discussed with the Fund staff during the following month, should constitute a basic set of recommendations for the future actions of the new Government.

On the external prospects for the medium term, undoubtedly a set of policies such as those proposed in the active policy scenario could serve the economic objectives of Venezuela much better than the passive scenario. This is shown in Table 7 of the staff report, where the results of the strengthening of financial policies, combined with a flexible and unified exchange rate system and the implementation of trade reforms, indicate stronger economic growth with higher investment and national savings and a lower external debt burden, as measured in relation to GDP. In this regard, we fully support the measures suggested by the staff to achieve a more flexible and unified exchange rate system and trade liberalization.

With respect to domestic policies, we share the authorities' concern about the size of the current fiscal deficit. We hope that the overestimation of the state enterprises' investment figure is correct and that the fiscal deficit will be smaller than initially projected. Furthermore, there seems to be room for further action in 1988, such as added reductions in low-priority investments, in expenditures of the public enterprises, and in government transfers. The measures suggested on the revenue side seem appropriate, in particular, the reduction in exchange losses that could result from the modification of the exchange system. Any action to reduce the fiscal deficit at this stage could help to avoid excessive credit expansion and would be consistent with the targets for international reserves and monetary expansion implicit in the program. Furthermore, the efforts to reduce the fiscal deficit in 1988 could also facilitate the further reductions that are called for in the coming years to make room for the reactivation of private sector credit and activities and to meet the objective of balance of payments equilibrium.

In the monetary sector, major efforts are needed to adopt a flexible interest rate system and to liberalize the existing ceilings on interest rates. The implementation of these measures would reverse the recent development of curb market activities that operate outside existing regulations. In this connection, we welcome Mrs. Filardo's indication that the private and public sectors have been allowed to issue long-term bonds at market-determined yields. This is a positive step in the right direction.

In sum, the authorities are implementing measures within the limits allowed by the transitory conditions of the upcoming presidential elections. Furthermore, they are fully aware of the problems and are preparing, with the assistance of the World Bank and the Fund, an appropriate set of economic policies--including some important structural reforms--that will be implemented by the new Government.

Mr. Goos said that the fundamental issues seemed to have changed little since the Board's Article IV consultation discussion on Venezuela in January 1988. The views expressed at that meeting--both by the staff and by his chair--remained broadly valid. Of course, that was a matter of concern as it reflected continued large discrepancies between the advice given by the Board and the policies actually pursued by the authorities. As to the relevance of those discrepancies, he differed with Mrs. Filardo inasmuch as he continued to believe that they put into question the usefulness of the enhanced surveillance exercise. If the Fund were compelled to reveal repeatedly the substantial differences in views between the authorities and the staff, he wondered how that would enable the Fund to contribute effectively to the normalization of creditor relations. Furthermore, such differences might also affect the credibility of the Fund vis-à-vis the commercial banks.

He recognized the difficulties associated with the forthcoming elections, although the potential willingness of the electorate to accept even painful decisions in pursuit of well-considered adjustment targets should not be underestimated, Mr. Goos continued. He did not wish to minimize the commendable adjustment efforts and achievements over the recent years that had been pointed out by previous speakers. However, he had considerable doubts that the country could afford to pursue a mere holding operation considering the already substantial strains on its reserve position, the need to contain external borrowing, and the existing inflationary pressures.

Against that background, he welcomed Mrs. Filardo's statement that the authorities had recently taken additional adjustment measures, Mr. Goos said. While pointing in the right direction, those measures should be supplemented by additional steps, notably in the areas of exchange rate and interest rate policy, whose current implementation obviously remained the main obstacles to a fuller and more sustainable utilization of the substantial growth potential of the country. It would be unfortunate if the authorities, by pursuing too gradual an approach at present, would incur substantially higher adjustment costs in the future. The likelihood of such an outcome should not be dismissed lightly, in particular taking into account the risk that a renewed widening of the financial imbalances might jeopardize the emerging and hard-won restoration of Venezuela's creditworthiness in the international capital markets. Finally, he supported the staff appraisal.

Mr. Pineau observed that most of the concerns and recommendations expressed on the occasion of the Board's previous consultation discussion in January on Venezuela remained valid. Little progress had been made since the beginning of the year in tackling the severe imbalances of the economy. Of course, the prospect of the presidential election helped to explain the near passivity of the present Administration in the face of aggravating strains. Nevertheless, that state of affairs was detrimental to the country; by further delaying the necessary corrective measures, the authorities were taking the risk of being confronted with harsh decisions later.

His authorities fully endorsed the staff appraisal, which tended to reinforce their frustration about the working of enhanced surveillance, Mr. Pineau stated. His authorities' views on that issue were well known. To the extent that the staff had taken no part in the formulation of the country's Quantified Economic Program, the only way for the staff to distance itself from the authorities' policy was to point out their differences of views, as was done clearly and helpfully in the staff report.

The new Administration would have to address major problems without delay, Mr. Pineau observed. The first priority was the reduction of the fiscal deficit. The staff had pointed to what seemed to be an inconsistency in the authorities' economic program: if the deficit was to remain of the same magnitude as the previous year, the targets for inflation and net international reserves would not be met. That forecast underlined the need for a significant tightening of fiscal discipline, and it was reassuring to learn from Mrs. Filardo that the authorities were prepared to adopt a lower target for the fiscal deficit. The best approach to restoring a more sustainable fiscal position would consist of close monitoring of wage developments in the public sector. Another area where some risks of slippage seemed to persist was the state-owned industries' investment program. He would appreciate comment from Mrs. Filardo on the differences of view between her authorities and the staff on that point.

Lax monetary policy had also contributed to the recent pickup of inflation, Mr. Pineau remarked. In that connection, the single most important step to be taken was the restoration of positive real interest rates. That measure would be instrumental in dampening inflationary expectations and checking the continued erosion of the savings ratio.

On the external side, the persistence of subdued oil prices was an additional factor that should prompt the authorities to take decisive measures to reverse the rapid weakening of the balance of payments, Mr. Pineau commented. The loss of reserves had reached a level at which future access to international capital markets could become more difficult and costly. The country had been relying too heavily on short-term financing in the recent period, reflecting a shift in market sentiment. He would be interested in the staff's comments on the financial arrangements currently carried out with the BIS and several central banks. Perhaps Mrs. Filardo could comment on the authorities' intention regarding the continuation of the gradual drawdown of the country's reserve position in the Fund taking place since the beginning of the year.

No lasting improvement in the country's external viability could take place without a radical streamlining of the exchange rate policy, Mr. Pineau continued. The present multiple rate practices generated serious distortions and disincentives for the export sector. Significant steps toward a unified exchange rate system should be introduced as soon as possible. The major reform of the import regime, to be supported by the World Bank, should also be carried out promptly.

He hoped that the next Administration would be in a position to assess rapidly the seriousness of the present situation so as to commit itself to a comprehensive program of stabilization and structural measures, Mr. Pineau concluded.

Mr. McCormack observed that the Venezuelan economy seemed to be at a critical stage in its adjustment effort as it sought both to regain access to voluntary market borrowing and to proceed on a viable growth path. Recent economic trends and policy performance, however, were not entirely reassuring as to whether enough had been done to achieve the authorities' objective. Distortions resulting from inappropriate exchange rates, interest rates, price controls, and trade restrictions continued to affect adversely macroeconomic performance.

Delays in policy adjustment in the past two years had not served to reduce Venezuela's vulnerability to changes in external conditions, Mr. McCormack continued. While recognizing the difficulties associated with the current political situation, he viewed with concern the impact that further delays during the period may have on the domestic economy. As seen in numerous other cases, delays often made ultimate implementation of adjustment more difficult, as stressed by Mr. Goos and Mr. Pineau. The new Administration would need to take early and decisive action to strengthen economic management and instill the confidence of the financial community in the authorities' commitment to adjustment.

Inflation had reached 40 percent in 1987 and was projected by the staff at 19 percent for 1988, somewhat higher than the authorities' target in its Quantified Economic Program, Mr. McCormack noted. A reduction in inflation would represent a cornerstone in the return to economic viability; however, that reduction could be achieved only if sound financial policies were pursued. He was therefore disappointed by the size of the fiscal deficits in 1987 and 1988, as they absorbed a significant share of domestic resources. Moreover, further stimulus to inflation was provided by a loose monetary policy with interest rates remaining highly negative in real terms.

In conjunction with measures to restrain expenditures and improve revenues, he strongly recommended the liberalization of interest rate policy, Mr. McCormack stated. The cost of exchange subsidies represented a major element of the fiscal deficit. The free market exchange rate had come under renewed pressure earlier in 1988 as importers had faced increasing difficulties in obtaining exchange from the Central Bank at the official rate. The distortionary effects caused by the multiple rate system underscored the need for the authorities to move quickly toward eliminating the multiple exchange rate system and adopting a unified rate that reflected market fundamentals.

The staff noted a weakening of Venezuela's external prospects since late 1987, reflecting declining oil prices and high external interest rates, Mr. McCormack said. Those trends emphasized the need to pay increased attention to competitiveness so as to stimulate the non-oil sector. Initiatives to further encourage foreign investment were particularly welcome, and he commended the authorities on the easing of restrictions on investment income and capital earlier that year.

Venezuela's debt service burden, although substantially lower than in 1986, remained very high, Mr. McCormack remarked. External prospects were a source of concern, and it was important that prudent domestic policies be combined with careful management of the country's external debt. Assuming no significant change in current policies during 1988, Venezuela faced a potential rundown of reserves of about $3-4 billion. Equally worrying was that even with policy actions, sizable financing gaps could persist. While recognizing the authorities' desire to avoid a rapid depletion of reserves, he shared the staff's concerns about the possible accumulation of further short-term debt. Venezuela had indicated that it would be seeking new money from commercial banks to support its long-term needs, but success in that endeavor would depend heavily on the firm implementation by the authorities of policies to reduce the prevailing large imbalances.

Mr. Malhotra recalled that during the 1987 Article IV consultation with Venezuela, the Board had stressed, among other things, that the authorities should adopt a comprehensive economic program that would bring about a lasting reduction in the rate of inflation, strengthen savings, and ensure external competitiveness. He was heartened by the fact that those objectives were basically the same as those of the Quantified Economic Program, which aimed at reducing the rate of inflation to a range of 15-17 percent, maintaining growth at about 2-3 percent, and limiting the loss of net official international reserves to no more than $1.75 billion.

He realized that policy measures would inevitably be constrained, and the maneuverability of the authorities restricted, because of the upcoming election in Venezuela, Mr. Malhotra observed. The room for maneuver was also constrained by developments in the oil market. Adjustment had been made difficult for Venezuela by its experience with voluntary lending, as described by Mrs. Filardo. That experience was regrettable and deserved serious consideration as it could have repercussions on the resolve of countries undertaking strong adjustment programs. Nevertheless, to the extent possible, the momentum and direction of economic reform should be maintained. That task would no doubt be facilitated by the technical and political team put together by the Government, for which he commended the authorities.

A central ingredient in the Quantified Economic Program should be the containment of the fiscal deficit, so as to avoid fueling inflation and to prevent deterioration in the balance of payments, Mr. Malhotra noted. The authorities believed that the size of the fiscal deficit might turn out to be lower than the staff projections. However, as the financing of the deficit would nevertheless require extensive use of domestic credit, he supported the staff suggestion to strengthen expenditure controls. Those measures would inevitably entail some cost but were essential.

He commended the authorities for paying heed to the need to slow down monetary expansion, Mr. Malhotra said. The authorities were also aware of the negative effects of interest rate policy on savings and on the effectiveness of monetary policy. He encouraged them to move to a more flexible interest rate policy to reflect domestic price and exchange rate developments. Such a policy would yield significant dividends in encouraging savings, restraining capital flight, and reducing pressures on the balance of payments.

Trade policy reform would be considerably strengthened by the approval of a sectoral loan with the World Bank, Mr. Malhotra remarked. The information provided by Mrs. Filardo about the World Bank's evaluation of various sectors was also welcome. Schemes to promote foreign investment with an export-oriented slant would further build on the authorities' commendable achievements in liberalizing regulations on both foreign and domestic investment.

The authorities' commitment to resist any additional wage increases and to follow a flexible policy in the administration of price controls was praiseworthy, Mr. Malhotra commented. While he shared the staff view that the list of items subject to controls should be reduced, the authorities' caution in that area was understandable, at least for the present.

Mr. Yoshikuni made the following statement:

> I join other speakers in commending the Venezuelan authorities for their excellent management of the economy and good record of economic adjustment. Nonetheless, the performance of the past two years has been rather disappointing and poses some questions about the sustainability of sound economic growth. In this regard, I am in broad agreement with the thrust of the staff report; I will therefore make only a few points for emphasis.
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> The first point is the controversial relationship between wage increases and inflation. The high rate of inflation is the single most important problem facing the Venezuelan economy, and it should be tackled immediately to restore the confidence of creditors in the country. With the benefit of hindsight, the expansionary macroeconomic policy of 1986 was clearly too ambitious in trying to reverse the declining trend of GDP in the preceding years. The high inflation rate in 1987 was, therefore, a natural consequence of the lax policy management of the previous year. It should be stressed, however, that as the staff rightly points out, the high increase in salaries at the beginning of the year should be held largely responsible for the surge in the inflation rate to over 40 percent.
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> In this regard, according to Mrs. Filardo, the authorities took issue with the staff and identified the devaluation of the bolívar as the main cause of inflation; I do not consider this a convincing argument. The devaluation of the bolívar in 1986 was

in fact very large, and subsequently the terms of trade deteriorated sharply. However, the deterioration in the terms of trade reflected primarily the transfer of real income from Venezuela to the oil importing countries as a result of the decline in oil prices, as shown in Table 1 of the staff report. Whereas real GDP increased rapidly by 6.8 percent in 1986, it declined by 8.1 percent after being adjusted for the terms of trade. In other words, the growth of real GDP did not imply an increase in real wealth because of the transfer of income to oil importing countries. This phenomenon is the opposite of that experienced by the oil importing countries, including Japan, during the period of oil price increases. The important lesson we learned from these experiences is that, since there is no room for an increase in real wages, it is not appropriate to try to offset the inevitable loss of real wealth by simply increasing nominal wages, thereby triggering the vicious circle of wages and prices and exacerbating the overall economic performances. In sum, not only Venezuela but oil exporting countries as a whole should take into account the real income transfer effect when dealing with the economic difficulties caused by the change in oil prices.

Second, in the external sector, the rapid increase in short-term debt could undermine the smooth functioning of debt management, all the more so when there is growing uncertainty about the future course of U.S. dollar interest rates. In this connection, it should not be overlooked that short-term debt rose to $4 billion in only two years, underscoring the importance of maintaining a reliable external policy.

Meanwhile, the multiple exchange rate system serves to sustain various distortions, thereby hindering market-oriented adjustment. The early establishment of a unified, flexible exchange rate system, therefore, is an essential part of external policy. Furthermore, the exchange rate policy should be incorporated explicitly into the framework of enhanced surveillance, with specific measures to be implemented in order to enhance the reliability of this mechanism, the effectiveness of which is often questioned by some Directors.

Third, as regards the medium-term scenario, I am impressed by the remarkable differences between the two alternative scenarios. In fact, the passive policy scenario envisages a rather gloomy economic picture that cannot serve as a good basis for policy recommendations. Therefore, I have some concerns about the validity of the 1988 Quantified Economic Program, which corresponds to the first-year program of the passive policy scenario. In this connection, I fully share the concern of Mr. Goos about the possible adverse effect of enhanced surveillance on the creditworthiness of the country.

I agree with Mrs. Filardo that despite recent unsatisfactory results, the country's economic performance in the long run has been very favorable compared with that of other indebted countries in Latin America. It is, therefore, embarrassing that, according to Mrs. Filardo, the lending terms for the country are worse than those for problem debtor countries. This paradox raises serious implications for the whole debt strategy, especially if it arises in other countries; I would appreciate staff comment on this point.

Mr. Enoch said that the staff report presented a useful picture of the economy, and he endorsed its conclusions. The Venezuelan authorities had in some ways achieved a remarkable adjustment in their economy in recent years in response to the drastic fall in export receipts, as shown in Table 24 (SM/88/165) on the composition of imports. The authorities' record of meeting their debt service obligations and their intention to resume voluntary borrowing were commendable. Given their achievements and objectives, he urged them to pursue policies along the lines indicated in the staff report so that they could persist in that strategy.

The staff had referred to the authorities' statement that they would be unable to take significant action before the December elections, Mr. Enoch noted. He endorsed the comments made by Mr. Goos and others that the economy could not afford the delay. He took some reassurance from comments by the staff and Mrs. Filardo that some policy actions would be taken before the elections. Perhaps even more important, a more ambitious economic program would be prepared for the incoming Administration; he hoped that the program would take comments made by Directors and the staff into account. Indeed, that could well be regarded as a test of the process of enhanced surveillance. He recalled that several Directors had doubted the usefulness of enhanced surveillance when the Board had considered Venezuela previously, and he had noted Mrs. Filardo's comments on the issues he hoped that by the time of the Board's next review, Venezuela's implementation of appropriate policies would permit those doubts to be put to rest.

One of the main areas needing attention was exchange rate policy, Mr. Enoch stated. As a monoproduct exporter, Venezuela had to diversify its export base, but after the rebound in 1986, growth in the non-oil sector had been sluggish, perhaps reflecting a continuing lack of competitiveness. There had been a helpful depreciation of the currency since the staff report had been written, but further adjustment might be needed. The unexpected oil price weakness that year and the substantial current account deficit projected for 1988 reinforced the case. Beyond that, and even more fundamentally, the continued persistence of a multiple exchange rate system clearly hindered efficient resource allocation. Perhaps controls had been introduced to ease the transition in the face of needed drastic adjustment, but had stayed in place to the point where they served to hinder the transition. The fiscal implication of the multiple exchange rate system through its effect on the Central Bank was particularly unhelpful and aggravated the problems of managing the domestic economy. He welcomed the reduction in the extent of those practices and hoped that the multiple exchange rate practices could be ended as soon as possible.

Positive real interest rates needed to be established, Mr. Enoch commented. As described by the staff, interest rates had ceased to be an effective policy instrument, except for short-term operations by the Central Bank. The current rate structure was giving rise to increasing disintermediation. For a country with the financial resources and sophistication of Venezuela, the development of efficient financial and capital markets could make a significant contribution to the economy.

More effective monetary policy was also necessary to combat inflation, and doing so should be a government priority, Mr. Enoch remarked. Pressures on prices had re-emerged in the second quarter of 1988, when prices had risen by 8 1/2 percent, bringing the year-on-year rate to over 25 percent, and further increases were likely prior to the elections as the union strengthened calls for boosts in wages. Reductions in the fiscal deficit would help the fight against inflation, and he endorsed the staff's calls to move away from price controls as an important part of structural reform.

The medium-term scenarios in the staff report demonstrated the authorities' urgent need to adopt the active policy approach, Mr. Enoch noted. The contrast in outcomes between strategies was clear; under the active strategy, non-oil exports grew by 10 percent a year, against 3 percent in the passive strategy; private sector investment rose to almost 15 percent of GDP by 1993, rather than falling below 4 percent, and growth was maintained each year, rising to 4 percent by 1993, while under the passive policy scenario, GDP in 1993 remained below its 1988 level. He welcomed the authorities' reassurance that they intended to use those scenarios as a useful point of reference for the new Administration.

In some areas, the staff report was somewhat out of date, Mr. Enoch observed. For example, Table 27 on the exchange rate could usefully have been extended beyond March to show the effects of the depreciation that had occurred over the summer.

Mr. Rebecchini made the following statement:

> The economic performance of Venezuela remains disappointing, owing to a combination of unfavorable external developments and insufficient progress in key policy areas. Since I fully share the thrust of the staff appraisal, I will comment only on a few macroeconomic issues and on the likely outcome for some targets of the Quantified Economic Program for 1988.
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> The containment of the budget deficit remains a key element of the adjustment process of Venezuela. In view of the difficulties that a continued reduction in oil prices could create for the process of fiscal consolidation, the authorities should

renew their efforts to expand non-oil revenue and to contain public expenditure, particularly of a current nature, and avoid unduly sacrificing public investment. A welcome development in the process of budget consolidation is represented by the containment of public wages in the course of this year. As to the outcome for 1988, I am glad to learn from Mrs. Filardo that further restrictive fiscal measures have been decided, aimed at achieving a deficit of 4 percent of GDP. We would be interested in having additional information regarding the nature, timing, and impact of these measures on the 1988 deficit.

Monetary aggregates have to be kept under tight control to curb inflationary pressures, particularly if external developments continue to turn out unfavorably. In this respect, the authorities have envisaged in the Quantified Economic Program for 1988 an appropriate set of monetary targets consistent with inflation and growth targets. I am somewhat concerned, however, to learn from the staff report that in the first quarter of 1988, the rate of bank credit expansion on a 12-month basis remained at 28 1/2 percent. We would be interested to know from the staff whether this development in credit expansion is consistent with the Quantified Economic Program objective of an 18-19 percent expansion of broad money and the objectives for inflation and the external account.

A major concern remains the inflationary performance: I wonder whether the target of 15-17 percent envisaged in the Quantified Economic Program for 1988 can be reached, given a rate of price increase of 2 percent on a monthly basis in the second quarter of 1988.

All things considered, we recognize the efforts undertaken by the Venezuelan authorities to improve the economic situation in a particularly difficult year. However, like most speakers I wish to forcefully underscore the urgent need for a comprehensive adjustment program encompassing demand-stabilization measures and structural reforms, a need that the authorities themselves acknowledge. In this respect, we are heartened by the indication that a team of experts is already at work to devise such a medium-term economic program for the incoming Administration, and the areas in which forceful actions are required have been described in the staff appraisal and highlighted by many previous speakers.

The effectiveness of the enhanced surveillance procedure needs to be kept under careful scrutiny. To this end, I acknowledge the improvements that have been introduced in this year's consultation through the use of medium-term scenarios. However, the time span of this midyear review with Venezuela is somewhat too long. As a matter of general principle, the effectiveness of enhanced surveillance depends on a timely involvement of the Board in the assessment of the economic program of the country. In this case, staff discussions with the authorities started in April and continued in June and July, but the report was circulated to the Board only in mid-September. Consequently, as the focus of the discussion is on the 1988 program, it is reasonable to doubt that the opinions expressed by the Executive Board can influence policy for this year. We understand the authorities' need for a "continuous and intense dialogue with the staff," as indicated by Mrs. Filardo, and we welcome such cooperation. However, this dialogue should be integrated with Board involvement so that Executive Directors can play a more effective role in the enhanced surveillance exercise and provide a more timely feedback to the authorities.

Mr. Al-Assaf made the following statement:

I agree with Mr. Pineau and Mr. Goos that the nature of the economic difficulties facing the Venezuelan authorities has not changed significantly since the previous Article IV consultation in January. At that time, a substantial reduction in the overall fiscal deficit was needed. This view remains valid today. While not excessively large, the fiscal deficit remains high enough to prevent the complete achievement of the authorities' objectives, especially in relation to inflation, balance of payments targets, and the recovery of private investment. Therefore, the next Administration should give top priority to a comprehensive program of tax reform and a strengthening of expenditure controls.

The distortions resulting from the existing interest rate system have continued to impose a burden on the economy. Ceilings on deposit rates not only affect the level of savings but also encourage curb market activities as well as capital flight.

The rapidly rising level of short-term borrowing for balance of payments purposes has increased the vulnerability of the economy to interest rate movements. This factor, coupled with the continued decline in foreign exchange reserves, might affect the full restoration of access to international capital markets. This would be regrettable, especially as Venezuela obviously deserves the restoration of access in view of its satisfactory payments record.

The need for substantial progress toward a unified exchange rate system is no less urgent now than it was last January. The current system not only imposes a direct cost on the Central Bank and the budget but also leads to substantial economic distortions. I am encouraged by Mrs. Filardo's statement that the authorities remain committed to the unification of the exchange rate. However, it seems that unexpected difficulties have, so far, prevented progress. The Fund should stand ready to provide all necessary assistance in the design and implementation of unification measures, when they are considered by the new Administration. In this respect, a World Bank trade liberalization sectoral loan has been under discussion for some time. An update on the progress of these discussions would be helpful, especially regarding the likely impact of trade liberalization on exchange rate policies and the eventual unification of exchange rates.

The economy would generally benefit from a broader approach to structural reforms; in particular, the widespread controls and regulations on prices have adverse effects on resource allocation and growth. The scope for improvement in this area is wide, and the gains could prove substantial. In view of the exchange rate measures to be considered soon by the new Administration, measures affecting price determination for a number of goods and services could play an important supportive role.

Mr. Othman made the following statement:

Economic policy in Venezuela during the recent period has been complicated by a number of factors, including the uncertainty in the international oil market and in global interest rate movements. The scope for major policy adjustments is also being limited by the fact that presidential elections are scheduled for December. Given these considerations, it is not surprising that economic performance and the pace of adjustment have not been as strong as one would have liked. These same considerations, however, make it essential that, when in place, the new Administration should move quickly to strengthen and broaden the adjustment effort. We therefore welcome the fact that, in many areas of economic policy, preparatory work is currently under way to allow a more ambitious economic program to be launched early next year. At the same time, we agree with the staff that policy adjustments that can be feasibly implemented now should not be delayed, since this will only add to the magnitude of adjustment that will be necessary in the future.

An important policy objective should be to reduce the high rate of inflation which, last year, was responsible for offsetting much of the gain in competitiveness associated with the 1986 devaluation of the bolivar. Thus, a tightening of fiscal and monetary policies will be crucial. The authorities intend to follow a more active monetary policy in order to contain the rate of liquidity expansion. However, as the staff report indicates, unless the fiscal deficit for 1988 turns out to be significantly less than projected, the authorities will be faced either with a rate of inflation that is significantly higher than the target or with a slowdown in economic activity if credit to the private sector is made to carry the burden of monetary tightening.

A slowdown in private sector investment would clearly be detrimental to the medium-term growth prospects. Private sector investment improved significantly during 1987 and 1988, and it is important that economic policies continue to be conducive to further increases in private sector capital formation. In this connection, we welcome the authorities' emphasis on attracting foreign direct investment.

Obviously, structural reforms play an important role in increasing the domestic and foreign savings that are available for investment and ensuring that such resources are channeled to productive activities. The authorities have indeed taken many steps to improve the structure of incentives and to reduce distortions in relative prices. Clearly, however, a broader effort is required, including in the exchange rate system. We welcome the authorities' cooperation with the World Bank in undertaking an exhaustive evaluation of various sectors to initiate further structural reforms in the next five years.

The medium-term prospects for the balance of payments make it clear that a sustained increase in exports will be essential if an adequate rate of growth is to be achieved without aggravating the external position. The improvement in Venezuela's credit standing provides the authorities with a little room for maneuver, but continued progress in access to financial markets will require a sustained policy of adjustment. We share, however, the concern expressed by Mrs. Filardo regarding the unfavorable lending terms in spite of Venezuela's good record of debt settlements.

One difficulty in formulating a medium-term adjustment path in Venezuela is the country's vulnerability to changes in international oil prices and interest rates. Recent movements in both are not very encouraging, and the persistence of the recent trend will inevitably complicate further the adjustment task in the period ahead.

Mr. Salehkhou observed that like other oil exporting countries, Venezuela remained heavily dependent on the oil sector, as 86 percent of its total exports consisted of oil products. The unfavorable impact of the downturn in the international oil market had resulted in a sharp decline in oil revenues from $15 billion in 1984 to $9 billion in 1987. That trend had been further aggravated by the heavy burden resulting from the authorities' tremendous efforts to repay their external debt. The response of the authorities to the challenge posed to them by the decline in oil revenues had been initiated in 1983 with demand-management policies that were sustained until 1985. The corrective measures included the reduction of public expenditures, wage restraints, and import and investment compression.

The austerity-oriented policy, however, had had a naturally depressing impact on the economy, particularly on growth and employment, Mr. Salehkhou remarked. Against that background, the authorities had adopted a growth-oriented strategy in 1986, embodied in the Quantified Economic Program. Despite the sizable reduction in oil prices, the achievements were encouraging thus far. Growth in the non-oil sector had recovered, and unemployment had declined.

On the external side, the authorities had realized a sizable reduction in the current account deficit and had managed to maintain official foreign reserves at a level equivalent to 12 months of imports, Mr. Salehkhou noted. Among other positive achievements, the sizable reduction in external arrears was also welcome. Nevertheless, the economy still faced the enormous challenge of sustaining growth and faithfully pursuing economic adjustments, despite the external shocks exerted again by the most recent reduction in oil prices and the rise in interest rates. In that respect, although 1988 was considered by the authorities to be a transitional year before the presidential election, he was impressed by their commitment to reduce inflation and unemployment, to further correct the fiscal deficit, and to avoid increases in salaries. He also welcomed the determination to prepare a more ambitious economic program to be implemented by the new Administration. That program should aim at achieving a lasting reduction in the rate of inflation, strengthening savings, and improving the internal and external financial positions. A set of structural measures to be identified in collaboration with the World Bank would also help the authorities in preparing a comprehensive medium-term program.

While such a strategy would go a long way toward improving voluntary access to foreign financial markets, he was somewhat concerned by the high sensitivity of the medium-term prospects to the uncertainties surrounding oil prices and interest rates, Mr. Salehkhou said. Therefore, given the authorities' efforts in maintaining good relations with its foreign creditors, the international financial community, and commercial banks in particular, should alleviate any adverse consequences of unforeseen developments by providing Venezuela with the needed financial support. The authorities, on their part, should strive to achieve more diversification of the economy by increasing nontraditional exports and by reducing the size of short-term external debt so as to curb the already high debt service ratio.

He shared Mrs. Filardo's candid analysis of the failure of the enhanced surveillance procedure to restore voluntary lending by commercial banks, Mr. Salehkhou commented. That view confirmed the doubts, misgivings, and reservations consistently expressed by his chair on the usefulness of the enhanced surveillance procedure. In particular, he concurred with Mrs. Filardo that the process was too slow and too costly. He expressed regret that at times the Fund appeared to be keen on learning only by experience, which often involved tremendous cost and sacrifice on the part of the member concerned.

Mr. Hogeweg said that Mrs. Filardo's observations on enhanced surveillance were of great interest. Her authorities perceived enhanced surveillance as extremely constructive and beneficial; however, he believed that Venezuela could have benefited more from the procedure if the authorities had made better use of Fund advice. Such action would also have gathered further support for the procedure, as witnessed by several comments by other speakers.

He endorsed the staff's recommendations, especially the need for exchange rate unification and for flexible, positive interest rates without ceilings, Mr. Hogeweg noted. He wondered whether the lack of progress on both fronts was not interrelated. Without the possibility of implementing an adequate interest rate policy, the authorities feared the inflationary impact of transferring imports to the free exchange market. Therefore, interest rate policy and monetary policy in general had taken exchange rate policy prisoner. Any attack on Venezuela's economic problems, to be meaningful and to have a chance of success, should at least tackle those two problems simultaneously.

The World Bank trade liberalization loan was significant with respect to that issue, Mr. Hogeweg added. However, he was concerned to read in the Economist that Venezuela would have turned that loan down. He would appreciate comment by the staff or Mrs. Filardo on that report. Moreover, he wondered how the money market operated if the Central Bank charged only 8 1/2 percent for short-term liquidity support to commercial banks while it offered 17-19 percent on short-term deposits.

Mrs. Walker made the following statement:

> Before addressing Venezuela's economic situation, I would like to make some comments on Mrs. Filardo's statement, even though they may be more generally related to the debt strategy, which we have discussed at length on other occasions.
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> In the first paragraph of her statement, Mrs. Filardo noted that the purpose of enhanced surveillance was basically to provide a credit rating for the commercial banks. While to a certain extent it is understandable how she came to this conclusion, in our view the purpose of enhanced surveillance is to enable a country to develop a set of policies that can provide a basis for and can facilitate a return to more normal credit market relations. The role of the Fund in enhanced surveillance should be to work closely with members in designing and implementing strong and comprehensive macroeconomic and structural reform policies through the consultation process, not just to

rate whatever policies may have been pursued by a member country. Implicit in this collaboration is an active attempt to narrow any divergent views between the authorities and the Fund, so that the Fund can feel comfortable with the countries' policies and provide positive assessments for banks and other creditors to review.

In this sense, we agree with the conclusion regarding enhanced surveillance in the second paragraph of Mrs. Filardo's statement: that the enhanced surveillance process should serve to help countries normalize relations with the market. For this to occur, however, the market must be convinced that appropriate policies are in place. In Venezuela's case, Mrs. Filardo says that, in spite of an outstanding record of payments, the restoration of market access has not been commensurate. We welcome Venezuela's payments record, and Venezuela's access to short-term financing probably demonstrates that the financial markets recognize Venezuela's payments record as well. However, we are convinced that, for future medium- and long-term lending to occur at the desired levels, Venezuela needs to adopt a stronger and more comprehensive set of policies than has occurred to date, with these policies aimed especially at diversification of the export base, so that Venezuela's medium-term balance of payments outlook would provide more assurance than in the past. It may well be slow and costly to grow out of debt if appropriate market-oriented policies designed to bring about growth and a sustainable balance of payments position are not pursued in a timely and comprehensive fashion. I agree with Mr. Salehkhou that banks should increase lending and that the authorities should adopt policies to diversify exports. These two actions go hand in hand.

The decline in world oil prices since late 1987 combined with the economic policies pursued by the authorities have weakened significantly the prospective balance of payments outcome for 1988. Since the staff report was prepared, oil prices have declined and interest rates have risen further. Given the sensitivity of Venezuela's balance of payments scenario to these developments, the need for the country to adopt immediately a decisive and strong reform package is all the more urgent. It would also strengthen Venezuela's ability to secure additional financing.

On the specific reforms required, we are basically in agreement with the staff appraisal. In the fiscal area, additional measures to reduce the deficit in 1988 will be needed, in spite of the authorities' efforts to reach a deficit of 4 percent of GDP, particularly if the inflation and balance of payments targets are to be met. Notably, attention should be given to improving the financial position of state enterprises by strengthening export controls, cutting government transfers, and adjusting prices of goods and services.

There also is a need to slow down monetary expansion if inflation is to be reduced. The measures the authorities are undertaking in this regard will need to be supplemented by changes in interest rate policy, thus reducing or eliminating borrowing and lending ceilings to allow positive real interest rates.

A unified and flexible exchange rate policy will ultimately be needed to strengthen the balance of payments by improving export diversification and competitiveness and to increase foreign investment. In the meantime, a significant move in this direction is critical. We agree with the staff recommendation to eliminate imports at the subsidized rate and to transfer some imports and private sector exports to the free market.

In the area of structural reform, we recognize the progress that has been made in liberalizing foreign and domestic investments. Replacing import quotas with uniform import tariffs will be an important step to further these efforts. Also, a reduction in price controls is critical.

We note with interest that the authorities generally agreed with the medium-term scenarios. We hope that the more active scenario can be a basis for the Government's comprehensive plan and for discussions with the World Bank. It is important that the Bank should be reassured about the macroeconomic framework for its lending. Finally, I agree with Mr. Enoch that the Venezuelan case may be a test of the effectiveness of enhanced surveillance.

Mr. Fogelholm made the following statement:

Like other Directors, I am in broad agreement with the staff assessment; in particular, I endorse the staff's views on the urgent need to re-establish a unified and flexible exchange rate system. Also, a strengthening of fiscal policies--especially expenditure control--seems to be most important in achieving the targets for inflation and net international reserves.

The comments by Mrs. Filardo relating to the experience of enhanced surveillance are interesting. If one were to generalize rather freely, the conclusion could be reached that the authorities have found the surveillance mechanism to be constructive and beneficial. However, I agree with Mr. Hogeweg that the authorities did not seem to have followed to any significant extent the advice provided by the staff. This is, of course, one reason why many skeptical comments about enhanced surveillance have been voiced by Directors. In this connection, I would appreciate having the views of both the staff and Mrs. Filardo on what they consider to be the most important accomplishment of the enhanced surveillance in this case and in what respects the economy could be assumed to be better off as a result of it. I hasten to point out that this chair is in favor of enhanced surveillance, but we would like to see positive results emerging from it.

Another point that was raised by Mrs. Filardo deserves to be considered. She notes that, despite the country's good track record in servicing its debt, Venezuela faces huge difficulties in receiving new money at reasonable rates. That is not surprising, however, if one considers the secondary market price of Venezuelan debt, namely, a discount of roughly 50 percent. Certainly that cannot arouse the interest of bankers for new lending. I would be interested to hear the reasons behind the poor showing of Venezuelan debt in the secondary market; does it reflect the existence of arrears to private creditors and the lack of confidence on the part of banks in the policies pursued by Venezuela, or is it merely a reflection of an imperfect and thin secondary market?

The active medium-term policy scenario, which apparently will be discussed with the new Administration in February, shows a doubling of GDP growth from 2 percent in 1988 to 4 percent in 1993. However, this will not be enough to improve the current account, which will show a deficit of about $1 billion each year during the projection period. Owing to the deteriorating capital account, the financing gap will increase from $1 billion in 1988 to $3 billion in 1993. Would it not have been more appropriate--under enhanced surveillance--to present a scenario aimed at a sustainable balance of payments situation in the medium term?

According to the staff report, the financing gap calculated for 1988 is $2 billion, and the authorities seem to be in the process of raising funds to cover this amount. A financing gap of that size--double the size of the gap in the active scenario--is found in the passive policy scenario, which shows a much gloomier picture with regard to both GDP growth and the capital account. Since the Venezuelan economy currently seems to be developing along the lines of the passive scenario, it would have been useful to have a more realistic scenario based on the estimate of the actual size of the financing gap and assuming that policy measures recommended by the staff could be implemented only after the election.

The staff representative from the Western Hemisphere Department, referring to monetary policy, explained that the rate of growth in bank credit in the early part of 1988 had been taken as a trend estimate that was likely to continue for the rest of the year, given the outlook for the fiscal position. In that sense, the credit expansion envisaged for 1988 was significantly above the level the staff had considered consistent with full achievement of the Government's Quantified Economic Program, but it coincided with the authorities' projected broad money growth rate partly because the leakage through the balance of payments would be higher, in terms of both the current account deficit and the overall reserve loss. Moreover, the price performance had been somewhat worse than targeted under the Government's program, and the staff estimated an inflation rate of 20-25 percent for the year. On the question of central bank intervention in the interbank money market, a substantial distortion had occurred in the interest rates offered. The Central Bank had attempted to segment the market by preventing those banks that used the rediscount facility from taking advantage of high-yield deposits sold by the Central Bank. Recently, the Central Bank had reduced its offer rate for deposits sold in interbank operations and thus the sharp discrepancy in rates--which had prevailed for about one year to August 1988--had disappeared.

A team of World Bank specialists was working in Venezuela at the request of the authorities with a view to developing policy proposals that would be ready in time for the present Administration to review before preparing recommendations for the new Government, the staff representative reported. The work of the Bank was broadly in four areas. First, discussions on trade reform that had begun in 1987 were continuing, focused primarily on lowering overall tariff protection and eliminating the distortion in tariff rates, thereby reducing effective protection. In addition, work was under way on the phasing out of quantitative restrictions and replacing them with tariffs. There had also been some discussion of substituting domestic taxes on certain luxury imports for customs tariffs.

Second, the World Bank was studying the financial sector, considering both possible reforms in the financial institutions' legal arrangements that would help to make the system more efficient and more competitive, and changes that would help to develop local markets for better public debt management, the staff representative continued. The third area of the Bank's work was related to public finances. The authorities had indicated an interest in sales and income tax reform. Studies were also being conducted on the public sector investment program--its definition and implementation--and on the operations of the public sector enterprises. Fourth, the Government had indicated its interest in reforms in the social sector, and it was considering possible technical and financial assistance from the Bank in the areas of education, health, and nutrition.

On the question of a possible World Bank sectoral loan, discussions had been particularly active toward the end of 1987, but negotiations had been placed in abeyance because of the political campaign, the staff representative said. Technical work in some of the areas that had been developed and discussed with the authorities was continuing, and the staff understood that possible financial assistance would be considered by the new Government early in 1989.

The Central Bank had undertaken two financial arrangements for short-term support, the staff representative explained. One operation, with the BIS, utilized a line of credit that had been arranged previously, which allowed Venezuela to draw up to $500 million in a relatively short-term facility that could be renewed. The Central Bank was also seeking a short-term borrowing facility with a European central bank for a similar amount.

With respect to the medium-term balance of payments scenarios, the active policy scenario represented a sustainable deficit in the light of certain objectives, the staff representative said. In that scenario, Venezuela's external debt position would be reduced in terms of GDP and the debt service ratio; the net international reserve position would be stabilized; and a minimum growth target for the country was achieved. According to those criteria, the scenario, notwithstanding the borrowing requirement, was a reasonable outturn on which to base projections and policies. When it had begun work on the medium-term scenario, the staff had considered possible changes in policy that would have set in train the reforms Directors had emphasized earlier that year. In revising the outlook for 1988, the staff found that the current account position and overall balance of payments were not significantly different from those projected in the passive scenario and, broadly speaking, the thrust of the active policy scenario as shown in the staff report was still largely relevant.

The discount on Venezuelan debt in the secondary market probably reflected the uncertain outlook for the petroleum sector and perhaps resulted from some concern about the direction of economic policies in Venezuela, the staff representative commented.

The enhanced surveillance mechanism had provided the framework for a positive exchange of views between the staff and the authorities on policy, the staff representative from the Western Hemisphere Department observed. Through the staff's recommendations, the authorities had been made more aware of the costs of certain policy outcomes, and efforts had been made to avoid certain problems and to work gradually toward an improved economic situation. The technical assistance provided under the mechanism had been useful in refining the authorities' approach to quantitative economic programming and to monetary targeting. During that year a number of particularly intense discussions between the staff and the Venezuelan authorities had both preceded and followed the issuance of the staff report, with the goal of defining and formulating policies that would be part of the authorities' comprehensive package to be considered by the new Government.

Mr. Salehkhou observed that as the value of enhanced surveillance apparently lay in the provision of technical assistance, perhaps members should simply request such assistance without incurring the other requirements of the enhanced surveillance mechanism.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/148 (9/14/88) and EBM/88/149 (9/16/88).

3. 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 consultations with Argentina, Bangladesh, the Philippines, Tunisia, Turkey, and Yugoslavia to be held in Geneva during the week of October 3, 1988, as set forth in EBD/88/251 (9/13/88).

Decision No. 8986-(88/149), adopted
September 15, 1988

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAP/88/227 (9/13/88) is approved.

APPROVED: April 7, 1989

JOSEPH W. LANG, JR.
Acting Secretary