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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/170

3:00 p.m., December 14, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	P. E. Archibong, Temporary
	Jiang H.
	M. K. Bush
	A. Rieffel, Temporary
	J. Prader
A. Donoso	
	A. M. Othman
	B. Goos
J. E. Ismael	J. Reddy
	J. E. Zeas, Temporary
	C. Enoch
M. Massé	
	J.-C. Obame, Temporary
Y. A. Nimatallah	
G. Ortiz	E. Ayales, Temporary
J. Ovi	M. Fogelholm
	D. Marcel
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	
	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	
	S. Rebecchini, Temporary

L. Van Houtven, Secretary and Counsellor
M. J. Primorac, Assistant

Also Present

Administration Department: P. K. Craig, R. Ramaciotti. European Department: G. Tyler. Exchange and Trade Relations Department: C. Atkinson, E. Brau, J. A. Buyse. External Relations Department: N. Worth. Legal Department: R. H. Munzberg, J. V. Surr. Treasurer's Department: F. G. Laske, Treasurer; D. Williams, Deputy Treasurer; D. H. Brown, D. Gupta, B. E. Keuppens, J. A. McLaughlin, G. Wittich. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; F. Coricelli, D. N. Lachman, P. Neuhaus, A. G. Santos. Office of the Managing Director: R. Noë, Internal Auditor. Advisors to Executive Directors: M. B. Chatah, G. D. Hodgson, K.-H. Kleine, A. Ouanes, P. D. Péroz, G. Pineau, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, J. R. N. Almeida, A. A. Badi, E. C. Demaestri, S. Guribye, C. L. Haynes, M. Hepp, G. K. Hodges, S. King, V. K. Malhotra, T. Morita, S. Rouai, G. Schurr, G. Seyler, E. L. Walker, D. A. Woodward.

1. INCOME POSITION FOR FY 1988 - MIDYEAR REVIEW; AND ADDITIONS TO SPECIAL CONTINGENT ACCOUNT

The Executive Directors continued from the previous meeting (EBM/87/169, 12/14/87) their consideration of a staff paper on the midyear review of the Fund's income position for financial year (FY) 1988 (EBS/87/242, 11/23/87, and Cor. 1, 11/25/87) together with a staff paper on additions to the Special Contingent Account (EBS/87/241, 11/23/87).

The Treasurer pointed out that the projections he had presented at the beginning of the previous meeting were based not on forecasts of interest rates but, as always, on rates in effect at the time that the projections were made. The projection of the net income position that he had given was based on the SDR interest rate as established on the preceding Friday; the net income indicated would be achieved only if that SDR rate prevailed for the rest of the financial year. Therefore, it could not be taken for granted that the Fund would actually achieve either a net income as projected in the staff paper, or that mentioned by himself in the previous meeting. In making such projections, the staff took into account all possible repercussions on the Fund's income position, including the cost of borrowing for the structural adjustment facility and for the enlarged access policy.

He had two points to make on Mr. Goos's proposal that a special line of reserves be established as an alternative to the Special Contingent Account, the Treasurer continued. The term "reserve" implied an amount that was retained from the Fund's earnings and as such could not be subject to refunding since special reserves and general reserves existed only for purposes specified in the Articles of Agreement. If a special line of reserves were to be established, not as an item of existing reserves, but as a new item, a justification for the establishment of that item would have to be made and disclosed in the notes to the Fund's financial statements. The External Audit Committee would certainly insist on an explanation too.

The judgmental approach was the only way that the Board could, according to generally accepted accounting principles, allocate amounts to either the Special Contingent Account or the special line of reserves, the Treasurer indicated. There could be some conflict between establishing the special line of reserves with a judgmental approach, and at the same time establishing objective criteria for determining the amount to be allocated to the account.

The response to Mr. Rye's question whether the FY 1988 addition to the Special Contingent Account could be 1.25 percent of the reserve target instead of the 2.5 percent proposed in the staff paper was that it was simply a matter of judgment, the Treasurer remarked. Given prospective developments in overdue repurchases, the staff had felt that 2.5 percent would be an appropriate amount to add to the Account for the following financial year.

The staff had proposed that charges against the Special Contingent Account--in the event that the Executive Board came to a recognition of a loss--be made in proportion to all allocations to the Account, and accordingly any refunds--when the Board decided that the arrears situation had been resolved--be made similarly, the Treasurer said. An alternative route would be to apply charges in proportion to existing amounts in the Account and to apply any refunds on the "first-in first-out" principle; but that system could create operational difficulties in a situation in which a charge would have to be made after refunds had already been distributed, since that would mean that the charge would be made on a different basis than had been the previous refund.

The staff took the view that it was more prudent to decide on allocations to the Special Contingent Account at the beginning of each financial year, the Treasurer concluded. If such a decision were not taken before FY 1988 began, the Fund would be exposing itself to uncertainties regarding net income actually achieved.

Mr. Goos questioned the point that the external auditors would insist that the funds which he proposed be transferred to the special line of reserve actually be placed in the normal reserve. If a particular uncertainty could be perceived as transitory, then should it not be possible to alleviate that problem in the context of a special facility? Similarly, financing the special facility through burden sharing should also be permitted as part of a specific solution.

The name of the special facility could readily be changed if the term "reserve" caused difficulties, Mr. Goos remarked.

The Treasurer explained that the external auditors would only insist that funds be assigned to general reserves if no other reason than general risks were given for the establishment of the special line of reserves.

Mr. Nimatallah asked whether naming the facility a "special contingent reserve" would satisfy Mr. Goos and the external auditors.

The Treasurer said that the reaction of the external auditors would depend on the reason for which the account was established.

Mr. Massé suggested that the name "Special Contingent Account" be retained, as it had already been adopted, and in order to avoid semantic discussions. The pragmatic question was how to split funds between the income reserve and the Special Contingent Account. It appeared that the Board had agreed to divide the 7.5 percent of target income by placing 5 percent in the general reserve and 2.5 percent in the Special Contingent Account. A further question was whether to place more than 7.5 percent into reserves and the Account combined.

Mr. Ortiz pointed out that since the decision approving the Special Contingent Account would expire in the spring of 1988, the wording of that decision could be changed at that time. It could then be explained that the Account was established to meet increased uncertainties, with specific factors being named if necessary, but the specific link between the Account and overdue obligations could be removed.

Mr. Chatah asked whether a de-linked account, which would then be considered a reserve, could still serve as a first line of defense in protecting the Fund's income.

The Treasurer confirmed that as long as the account were linked explicitly to reserves, it would be difficult to use it in the way that had been intended for the Special Contingent Account. There had to be some reference to the reason for which the account was established and maintained, so that there existed criteria against which charges could be made to the account.

Mr. Sengupta noted that a clear distinction had to be made between general reserves and the special line of reserves in order to satisfy the external auditors. Mr. Goos's proposal for a line which would be established on the basis of burden sharing to meet increased uncertainty seemed very similar to the Special Contingent Account which had already been assigned the 2.5 percent of reserves that was burden shared and could be returned to contributors. If that arrangement was possible within the existing rules, why should Mr. Goos's proposal to expand supplemental income to cover increased uncertainties not be feasible?

The Treasurer referred to paragraph 2 of Section 2 of Decision No. 8348-(86/122) on burden sharing, which read as follows: "...the Fund may decide to add supplemental income to be generated in accordance with the provisions of Section V." The relevant provision of that section referred to the problem of protracted overdue obligations. Therefore, any funds generated under the burden-sharing decision as supplemental income could not be placed in reserves, but had to be set aside as a separate item for the purpose of alleviating the problem of protracted arrears. The name of that item was not significant.

Mr. Massé saw no problem with calling the account a Special Contingent Account and placing more than the burden-shared 2.5 percent--perhaps 5 percent--into it.

Ms. Bush observed that Mr. Goos's formulation was very similar to that put forth by the staff as the judgmental approach. Mr. Massé had suggested assigning 2.5 percent of the 7.5 percent in reserves to the Special Contingent Account, with an additional 2.5 percent being raised by other means. Mr. Nimatallah's proposal to generate the additional 2.5 percent through burden sharing met that requirement. The question was whether to raise those funds at the beginning or at the end of the financial year. What options existed at the end of the fiscal year for financing the additional amount? Did that not mean that the opportunity for creditors to share in financing an increase would be lost? A decision to make the contribution at the beginning of the fiscal year would allow creditors to contribute to the increase, and the judgmental approach or the special line of reserves could be further studied for FY 1989.

Mr. Ortiz suggested that creditors could match the SDR 26.5 million raised by debtors in FY 1987 during FY 1988; the 2.5 percent generated by burden sharing could be added, so that the entire account from the outset would be burden shared. In that way, subsequent refunding would be simplified as all members would have contributed proportionately equal amounts.

Mr. Nimatallah stated that the External Audit Committee required that the new account be notionally related to the problem of overdue payments--a requirement that was met by the Special Contingent Account. The Account had been created because of the problem of overdue payments, and it was simply not relevant to discuss whether that Account was appropriate. He had suggested that in order to activate it, 2.5 percent of the 7.5 percent assigned to reserves be diverted to the Special Contingent Account. The question was whether additional amounts should be added. Some had suggested that with the proposed establishment of the enhanced structural adjustment facility, 2.5 percent would be sufficient for the time being, while others had observed that the problem of overdue obligations was growing and until it was solved an interim solution was needed. He felt that even a symbolic amount added to the original 2.5 percent would show the External Audit Committee that the Board was aware of not only the existence of the problem, but also its growth. It should be decided at the current meeting what that additional amount should be.

The Acting Chairman observed that there was not yet sufficient support to take a decision.

Mr. Posthumus said that he agreed with Mr. Nimatallah's points, and supported Ms. Bush's proposal that an addition to the Account be made at the beginning of FY 1988.

While it had been said that the staff had suggested the judgmental approach, he had not found that proposal in the staff paper, Mr. Posthumus remarked. The judgmental approach should be referred to explicitly, with an indication of which elements should be part of that judgment.

On Mr. Ortiz's proposal that creditor countries contribute SDR 26.5 million in order to match the amount raised in FY 1987, there had been no general agreement by the Board that the amount in the Special Contingent Account could be ascribed only to charges which had been paid in 1987, Mr. Posthumus noted.

Mr. Sengupta said that he would like to see a staff paper discussing Mr. Goos's proposal, in addition to some examination of objective criteria upon which the judgmental approach could be based, as Mr. Posthumus had suggested. Also, he would welcome input by the staff on how Ms. Bush's suggestion that creditor countries be given an opportunity to engage in the burden-sharing exercise in 1988 could be realized.

The Treasurer pointed out that burden sharing could not be done at the end of a financial year for that year because the process involved an adjustment of the rates of charge and remuneration; that could not be done retroactively, but only prospectively. Therefore, if the Board wanted contributions to the Special Contingent Account to be burden shared, the decision would have to be made before the beginning of the financial year.

Mr. Sengupta said that several courses of action seemed possible. First, it seemed to him that a majority of the Board agreed that the SDR 26.5 million had indeed been raised by the increased rate of charge, and that that amount should be returned to debtors. Second, according to projections, the income for FY 1988 would be in excess of the target income, and consideration could be given to using that excess to pay increased remuneration to creditor countries. The third possibility was to adjust the respective positions of debtors and creditors during the subsequent financial year.

Mr. Massé pointed out that since 2.5 percent of target income was equivalent to about SDR 30 million--approximately equal to the amount already in the Account earned by an increased rate of charge to debtors--if the Board increased the reserve target to 10 percent of net income and refunded the SDR 26.5 million to debtors, then the entire amount in the Special Contingent Account would be burden shared, the debtors would have been refunded their initial contribution to the Account, and supplemental income would be provided for the Account. In other words, 5 percent of target income would remain in reserves, and 5 percent would be allocated to the Special Contingent Account.

Mr. Posthumus questioned whether there had indeed been agreement that the SDR 26.5 million had been raised only by debtors.

The Treasurer recalled that one of the two possibilities mentioned in EBS/87/178 was to share refunding of the amount in the Account equally between creditors and debtors. However, if the Board had had perfect foresight at the time when the rate of charge for FY 1987 was set, it would have set that charge at a level that would have generated net income representing precisely 7.5 percent of reserves at the beginning of the financial year. The rate of remuneration for that financial year had previously been set at 100 percent of the SDR interest rate. Accordingly, the income which was eventually placed in the Special Contingent Account--the excess over the income target--had been raised in effect through charges paid by debtor countries. Therefore, when the need for the Account disappeared, that amount should be refunded to those who paid charges in FY 1987.

In response to a question by Ms. Bush, the Treasurer said that the rate of remuneration from May 1, 1986 to January 1987 had been below 100 percent; it had been increased to 100 percent in February 1987.

Mr. Enoch proposed that the Board delay any decisions on additions to the Special Contingent Account until the end of the financial year, when it would have the benefit of a staff paper on the issue of renewing the burden-sharing agreement. The possibility that the creditor countries should match the contribution of the debtors could be considered at that time, and reflected in the decisions taken for FY 1989.

The Acting Chairman made the following concluding remarks:

> A number of Directors noted that a considerable amount of progress was made in this discussion; Directors have gone a long way toward reaching a solution.
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> A broad consensus has developed on the need for some form of precautionary balance in the view of a continuing rise in arrears. There is a growing majority--in the range of 60 percent--in favor of adding to the Special Contingent Account, through a process that would depend on judgment and with financing based on burden sharing. At the same time, Directors remained open to considering approaches which might accomplish the same objective and achieve the necessary broad Board support. While at the moment there is not a basis for a decision, there was a general view that these issues could be dealt with by the end of FY 1988 in the context of the discussion on burden sharing and the income review for FY 1988. The exact timing of that discussion can be considered next year at the time of the work program discussion. On the basis of the discussion that has taken place today, the staff will prepare a paper for consideration at the time to explore in more detail some of the alternatives that were suggested today--Mr. Goos's proposal and other thoughts that were expressed that might lead to the necessary consensus.
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> A decision on the disposal of the SDR 26 million that is in the Special Contingent Account when the need for the Account disappears requires a 70 percent voting majority, which was not reached during the course of today's discussion; that is an issue to which we will have to return at the time of the discussion of the next staff paper.

The Secretary, in response to a question by Mr. Ortiz, said that less than the 70 percent of voting power necessary for a decision had been specifically in favor of returning the SDR 26.5 million to those countries which paid charges in FY 1987.

Mr. Sengupta said that if the additional 2.5 percent were to be raised in equal amounts by creditors and debtors, the rate of remuneration would have to be reduced by 8 basis points and the rate of charge increased by 8 basis points. According to the present projection of net income, one could expect SDR 125-128 million in income. According to normal practice, the rate of charge would be retroactively adjusted at the end of the financial year in order to compensate for the SDR 37 or SDR 38 million surplus. He asked by how much the rate of charge would be reduced, given that scenario.

The Treasurer said that he was reluctant to have any decisions based on the projections in the staff paper. It would be highly risky to assume that the SDR rate would continue unchanged, and to base a decision on the expectation of SDR 35 million excess income was not reasonable.

Mr. Sengupta then proposed that the Board agree to increase the Fund's net income by 2.5 percent, of which 1.25 percent would be raised by a reduction in the rate of remuneration. Creditors would thus have the opportunity to contribute in accordance with the principles of burden sharing, and the debtor countries would receive any income in excess of the 7.5 percent plus the additional 2.5 percent. Such a decision could be taken at the current meeting, with adjustments being made at the end of the financial year.

Mr. Massé said that since supplemental income was burden shared--and 2.5 percent of the 7.5 percent of reserves was already supplemental income--then would the result desired by Mr. Sengupta not be achieved by increasing supplemental income from 2.5 percent to 5 percent, and placing that into the Special Contingent Account?

Mr. Sengupta added that any net income above the total 10 percent target should be returned to the debtor countries.

The Treasurer said that as he understood it, Mr. Sengupta's proposal was to increase the income target for FY 1988 from 7.5 percent to 10 percent, the additional 2.5 percent being allocated to the Special Contingent Account according to the principles of burden sharing, by adjusting the rates of charge and remuneration.

Mr. Sengupta indicated that that was an accurate summary of his position. However, the account in which the additional 2.5 percent was to be held was an open question.

Mr. Posthumus asked whether, if the 10 percent target was not reached, charges would then be increased.

The Treasurer said that if the 10 percent target were not reached, then the Board would have to address the question of ways in which it could be met. The first step would be to adjust the rate of remuneration--within the limitation of 85 percent of the SDR rate--and the rate of charge.

The staff representative from the Treasurer's Department said that in the past, when the desired level of income had not been achieved, the Board had considered at the beginning of the following year whether it wished to raise the net income target for that year in order to make up for the shortfall; an alternative was to deem the shortfall acceptable in light of circumstances experienced in the preceding year.

The Acting Chairman suggested that the staff put Mr. Sengupta's proposal into writing for the Board's consideration at a subsequent meeting.

Mr. Posthumus said that it was still not clear to him whether surplus income should indeed be paid back to debtors alone.

The Treasurer stated that it was for the Board to decide how to dispose of excess income. It could retroactively adjust the rate of charge; it could place the amount into reserves; it could place the amount into the Special Contingent Account; or, it could decide to distribute the amount to the membership at large.

Mr. Sengupta said that the distribution of the original SDR 26.5 million was a separate issue. His proposal was that the target net income would be 10 percent of reserves, of which 5 percent would be supplemental income, burden shared, and the remaining 5 percent would be allocated to reserves. If the actual net income was less than targeted, then the 5 percent that was to be placed to reserves would have to be increased by changing the usual variables.

Mr. Ortiz pointed out that that had been the proposal of the staff--to generate an additional 2.5 percent in target income for 1988 which would be financed by a 0.18 percent increase in the rate of charge and a parallel reduction in the rate of remuneration. Mr. Sengupta's proposal merely added the caveat that the additional income be burden shared and that any excess would be returned to debtors in the form of a retroactive reduction in the rate of charge for the second half of FY 1988, with a shortfall being financed by a reduction in the rate of remuneration.

Mr. Chatah said that he understood Mr. Sengupta's proposal to imply an increase in the reserve target without changing the rates of charge or remuneration, resulting from the margin between the target income and the projected income. Any excess income from FY 1988 would result from excessively high rates of charge being paid by debtors.

Mr. Goos suggested that a decision not be taken until the beginning of FY 1989. As Board members had declared themselves ready to undertake burden sharing, the costs would be equally spread.

Ms. Bush said that she would welcome an attempt by the staff to close the loophole that could be encountered if income fell short of that necessary to generate the reserve target of 10 percent of net income.

Mr. Massé pointed out that in the event of a shortfall, the variable figure was the rate of charge. If a shortfall occurred in FY 1988, then the rate of charge would be increased for FY 1989 in order to make up the deficit from the previous year. Therefore, the additional 2.5 percent would be burden shared even if a shortfall occurred.

The staff representative from the Legal Department observed that if the additional 2.5 percent was considered supplemental income, a mechanism existed for that amount to be refunded and to be recorded separately. Whether that mechanism was actually used was for the Board to decide.

The Acting Chairman said that there did not appear to be enough support to return to the discussion at hand in a few days.

Mr. Sengupta suggested that the issue be discussed at the beginning of January 1988.

Mr. Goos said that he preferred to delay a decision on additions to the Special Contingent Account until his proposal had been discussed and until the income situation for FY 1988 was clear. On the basis of that information, a well-considered decision could be made on what to do with the surplus, if any, for FY 1987. Since the income position would have to be discussed in April 1988, there did not seem much to be gained by returning to the specific issue of additions to the Account before that time.

The staff representative from the Treasurer's Department, in response to a question from the Acting Chairman, said that any change in the rate of remuneration would take effect from the date of the decision; the rate of remuneration could not be adjusted retroactively.

The Executive Directors adjourned for the time being their discussion of the Fund's income position and additions to the Special Contingent Account.

2. PARAGUAY - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Paraguay (SM/87/251, 10/30/87), together with a paper on recent economic developments in Paraguay (SM/87/265, 11/19/87).

Mr. Donoso made the following statement:

> Paraguay experienced high rates of growth during the 1970s. Until 1981 the economy was growing at rates about 10 percent, while preserving its external balance. The impressive performance during the period until 1981 largely reflected a generally positive external environment as well as the beneficial effects of the construction of the Itaipu hydroelectric project, undertaken jointly with Brazil.
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> Like most Latin American countries, Paraguay had to face a dramatic worsening in its external situation after 1981. External interest rates became higher and the terms of trade deteriorated.
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> GDP grew at 8.6 percent in real terms in 1981, but, in 1982 and 1983 it decreased in real terms. Growth resumed after 1983 though at much lower rates, reflecting the persistence of deteriorated external conditions. The strong correlation between changes in terms of trade and rates of growth of GDP after 1980 clearly points to the vulnerability of the Paraguayan economy to external shocks and to the importance of external factors in the actual evolution of the macroeconomic variables after 1980.

The difficulties created by these phenomena were compounded by those which can be considered special characteristics of the Paraguayan economy. First, more than 40 percent of Paraguay's exports are to neighboring countries which have undertaken strong adjustment and suffered from recession after 1982. Second, Yacyreta, a major hydroelectric project to be developed after the Itaipu project, was delayed because of the difficulties in the region.

In the authorities' view it is impossible to understand the evolution of the economy in the recent years without considering the role played by the external developments in an economy located in a region plagued by difficulties. In particular, any judgment on the appropriateness of the decisions to invest in cement and steel production has to take into account the fact that those decisions were made with a view to export at least part of the production and at a time when the external environment was very different.

The authorities attach great importance to the role of appropriate policies in containing the negative impact of external developments and in preserving growth prospects. In designing their policies, the authorities considered the need to face the external developments and the internal difficulties created by a worsening economic situation.

Since policy adjustment could not have completely offset the negative external circumstances, it is difficult to establish so definitely as has the staff that Paraguay's economic performance has been disappointing.

At present Paraguay is experiencing public finance imbalances. After a period of surpluses in the nonfinancial public sector, public finances deteriorated markedly over the period 1980-83. Since 1983, when the nonfinancial public sector deficit reached 7.6 percent of GDP, the situation has experienced improvement especially in the central government finances, which present a small increase in revenues and, more important, reduction in both current and capital expenditures by 3.2 percent of GDP.

As the staff has noted, when the figures corresponding to the nonfinancial public sector are analyzed together with those of the Central Bank it is apparent that the combined deficit of the Central Bank and the nonfinancial public sector is at a high level, even though it is 2.4 percent of GDP lower than in 1984, and this is a matter of concern for my authorities. The Plan for Economic Reactivation presented during 1986 emphasized the need to introduce a value-added tax and an income tax. These measures, together with realistic pricing in public enterprises, were considered basic elements for improvement in the public finance situation. It is in this context that adjustments in tariffs were implemented in early 1987, after which the public enterprises' problems have been limited to a few cases. The authorities are actively pursuing the analysis of tax reform and measures to improve the public finances with the World Bank and especially in the context of projects supported by the Inter-American Development Bank.

The public finance imbalances and the support to the agricultural sector through credit at preferential rates have limited flexibility of monetary management in Paraguay. The resulting credit creation has caused price increases and losses of international reserves.

The authorities have introduced adjustments to the official exchange rate aimed at reflecting price movements and maintaining competitiveness. After the adjustments introduced in late 1986, the real exchange rate is substantially below the levels observed since 1980 and official and free-market rates are closer than they have been in most periods since the 1982 crisis. The authorities are also reviewing interest rate polcies so as to bring interest rates more in line with the rate of inflation.

While the basic difficulties in the regional economies have not disappeared, there are positive elements to consider. Some recovery in the access of the public sector to medium- and long-term financing should be expected. In net terms this type of financing steadily decreased from $280 million to $93 million between 1983-86 and to minus 20 million projected for 1987.

Current discussions with the World Bank and the IDB should lead to a resumption of net borrowing to finance projects in education, rural and urban development, roads, industrial development, electricity, and rural education.

The Yacyreta project has accelerated and it is expected that it will bring a net inflow of foreign exchange of about $75 million a year for the next several years. Also, receipts from sales of electricity produced by the Itaipu project should continuously increase to reach more than $100 million a year in the early 1990s.

The terms of trade have been affected by movements in cotton and soybean prices. After 1987 the export unit value declined by a cumulative 22 percent but, based on most recent developments, will recover significantly in 1987. Import unit prices decreased in 1985 but increased in 1986. If they increase by less than the export unit value in 1987, as expected, the terms of trade would improve by 14 percent in 1987.

Export unit values will increase by more than 20 percent in 1987 after decreasing more than 20 percent in the previous two years. In a sense, the effect of this is equivalent to a reduction in external interest rates, adding to the benefits of the improvement in terms of trade.

The authorities fully realize that in spite of these positive elements, policy corrections are needed. The exchange rate adjustments of late 1986 and the tariff adjustments of early 1987 represent, in the view of the authorities, major efforts to address the issue of price distortions while avoiding the use of inflation as the variable absorbing systemic tensions. Serious work is being done to improve administrative procedures and enhance control over tax payments. Recent estimates indicate that tax collections will be 20 percent above the original budget estimates and nearly 40 percent above 1986 collection--and even higher in real terms.

It is the authorities' view that given a more positive evolution of the economy it should be easier to proceed with the comprehensive reforms they are planning to correct the public finances imbalances and price distortions that are negatively affecting the economy.

Mr. Zeas made the following statement:

Paraguay's economic performance improved significantly during 1987. Real growth is estimated to have reached 4 percent, owing in part to more favorable weather conditions than in 1986, as well as to the fact that the construction sector boomed, led by an acceleration of the Yacyreta hydroelectric project. Unemployment was reduced significantly to 7 percent, and the annual inflation rate was reduced by one third--to 21 percent--from the previous year.

Per capita GDP for 1986 was near $1,400. On this matter, the staff indicates that "real GDP per capita in 1987 is still 12 percent below the 1981 level." If this is meant to imply that Paraguay's performance has been uniquely deficient, it is somewhat misleading. The fact is that there are few Latin American countries which performed much better in the same period for a number of causes, including important external factors, with which we are all familiar, such as the deterioration in the terms of trade and the high interest rates on foreign debt. This point relating to the deterioration of the external environment of Paraguay is well explained in Mr. Donoso's statement.

At the end of 1987, the public sector's foreign debt in relation to GDP reached only 40 percent. However, given the rather high costs of the debt, its service ratio had already surpassed 44 percent of exports of goods and nonfactor services. Therefore, we do view with concern, as does the staff, the overall deficit in Paraguay's external sector for the last five consecutive years, reflecting in large part sizable investment efforts in the hydroelectric, steel, and cement projects.

The staff is quite pessimistic about these projects and states unequivocally: "These projects, which have recently come on stream, are not expected to generate sufficient revenue to service their external debt." At the outset, I would like to note that the projects were in part financed with official foreign suppliers' credits, and our position is that perhaps it is too early to predict the long-term viability of these projects. Many long-term viable projects produce cash flow deficits in the initial years of operation. We understand that these projects were initiated because the authorities had an agreement that some electricity, steel, and cement were going to be exported to the relatively large neighboring countries. This may still be the case when the economic circumstances in the neighhboring countries improve.

The staff points out that the fiscal gap has been reduced from approximately 9 percent in 1984/85 to about 7 percent in 1986/87. As the figures show, there has been progress. About 3 percentage points of the deficit correspond to the Central Bank's losses on sales of foreign exchange to the public sector; therefore, the nonfinancial public sector's deficit was in fact only equivalent to 4 percent of GDP.

The financial situation of the Central Bank will improve as the exchange system is adjusted gradually. With respect to the deficit of the nonfinancial public sector, we would like to make the following comment: the central government revenue/GDP ratio is quite low in Paraguay at only 7 percent. A low revenue/GDP ratio can be justified, in principle, when a country is determined to allow maximum incentives to the private sector. However, we would encourage the authorities to proceed with the programmed introduction of the income tax and to review periodically and gradually the tariffs and prices of the state enterprises. In this respect, adjustments to the tariffs were made at the beginning of 1987; nevertheless, this continues to be a matter of concern for the authorities.

On the exchange system, we agree that a gradual reduction of the multiple rates is desirable, among other reasons, in order to prevent the underinvoicing of exports. However, we note that the exchange rate for exporters was already increased from ₲ 126 to ₲ 550 between 1983 and 1986--a 337 percent increase. We can understand the authorities' hesitancy to immediately adjust all of their exchange rates to the street market rate of ₲ 850 = US$1 when only four years ago the guaraní rate was

¢ 126 = US$1. Neither the inflation differentials nor the overall structure and performance of the external sector would justify such a large devaluation in real terms. The free market exchange rate seems to be quite unstable at the moment and heavily influenced by short-term capital outflows, particularly those by nonresident investors.

We feel that the overall economic performance of Paraguay improved during 1987. We agree that a further reduction of the overall deficit of the public sector, and the elimination of external arrears and multiple currency practices are quite desirable policy objectives, but these adjustments must continue to be carried out on a gradual basis in order not to jeopardize the recovery that seems to have begun.

Mr. Ayales made the following statement:

After rapid growth for a long period, Paraguay's economic performance has deteriorated in the last seven years. This deterioration is due to exogenous factors as well as to the pursuit of unsuitable economic policies. The reduction in physical investment has been compounded by weather-related damages, which have adversely affected output. Furthermore, owing to the high vulnerability of the Paraguayan economy to external shocks, the difficult economic situation experienced by neighboring countries--Paraguay's most important trade partners--is also important in explaining recent economic developments in Paraguay.

Public finances require close monitoring. The overall deficit/GDP ratio stands at a rather high level--7.1 percent in 1986--despite the fact that it fell in the last two years, reducing the effectiveness of domestic stabilization efforts. The fact that almost half of the deficit corresponds to central bank losses, which in turn stem from exchange rate subsidies to the public sector, exacerbates its negative consequences.

The Central Administration's deficit has been steadily reduced during the last three years, and in 1986 was equivalent to only one third of its level in 1983. Some improvement has also been achieved in the public enterprises' financial situation in that the deficit/GDP ratio was reduced from 4.2 to 2.4 percent in the same period. However, we have to be cautious when analyzing these figures. To obtain a clearer picture of the public finances and of the financial performance and operations of the different subsectors within the public sector, the data on central bank exchange losses would have to be divided according to the various subsectors. Without that information, the analysis is limited to the available data for the combined nonfinancial public sector.

On the monetary side, we find that the expansionary credit policy pursued during recent years might have contributed to the acceleration of inflationary pressures and to the expansion of the external imbalances. This situation has been aggravated by the existence of highly negative real interest rates, which in turn may help to explain the reduction of domestic financial savings in real terms.

We believe that, in spite of an expected satisfactory recovery in exports for this year, the current exchange rate is hindering export efforts. It is desirable that the authorities simplify the current exchange rate system. Considering that most private sector imports already take place at the free-market rate, the inflationary consequences of an exchange rate unification may not be all that significant.

We encourage the authorities to move toward exchange rate unification, accompanying exchange rate policy measures with fiscal restraint and prudent monetary management. We welcome the authorities' efforts to improve administrative procedures and to enhance controls over tax payments.

However, we concur with the staff that a major tax effort and a revision of the operation of public enterprises--particularly the adjustment of public prices in the context of reduced exchange rate subsidies--may be important at this juncture. At the same time, a cautious credit policy should be accompanied with rates of interest more in line with the current rate of inflation.

We support the proposed decisions.

Mr. Rieffel made the following statement:

In its review of Paraguay's economic policies last year, the Board noted the fundamental disequilibrium in public finances and the serious distortions caused by the exchange rate system, and it stressed the urgent need for reform. We recognize that there have been external factors in recent years that have had an adverse impact on Paraguay's economy--such as reduced demand in its principal export markets and difficulties related to its two major hydroelectric projects. Nevertheless, policy implementation since our last review has been disappointing and consequently the need for reform is even more urgent.

The two areas in which inappropriate policies appear to be causing the greatest strains on the economy are the multiple exchange rate system and the parastatal enterprise sector. Indeed, the two areas are interlinked because the exchange rate system is used to protect or conceal inefficiencies in the parastatal sector. For example, certain parastatal enterprises are able to purchase foreign exchange at a rate of ₲ 240 per U.S. dollar, compared to the free rate of ₲ 950 per dollar--a subsidy of 350 percent on their foreign exchange costs. Subsidies of this kind are an incentive for those who benefit from them to use scarce foreign exchange inefficiently. In addition, they create irresistible opportunities for illegal diversion of foreign exchange, and capital flight.

Table 2 on page 4 of the staff report (SM/87/251) provides a disturbing statistical picture of the cost of Paraguay's exchange rate system. The overall fiscal deficit for 1987 is projected to be 7.1 percent of GDP--which is unsustainably high. Within this ratio, central bank exchange losses represented 5.2 percent of GDP and foreign exchange subsidies to the parastatal sector represented another 1.1 percent of GDP.

It is difficult to see how Paraguay will achieve a sustainable external position without a major adjustment of the exchange rate system, and a thorough overhaul of the parastatal sector appears equally necessary. In particular, we hope that in our next review of Paraguay's policies we will find that steps have been taken to prevent the new steel and cement enterprises from becoming a long-term burden on the public.

With respect to fiscal policies, the staff points out that Paraguay's mobilization of domestic resources is the lowest in all of Latin America. If Paraguay were able to limit tax collection to 8 percent of GDP without running a fiscal deficit and still experience strong economic growth, it would be the envy of many countries. Unfortunately, this is far from the case, and immediate steps to raise government revenues are critically needed.

For example, some of the measures contained in the Plan for Economic Reactivation announced more than a year ago, such as a value-added tax and an income tax, strike us as reasonable. We note that the authorities consider the introduction of major revenue measures to be politically unfeasible, but surely further delay in introducing such measures will mean that they will be more stressful when they come.

In the area of monetary policies, there have been two welcome developments, namely, the repeal of the usury laws and the central bank proposals to raise the rediscount rate. Nevertheless, the loose monetary stance of the authorities bodes ill for the future, and negative real interest rates are almost a guarantee that the economy will stagnate in the years ahead.

Reflecting the policy weaknesses noted above, Paraguay's balance of payments shows the classic signs of unsustainability,

> notably growing payment arrears. Given the absence of appropriate policies, we support the decision to conclude this Article IV consultation without approving Paraguay's multiple currency practices and exchange restrictions.

The staff representative from the Western Hemisphere Department said that while the change from ₲ 126 per US$1 to ₲ 550 per US$1 in the exchange rate over a period of three years was significant, the exchange rate of ₲ 126 per US$1 had been maintained for over 15 years as a result of the inflow produced by large-scale hydroelectric projects. During that period, there had been a substantial amount of inflation. Currently, Paraguay needed to generate additional foreign exchange, and it was for that reason that the staff had suggested a review of the exchange rate system.

On the issue of central bank losses, the staff representative from the Western Hemisphere Department concluded, those were generally the counterparts of subsidies to parastatal enterprises for interest payments being made abroad or for their imports.

Mr. Donoso thanked Executive Directors and the staff for their contributions to the Article IV consultation discussion.

The Acting Chairman then made the following summing up:

> Directors were in general agreement with the views expressed in the staff appraisal.
>
> Concern was expressed about the continuing domestic and external imbalances in Paraguay. Although certain steps had been taken in late 1986 in the area of exchange rate policy, the balance of payments continued to be under pressure and inflation remained quite high. While the external causes of these developments were recognized, the view was expressed that weaknesses in policy implementation affected the performance of the economy.
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> The overall public sector deficit, including the losses of the Central Bank, was cited as being at the heart of Paraguay's economic difficulties, and the authorities were urged to make every effort to reduce that deficit. The large size of the fiscal imbalance indicated the need for simultaneous action on several fronts, but particular emphasis was to be placed on measures to improve Paraguay's tax effort, which was considered inadequate.
>
> Directors also noted the weakening in the operations of the public enterprises and encouraged the authorities to review the adequacy of the present level of public enterprise tariffs and to examine whether it might be desirable to curtail the operations of some of the enterprises.

It was noted that the main factor in the acceleration in the rate of monetary expansion was the foreign exchange subsidies provided by the Central Bank to the public sector, and that a correction of this situation would require that the fiscal imbalances underlying those subsidies be addressed.

The exchange rate measures adopted at the end of 1986 were welcomed as a step toward making Paraguay's exchange rate system more realistic, but it was observed that further substantive action was required in this area. It was emphasized, however, that such action needed to be accompanied by supporting fiscal measures and monetary restraint in order to deal successfully with the country's external and internal imbalances.

The authorities were encouraged to dismantle Paraguay's restrictive trade policies and exchange controls and to eliminate the commercial payments arrears that had accumulated in recent years.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Paraguay's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1987 Article XIV consultation with Paraguay, in the light of the 1987 Article IV consultation with Paraguay conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Paraguay maintains restrictions on the making of payments and transfers for current international transactions and multiple currency practices subject to Article VIII, as described in SM/87/265. The Fund notes the complexity of Paraguay's exchange system and urges the authorities to simplify it by unification of the exchange rate and by the removal of restrictions on payments and transfers for current international transactions.

Decision No. 8751-(87/170), adopted
December 14, 1987

3. ARGENTINA - REPORT BY DEPUTY MANAGING DIRECTOR

The Acting Chairman reported briefly on the Fund's negotiations with Argentina.

APPROVED: July 25, 1988

JOSEPH W. LANG, JR.
Acting Secretary