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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/98

10:00 a.m., June 19, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
C. H. Dallara	
	G. Ercel, Temporary
	T. Alhaimus
H. Fujino	
	B. Goos
	Song G., Temporary
	J. Reddy, Temporary
	J. R. N. Almeida, Temporary
T. P. Lankester	
H. Lundstrom	
M. Massé	
	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
	G. Ortiz
	G. Nguyen, Temporary
	J. de Beaufort Wijnholds
	A. V. Romuáldez
	O. Kabbaj
	A. Vasudevan, Temporary
	F. Di Mauro, Temporary

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

Also Present

IBRD: K. Marshall, Latin America and Caribbean Regional Office. Exchange and Trade Relations Department: M. Guitián, Deputy Director; C. Atkinson, R. L. Sheehy. Fiscal Affairs Department: E. S. Kreis. Legal Department: J. V. Surr. Research Department: L. Alexander, E. C. Meldau-Womack. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, H. M. Flickenschild, B. Fritz-Krocow, J. Jaramillo-Vallejo, C. M. Loser, J. Sol-Perez. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, K. Murakami, D. C. Templeman, M. A. Weitz. Assistants to Executive Directors: M. Arif, A. Bertuch-Samuels, B. Bogdanovic, W. N. Engert, G. K. Hodges, S. King, T. Morita, R. Msadek, J. A. K. Munthali, A. H. Mustafa, J. E. Rodríguez, D. Saha.

1. BOLIVIA - STAND-BY ARRANGEMENT AND EXCHANGE SYSTEM

The Executive Directors considered a request from Bolivia for a stand-by arrangement in an amount equivalent to SDR 50 million, together with a proposed decision regarding Bolivia's exchange system (EBM/86/120, 6/2/86; and Cor. 1, 6/16/86).

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

> Recent information indicates that the Bolivian authorities' economic program is on track. Consumer prices rose by 0.9 percent in May 1986, bringing cumulative inflation since December 1985 to 50 percent, approximately as projected under the program. All but a small part (less than 5 percent) of that cumulative increase was attributable to the sharp increase in the price level in December 1985 and January 1986. The official exchange rate has remained at about $b 1,900,000 per U.S. dollar since mid-March 1986 and the parallel exchange rate generally has remained very close to the official rate. On June 17, 1986 the official rate was $b 1,905,000 per U.S. dollar, while the buying rate in the parallel market stood at $b 1,940,000 per U.S. dollar, representing a premium of 1.8 percent. In the first five months of 1986, net international reserves of the Central Bank rose by US$42 million.
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> Underlying the recent price and exchange rate performance was a tight fiscal and monetary policy. During the first five months of 1986 central bank credit to the nonfinancial public sector contracted sharply. In the Treasury accounts, a shortfall of revenue was more than offset by a lower than projected level of spending; however, outlays for wages were slightly above projections, possibly reflecting the wage increase given to the teachers in April 1986. In responce to the tight fiscal stance and the emergence of excess liquidity in the commercial banks, the net domestic assets of the Central Bank contracted sharply from January 1-May 10, 1986. The high real interest rates (see below) and the return of confidence led to a strong increase in the demand for money and quasi-money. While currency issue expanded moderately, bank deposits almost doubled in the four months ended April 1986 from the equivalent of US$59 million to the equivalent of US$112 million.
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> Against the backdrop of the favorable price and exchange rate developments, the level of interest rates and the spread between lending and deposit rates started to decline. The lending rate on local currency loans, which was 20 percent a month in late 1985 and early 1986, has since then fallen to 8 1/4 percent a month in May 1986. Rates on local currency deposits declined somewhat less rapidly, thus reducing the monthly interest rate spread on operations in local currency from about 10 percent in early 1986 to about 4 percent in May 1986.

Mr. Nebbia made the following statement:

The staff paper prepared in connection with the request for a stand-by arrangement with Bolivia provides in the view of my authorities, a fair and comprehensive assessment of the Bolivian economy. My authorities want to thank the staff on its report and the management for its support of the stabilization program for Bolivia.

As Directors are aware, Bolivia is facing extremely difficult economic circumstances. During the past years there has been an extremely high level of inflation, a sharp reduction in economic activity, an increase in the unemployment rate, an important reduction in real wages, a dramatic fall in investment, and continued weakness in the external sector. This deterioration in the economic situation can be associated with extremely adverse external factors and with political events that prevented the adoption of the needed domestic policies.

On the external side, the depressed prices for Bolivia's main exports, as well as natural disasters, have negatively affected the economy but my Bolivian authorities recognize that domestic factors have also contributed to the deterioration of the economy. Important decisions on policy actions were delayed, and political instability has had an important bearing on the economic situation of the country. The sharp deterioration in the financial position and economic performance of Bolivia has been the result of the steady expansion of the deficit of the nonfinancial public sector.

On August 29, 1985, the new Government of Bolivia announced a wide-ranging economic policy package aimed at eliminating the severe imbalances in the economy that included the implementation of a flexible exchange rate policy, a movement of the prices of petroleum products toward international levels, the increase in prices of other goods and services produced by state enterprises, and the liberalization of all other prices, interest rates, and the trade and payments system.

The implementation of additional measures related to wage policy, the decentralization and reorganization of the state enterprises, currency reform, reform in the financial sector, and external debt management required more time because of political constraints and the need to work out the necessary technical details.

The Bolivian authorities were generally satisfied with the effects of the economic package, but they felt that additional measures were needed in order to correct the huge internal and external imbalances. Unfortunately, external factors contributed to a worsening of prospects for the economy in late 1985 and early 1986 when the prices of tin and hydrocarbons, which accounted for

85 percent of Bolivia's exports and 56 percent of nonfinancial public sector revenues, began to tumble in international markets.

Available indicators show that Bolivia's financial imbalances have been considerably reduced as a result of the stabilization program introduced by the authorities in August 1985. Net international reserves increased by US$32.3 million to US$192.8 million in the first four months of 1986. The official exchange rate has been stable at about $b 1,900,000 per U.S. dollar since late January 1986, while the premium between the parallel and the official exchange rates has virtually disappeared. The nonfinancial public sector has accumulated considerable deposits in the financial system, suggesting an overall domestic surplus of the public finances. There have been no wage increases except for the increase in April for the teachers, which will, however, be financed without recourse to central bank net credit. As a result, virtual price stability was achieved during the months of March and April 1986.

The Government of Bolivia has now completed a comprehensive economic program for the period April 1986-March 1987, in support of which the authorities are requesting a stand-by arrangement with the Fund.

The features of the program are clearly described in the staff report and do not bear repeating. I will thus concentrate my remarks on a few concepts that are important for my authorities.

The main objective of the program is a decline of inflation from over 8,000 percent in 1985 to less than 85 percent in 1986 and less than 40 percent by the end of the program period. The authorities are satisfied with the tremendous progress already made in this area but they believe that continued efforts in the areas of fiscal, monetary, and external policies will be required to ensure success in controlling inflation.

My Bolivian authorities consider that their effort to control inflation is a remarkable and important accomplishment of the new Government. It should be emphasized in this context that the Bolivian stabilization effort might provide some interesting elements of analysis for future studies on countries with hyperinflation.

After five years of economic decline, the authorities now consider that a reactivation of the economy is essential to ensure social and political stability, and they are confident that the program before us will help to achieve this aim.

The key element of the adjustment program is the reduction of the deficit of the nonfinancial public sector from 14 percent in 1985 to 6.4 percent in 1986 and to below 6 percent of GDP in the program period. The Bolivian authorities would like to stress that this control of the public finances will be extremely important in the effort to achieve the inflation and balance of payments objectives envisaged in the program.

In order to achieve the improvement in the fiscal situation, the authorities will carefully implement a tax reform package, a restrained wage policy as well as a flexible pricing policy in the state enterprises. The authorities agree with the staff's description and analysis of these measures and they are fully committed to implementing all the policies that are necessary to control public finances.

The authorities' determination to restructure the enterprises in the public sector and to adapt them to the changed economic circumstances is shown by the streamlining and regional decentralization of the state mining company (COMIBOL).

In view of the collapse of the international price of tin, the Government has decided to close the most unprofitable mines and has already made progress reducing overstaffing by laying off several thousand company workers, especially those not directly involved in mining activities.

Technical assistance from the World Bank is being provided to help the authorities reorganize the streamlined enterprises into four regional subdivisions, which will also absorb two previously independent refineries.

In May 1986, the Bolivian Congress approved an important tax reform package. The Government is committed to implementing the reform without delay. In particular, the authorities plan to implement the new taxes in such a way that existing taxes will not be withdrawn before their replacements have begun to produce revenues.

On wage policy, the public sector wage bill will remain frozen until the end of June 1986. After that, the Government will grant a wage increase in light of its financial situation and taking into account the achievement of the objectives of the stabilization program.

Considering that the medium-term outlook for the Bolivian economy is not very encouraging, the Government feels that growth-oriented investment programs are very important for the future of the economy. The World Bank should play a key role in this area, and the authorities are confident that prospects for a growing Bank involvement in Bolivia are excellent now.

Regarding the implementation of their credit policy, the authorities are committed to ensuring that it is compatible with a very low level of inflation and the attainment of the balance of payments objective. They believe that the monetary program is consistent with improved access to credit for the private sector, given the strengthening of the public finances. Also, the authorities are committed to pursuing a flexible exchange rate policy in order to improve the balance of payments situation and public finances as well as to encourage economic growth. They consider that the auction market system for the determination of the exchange rate of the peso has functioned well and should be maintained.

Bolivia's trade system is virtually free of restrictions, and the Government is determined to continue with this free trade system.

In order to arrange the foreign financing necessary to support the stabilization program, the Government is conducting negotiations with its major creditors to obtain fresh funds and also to restructure on more generous terms debt service on arrears and on obligations falling due during the program period. Also, the authorities recognize the useful role that foreign private investment can play to help the achievement of sustained growth, and it is working in this area to attract new foreign investment.

Considering the weakness that characterizes administrative procedures and the statistical information base, my authorities want to request additional technical assistance from the Fund and other international organizations.

Finally, the Bolivian authorities would like to ask for the support of the Board to their request for a stand-by arrangement with the Fund. They consider that this agreement will greatly improve confidence in the economy and it will help Bolivia to solve important economic problems.

Mr. Almeida considered that the Bolivian authorities should be congratulated for their determination to initiate an adjustment program that, in its magnitude, was strong but realistically took into account some features of the Bolivian economy. The program continued to emphasize a dramatic reduction in the public sector deficit, which was programmed to decline from 29.2 percent of GDP in 1984 to 6.4 percent of GDP in 1986. At the same time, account had been taken of the deteriorating export market, in both price and volume terms, for natural gas and metals. In that respect, the program did not target a reduction in the current account deficit for 1986 but allowed instead for a modest increase. He had also taken note of the prudence of the authorities in targeting only a small recuperation in national savings for 1986. Following a period of hyperinflation, it made sense not to pursue a rapid return to previous savings levels, as the public would need some time to restore its confidence in the purchasing power of the peso.

He was concerned about what might constitute an excessive concentration of the adjustment effort on petroleum taxes, Mr. Almeida continued. From 0.3 percent of GDP in 1984, tax revenue on petroleum and gas would increase to 8.5 percent of GDP in 1986. He would appreciate staff comment on why the tax effort had relied so heavily on only one product, particularly during a time when estimates of petroleum prices were subject to frequent change.

On exchange rate policy, Mr. Almeida noted that the premium of the U.S. dollar in the parallel market had been made a performance criterion, which seemed to give official status to the so-called parallel market. He wondered why the staff had not used as a reference for exchange rate policy a real exchange rate based on official rates and domestic and foreign price increases, as had been useful for several other cases. Also, he wondered whether the staff had suggested to the authorities that they unify the so-called parallel market with the official exchange market as another way of dealing with the problem.

Bolivia was an ideal candidate for a structural adjustment facility loan, Mr. Almeida considered. Its export revenues were dependent in large part upon a single product, which was covered by an agreement that was due to expire in 1992 and that was also subject to periodic renegotiation of prices. It was encouraging to see that the price on gas negotiated for 1986 fell short of the drop in petroleum prices in world markets. The situation should benefit Bolivia in terms of export revenues, although it might jeopardize the economy's position in the coming years, given the recent discovery of gas deposits in Argentina and the possibility that Argentina's need to import gas could rapidly decline.

Bolivia's new political and social environment made the implementation of the program quite viable, although it was clear that it could not succeed without substantial financial assistance beyond that provided by the Fund, Mr. Almeida said. Confidence in Bolivia's economic management was beginning to be restored, and that confidence was crucial to the effort to channel savings into the financial system and encourage the support of international financial banks. In conclusion, he could strongly support the proposed program.

Mr. Wijnholds, welcoming the strong adjustment effort by Bolivia, observed that Fund support for the Bolivian program was crucial to help generate financial support from other sources in amounts sufficient to enable Bolivia to return to a more normal internal and external position in the years ahead. At the same time, it was important to recognize that the present adjustment program was subject to considerable risk.

The experience of Bolivia in recent years offered the dispassionate observer an interesting example of how the interaction of a weak economic policy, social and political unrest, and runaway inflation could wreak havoc on an economy, Mr. Wijnholds continued. The Bolivians themselves, however, could not be dispassionate about the fact that their standard of living had declined by 30 percent since 1980, although it was to be hoped that that traumatic experience had increased their willingness to accept the demand constraint that was the inevitable initial consequence of the courageous stabilization effort currently under way. The success of the disinflation process introduced by the new Government in August 1985 could be consolidated and enhanced only if the population was willing to show restraint in the crucial area of wages and was willing to accept a higher tax burden. For their part, the authorities needed to show results in a relatively short time in order to convince the population that the disinflation process was working. The aim of bringing inflation to 85 percent in December 1986 and to below 40 percent by mid-1987 appeared to be a realistic and necessary goal. The objective was realistic in the sense that the authorities were not aiming at an immediate eradication of inflation in a country with a strong inflationary tradition; and its achievement was necessary in order to restore confidence and bring about a normalization of economic conditions in general.

The causes of the hyperinflation in the Bolivian economy during 1985 seemed clear and did not need repeating, Mr. Wijnholds continued. More important, perhaps, were the consequences that the inflation in Bolivia had had on the economy. He had already mentioned the severe fall in per capita income, which it was hoped would be halted during 1986. For economists and policymakers, however, it was perhaps more interesting to see the effect on national savings and investment, two macroeconomic variables that were crucial to economic performance. As a percentage of GDP, national savings had stood at some 16 percent in the mid 1970s before declining dramatically with the pickup of inflation. Indeed, national savings had fallen to zero by 1983 and to minus 3.6 percent in 1985. It was clear in the circumstances that domestic investment must also have dropped sharply; in fact gross investment had fallen from more than 20 percent of GDP in 1976-78 to less than 3 percent of GDP in 1985. No country could hope to grow with such extremely low levels of investment. Of course, the social and political turmoil in Bolivia in recent years was likely to have had an important negative impact on savings and investment decisions; but he saw hyperinflation as at least a major factor, and perhaps the major factor, in the precipitous decline in savings and investment in Bolivia. Political instability in the country could perhaps also be attributed in part to runaway inflation, a process that tended to be highly disruptive in any society. In the circumstances, it was fully appropriate that the economic program focused on reducing inflation to more moderate levels with emphasis on a strong improvement in the public finances, backed by tax reform and a firm wage policy. Only if inflation was contained could Bolivia hope to establish sustained growth.

The approach followed in Bolivia for combating rampant inflation differed from that followed recently in a number of other high-inflation countries, Mr. Wijnholds observed. Bolivia had not attempted to stop inflation in one blow, which could only be accomplished by means of comprehensive wage and price freezes. Whether or not such an approach would have been better suited to Bolivia's circumstances he could not judge; in passing, however, he observed that the requested comparative staff study of the recent experience of anti-inflation programs in a number of countries should be useful, and he recalled that Mr. Nebbia had mentioned that the Bolivian stabilization program might provide some interesting elements for analysis for future studies of countries with hyperinflation. About all that one could say at present was that, if Bolivia succeeded in pushing back inflation to acceptable levels without resorting to direct controls, it would later on not have to face the difficult task of "unfreezing" which other countries might have to face.

Remarking on specifics of the economic program, Mr. Wijnholds welcomed the move toward sounder public finances, which should remain a central element in the disinflation strategy. A large part of the targeted reduction in the public sector deficit was related to higher revenues from the production and sale of oil and gas, and it was to be hoped that no problems arose in that area. The recently adopted tax reform package was to be welcomed, as was the new wage policy and the hiring freeze in the public sector. As he had observed earlier, a strong recovery of investment was essential if Bolivia was to replenish its depleted capital stock. Public sector investment outlays of 9 percent of GDP were planned for 1986 on the basis of an investment program prepared by the Fund staff and tentatively endorsed by the World Bank. While that seemed to be a good beginning, it was clear that private sector investment remained low in the current year and should be given greater emphasis so that Bolivia could return to investment levels of the sort that had prevailed in the past.

Financial policies appeared to be reasonably prudent, and the maintenance of a flexible interest rate and exchange rate policy, together with the use of an auction market for foreign exchange sales, were commendable, Mr. Wijnholds commented. The ceilings set for external arrears for one-to-ten-year loans seemed fully appropriate, and it would be desirable for the authorities to develop without delay a system for reporting and monitoring short-term external debt, an action that should be followed by the establishment of a ceiling for such debt as a performance criterion at the time of the mid-term review. If that was not done, a significant loophole could be created for the contracting of external debt.

The staff had made it clear that over the medium term, the external position of Bolivia would remain fragile, and that new restructuring agreements would most likely be needed after the considerable relief to be provided in the current year, Mr. Wijnholds observed. The staff had also noted that the Fund would need to remain involved in Bolivia in the years ahead. The argument for such involvement, including a structural adjustment facility credit, was compelling; however the staff's candid warning that many risks were involved in the implementation of the present adjustment program implied a more than usual risk for the Fund with respect to the stand-by arrangement and its timely repayment. In the circumstances it was appropriate to limit the first stand-by arrangement to a period of 12 months. If the authorities were able successfully to implement the program underlying the stand-by arrangement, he would be willing sympathetically to consider any follow-up requests for use of Fund resources.

Mr. Grosche recalled that during the September 1985 Board discussion of the staff report for the 1985 Article IV consultation with Bolivia, he had commended the then new Government for its remarkable determination in making a new beginning in economic policy, and he had welcomed explicitly the bold steps taken by the Government to stabilize the then rapidly deteriorating and potentially explosive situation inherited from the previous governments. In looking at the current program, he continued to be impressed by the stabilization effort, the more so since it had been broadened to include additional structural measures and the adoption of fiscal and monetary stabilization measures that appeared to go in the right direction. He welcomed, in particular, the tax reform package recently adopted by the Congress as well as the efforts to contain current expenditure growth and strengthen control over the operation of the state enterprises. Altogether, and taking into account the bold structural adjustment measures implemented in 1985, Bolivia's stabilization efforts seemed to encompass all the necessary elements of a growth-oriented adjustment strategy. Particularly noteworthy in that regard was the welcome fact that the authorities had opted for a drastic "shock" approach to adjustment rather than for the more common gradual approach. Also notable was the fact that they had resisted the temptation to rely on such questionable administrative safeguards as general price controls.

In view of the difficult external position and the "precarious medium-term outlook," there was perhaps no realistic alternative to the approach chosen by the authorities, Mr. Grosche continued. At the same time, the staff's assessment of the current and prospective situation clearly underlined the importance of a persistent and firm commitment to adjustment in the years ahead. Bolivia simply could not afford a repetition of the unsuccessful stabilization attempts seen in the past three years or the policy slippages that had occurred in late 1985 and early 1986. And a satisfactory record of adjustment by the new Government would help mobilize support from Bolivia's external creditors. There was little doubt that such support would remain critical to an orderly and successful adjustment for a number of years to come.

In view of the precarious balance of payments outlook, it was unfortunate that the current account deficit was projected to increase by no less than 25 percent in the course of 1986, Mr. Grosche commented. While acknowledging that the weakening of the current account had been due largely to adverse exogenous developments and the need to step up domestic investment, and despite the reassuring indication that new external borrowing would be limited to concessional loans, he would strongly urge the Bolivian authorities to make every effort to achieve a better outcome in the current account than projected under the program. He also encouraged them to lower their target for net interventions in the exchange market. In view of the difficult external debt situation of Bolivia, a more meaningful use could perhaps be made of the country's scarce international reserves, particularly given that an artificial support of the exchange rate would probably do more harm than good under existing conditions.

His concerns about the expected external developments led him to raise questions about the appropriateness of fiscal and monetary policy, Mr. Grosche said. While the authorities generally had committed themselves under the program to an impressive effort to mobilize domestic savings, he shared the staff's concerns about the heavy dependence on revenue from oil and gas, and he endorsed the staff's advice to the authorities to redouble their efforts to find alternative sources of revenue and to implement in full the tax reform package. An early and full implementation of that package should be given the highest priority in order to further reduce the fiscal deficit and to help the Government avoid, as soon as possible, further recourse to central bank financing. In that regard, he had found reassuring the staff's indication that central bank credit had already contracted sharply. Given the crucial importance of fiscal stabilization for the success of the adjustment effort, an assessment shared by Mr. Nebbia, he hoped that the staff would be able to report, on the occasion of the forthcoming program review, significant progress in the implementation of the tax reform effort. The progress in that area should also offer important social and political benefits inasmuch as it would broaden the scope for holding wage and salary increases in the public sector to more tolerable levels, thereby improving the acceptability of the stabilization effort to the Bolivian population. In that context, he noted the substantial decline in per capita income levels in recent years, a trend that was expected to continue under the present program. In the circumstances, he cautioned against setting targets that were too ambitious with regard to wage and salary restraint. It would certainly be of little avail--and might even be counterproductive--if such targets were to meet with insurmountable political resistance or if they were to severely undermine the efficiency of the public sector. He would be grateful for staff comment on that point.

Remarking on monetary policy, Mr. Grosche observed that the favorable price performance since late January 1986 could imply that the monetary growth targets agreed under the program might turn out to be expansionary. He therefore agreed with the staff's advice to keep credit developments under close scrutiny in order to contain domestic demand and forestall the emergence of undue pressures on the balance of payments.

Indicating his hope that the approval of the requested stand-by arrangement would help the Bolivian authorities to reach an earlier agreement with external creditors on the necessary restructuring of the arrears and debt service falling due in 1986, Mr. Grosche welcomed the program provision aimed at ensuring that "the nonfinancial sector will accumulate deposits reflecting the payments due under the anticipated new service schedules and that the Central Bank will increase the quarterly international reserve targets by the U.S. dollar equivalent of the deposit accumulation, if such an agreement has not been reached by the end of June." Needless to say, he attached great importance to the authorities' compliance with that provision as a means of securing an orderly discharge of debt service obligations and regaining the confidence of external creditors. Finally, he could support the proposed decisions.

Mr. Dallara noted that when the Executive Board had met in September 1985 to consider the Article IV consultation with Bolivia, the economic adjustment and reform efforts of the new Government had been only weeks old. The initial strong actions taken in August 1985 had since been reinforced by supporting action and policy commitments that constituted an overall program meriting Fund support. He saw the program as consisting of essentially three elements: the freeing up of relative prices; structural reform, including the strengthening and reform of economic institutions; and the exercise of prudent macroeconomic policies, especially in the fiscal and labor areas.

Considerable progress had been made in creating an array of flexible relative prices and in opening up and deregulating the economy, Mr. Dallara continued. Wage rates, the exchange rate, interest rates and the price of goods and services at present were generally the product of market forces or were being adjusted flexibly. He viewed those developments as critical to the effort to reduce existing and potential imbalances and as the basis for higher and sustainable growth.

A good beginning had been made to structural reform in a number of areas, Mr. Dallara considered. Given the chronic weakness and underdevelopment of some institutions and markets in Bolivia, such reforms were necessary to the establishment of a functional public administration, a healthy private sector, and a growing economy. Restrictions on trade and payments had been eliminated, and a uniform customs tariff was to be introduced shortly. The exchange rate was being determined by supply and demand, and a number of innovations or improvements in financial markets were planned that could be important in the development and growth of the Bolivian economy. Moreover, labor market rigidities were being reduced through possible layoffs of redundant workers in both the public and private sectors. A tax reform had recently been passed by a special session of the Congress, and reforms of public enterprises should make a major contribution to improving the fiscal situation. Having taken note of the ambitious and widespread structural measures being contemplated or acted upon in Bolivia, he stressed that the adoption of new legislation and new policies would be for nought if those laws and policies were not fully implemented. He had the impression that the breadth and scope of the program would tax the administrative structure, and he would therefore strongly support an effort by the Fund and other institutions to cooperate in providing technical assistance to Bolivia in a manner that would avoid duplication of work while helping the authorities to complete the difficult task of administering their program.

Progress under the program since August 1985 had been impressive in some respects, most notably in the arresting of inflation, which had exceeded 8,000 percent during 1985, Mr. Dallara noted. However, some dangers remained, including the upcoming wage negotiations in the public sector, where restraint would be very important. Clearly, wage restraint and more flexible labor practices would be crucial to a revival of sustainable growth. Initially, public investment was envisaged to lead the way to such growth, but, given the weakness of the private sector in recent years, some time might be required for private savings and investment to recover and for the private sector to generate new jobs to provide employment for both new entrants to the labor force and for those employees who might need to be released from the overmanned public sector. The extent of the problem could be seen in the data which reflected that there had been virtually no fixed investment in the private sector in the past three years: the overall fixed investment ratio had been less than 3.5 percent in 1985 and the private savings rate in 1986 was expected to fall to 3 percent of GDP. The need for capital formation and for mobilization of domestic savings was thus clear.

There was no question about the need to rebuild the revenue base in Bolivia, Mr. Dallara remarked. Even the most minimal public services could hardly be financed with a ratio of central government tax revenue to GDP of 3 percent, which was the ratio registered in 1983-84. Also, the pressure for money creation to help finance a public sector deficit that had peaked at nearly 30 percent of GDP in 1984, together with the reduced access of the private sector to available credit, needed to be corrected by reducing the fiscal imbalance as soon as feasible. In fact, the reduction in the public sector deficit in 1986 to less than 6.5 percent of GDP would be a notable achievement. Although nearly all the shift would be due to revenue increases rather than expenditure cuts, the composition of expenditures would be improved as a result of a rise in the share of public investment. In that connection, he was pleased to see that the World Bank had given its provisional approval to the public investment plans.

Also important, Mr. Dallara continued, was the need to maintain realistic petroleum product prices and the commitment of the authorities to raise the price above the 23-cent per liter level, if that should prove necessary as a result of any larger than expected wage hikes in the public sector or as a result of shortfalls in revenue under the new tax reform. In that latter connection, the tax reform must be implemented and better tax administration must be achieved if the fiscal effort was to be successful. Finally, reforms of the public enterprises, particularly the reorganization and decentralization of the state mining company (COMIBOL) and the Bolivian petroleum company (YPFB), were important elements of the program.

It appeared that the exercise of monetary policy should be greatly facilitated by the sharp reduction in the fiscal deficit and its financing mainly from foreign financial sources, Mr. Dallara commented. Priority was to be given to credit to agriculture and to the new export financing facility, and he wondered how that related to the reference in the staff report to the "untimely extension" of credit to agriculture earlier in 1986. Also, he would be interested in knowing whether the export credit scheme involved any subsidy.

On the external accounts, it was clear that the balance of payments and foreign debt picture remained serious, in part due to the expected worsening in Bolivia's terms of trade in 1986 but also to some longer-term factors at work on the external position, Mr. Dallara said. The fall in gas and tin prices and the need to encourage economic recovery after five years of negative growth justified some increase in the ratio of the current account deficit to GDP, which would apparently move from 6.5 percent in 1985 to nearly 8 percent in 1986. With exceptional foreign assistance, a deficit of that size could be handled for a short time, but a continuation of such a ratio through 1991 might not be sustainable. A decline in the debt service ratio from 92 percent in 1985 to 59 percent in 1991 would be a more positive outcome, although still not satisfactory. A flexible exchange rate policy should help to encourage export growth and diversification, and the authorities needed to be cautious about exchange market intervention.

The actions taken in late 1985 and early 1986 to free the trade and payments system of restrictions was particularly commendable, Mr. Dallara considered; and the liberalization of the regulation of foreign investment and remittances provided a positive sign of an improved investment climate in Bolivia, as did the signing of an agreement with the Overseas Private Investment Corporation and the acceptance of the Multilateral Investment Guarantee Agency (MIGA) convention.

Many of the debtor countries associated with the Baker debt initiative had been working with the Fund and the World Bank on a continuing basis since the Annual Meetings in Seoul, often under existing Fund and Bank-supported programs, Mr. Dallara observed. It was interesting to note that Bolivia was the first country on the list of 15 countries cited as potential beneficiaries of the Baker debt initiative to come before the Executive Board seeking support for a new program. It was also interesting that Bolivia was the only country on the Baker list that would also be eligible for assistance from the structural adjustment facility. As he saw it, the package of macroeconomic policy actions and commitments and the structural reform efforts by the Bolivian authorities constituted a strong and comprehensive program. Without wishing to underestimate the difficulty of Bolivia's economic situation, including its medium-term debt outlook, he noted that the breadth and scope of the program might cause a major challenge for the Government, which had not in the past benefited from a strong administrative structure. Nonetheless, the program was worthy of the Fund's support. Evidence suggested that similar support could be expected from donors and other creditors if a continued strong reform was pursued. He welcomed the active role being played by the multilateral development banks, including the World Bank, and hoped that bilateral donors would respond favorably, within their budget constraints, to the efforts of the Bolivian authorities. Also, the opportunity had been provided for the commercial banks to show their willingness to participate in the debt initiative in support of the comprehensive program. Bolivia, for its part, needed to move promptly to conclude an agreement to regularize arrears with the banks within the time periods envisaged in the program. The staff's medium-term debt scenario showed a very substantial financing gap into the early 1990s, but with good economic policy and close cooperation with Bolivia's foreign debtors and creditors, the prospects for filling that gap should be enhanced. Finally, he could support the program and the proposed decisions.

Mr. Suraisry noted from the staff paper that the Bolivian Government that had taken office in August 1985 had inherited a difficult economic situation: inflation rates had been extremely high; measured per capita output had declined by 30 percent since 1980; and government finances had deteriorated sharply, with the nonfinancial public sector deficit having reached nearly 30 percent of GDP in 1984. Those problems had been compounded by a sharp deterioration in Bolivia's external environment and had left the new Bolivian Government facing the prospect of pursuing a long period of adjustment. In that regard, the staff's medium-term scenario showed that restructuring agreements would seem to be necessary to close the large financing gaps projected over the next few years.

For their part, the Bolivian authorities had taken commendable measures to deal with the problems facing the economy, Mr. Suraisry continued. Specifically, they had introduced an auction system and had liberalized both international trade and the financial system. The success of the authorities' policy actions had been reflected in the remarkable drop in the inflation rate. However, given the magnitude of the problems facing Bolivia, more remained to be done. It was important, therefore, to establish a fundamental realignment in the underlying fiscal balance. Some progress had already been made toward that end, with total public sector expenditure having declined from 34.5 percent of GDP in 1984 to 20.1 percent in 1985. However, as the fiscal deficit for 1985 was estimated to have been 14 percent of GDP in spite of a sharp reduction in expenditures, further progress was necessary if the monetary objectives of the authorities were not to be compromised. In particular, it would be desirable to increase tax revenues. It was striking to note that, after excluding taxes on petroleum and gas, the balance of tax revenue was expected to amount to only 3.3 percent of GDP in 1986, which reflected a low tax burden by any standard and made the rapid and complete implementation of the recently announced tax reform package all the more important. In that context, the prospect of 10 percent value-added tax represented an appropriate broadening of the tax base, and he was encouraged by Mr. Nebbia's assurances of the Bolivian Government's determination to implement the tax reforms. Moreover, measures to enhance tax revenues could usefully be supplemented by ongoing efforts to restrain expenditures, and he thus commended the authorities for their restrictive wage policy, noting that the share of central administrative expenditures on wages and salaries was projected to decline to 2.5 percent of GDP in 1986 from a level of 8.2 percent of GDP as recently as 1984.

On the monetary side, the attempt to sharply reduce inflation would need the support of a cautious monetary policy, Mr. Suraisry commented. He welcomed the commitment of the authorities to taking a cautious stance and commended them for the recent sharp contraction in central bank credit to the nonfinancial public sector. However, the authorities should be encouraged to monitor the situation carefully, especially as the sharp drop in inflation could generally be expected to affect the demand for money. In addition, as pointed out by the staff, the frequent banking strikes had resulted in the unusual outcome of an increase in the relative demand for currency during the hyperinflationary period. Furthermore, as could be seen from Table 3, velocity had been volatile. It was important in such dynamic circumstances to pay particular attention to the behavior of monetary aggregates so as to ensure their consistency with other policy objectives. On external matters, the adoption of a flexible auction-oriented approach to exchange rate determination had clearly been one of the great successes of the recent policy package. Again, however, close monitoring of the situation would appear to be necessary. In passing, he hoped that the recent real appreciation of the peso reflected underlying real trends.

Decisive policy actions aimed at addressing short-run disequilibria were an essential precondition for a return to sustained growth, Mr. Suraisry considered. As confidence returned, the private sector would again play an appropriate role in the economy. In some respects, the change was already occurring. In particular, the share of gross domestic investment was programmed to rise to 10.5 percent of GDP in 1986, in sharp contrast to the 2.9 percent of GDP ratio registered in 1985. However, further measures to alleviate structural rigidities were clearly necessary. He welcomed the structural reforms being introduced into the state enterprise sector as well as the growing World Bank involvement in indentifying priority projects. In that context, export diversification should receive great emphasis. The prospect of Argentina becoming self-sufficient in natural gas served to emphasize the longer-term vulnerability of Bolivia's external position.

It was worth noting that in contrast to the approach adopted by other countries that had recently attacked the problem of very high inflation, Bolivia had not at the outset invoked a price freeze, Mr. Suraisry commented. Instead, the authorities had encouraged price flexibility, and the success they had achieved in attacking Bolivia's inflationary problems proved that a price freeze was not a necessary condition for overcoming hyperinflation. He would appreciate staff comment on that view and, more generally, hoped that the matter could be addressed in a separate staff paper analyzing options for tackling hyperinflation. Finally, commending the bold policy initiatives adopted by the Bolivian authorities and expressing the hope that the momentum of the adjustment could be sustained, he supported the proposed decisions.

Mr. Nguyen observed that in recent years Bolivia had experienced severe internal and external imbalances: real GDP growth had been negative, and inflation had risen to nearly inconceivable levels. During the 1985 Article IV consultation discussion, the Executive Board had welcomed the implementation of a package of measures aimed at addressing the situation. It was regrettable that the results of that effort had fallen short of expectations, mainly because of unfavorable exogenous developments. Given the size of the imbalances, the poor outlook for Bolivia's traditional exports, and the level of indebtedness, the effort needed to correct the situation would continue to be painful.

The Bolivian authorities should be commended for having reached agreement with the Fund on a program aimed at bringing Bolivia out of its financial difficulties, Mr. Nguyen continued. Fund support of the program should enable some improvement of the financial relations between Bolivia and its external creditors and should help the authorities to reorganize government finances. At the same time, as severe the stabilization program might seem to be, it left room for a much needed resumption of growth following five consecutive years of reduced economic activity. He had no difficulty with the measures recommended in the program itself; in particular, he could support the emphasis placed on the reduction of the overall deficit and the recourse to central bank credit aimed at reducing the inflation rate to the targeted level. Due attention should also be paid to policies regarding the exchange rate, interest rates, pricing and wages; it was obvious, for example, that wage policy must be consistent with program targets. The seriousness of the situation also called for structural reforms, including tax reform and the restructuring of state enterprises, together with involvement by the World Bank in assessing Bolivia's investment program and in devising with the Fund a policy framework paper for a structural adjustment facility loan.

Given Bolivia's economic situation, support from the international financial community would be required for a number of years, Mr. Nguyen commented. It was thus crucial that Bolivia demonstrate its capacity to adjust. Information provided in the opening statements by Mr. Nebbia and the staff was encouraging, but the preliminary indications must be confirmed. In that regard, he looked forward to the next review under which the results of the program would be assessed. Finally, like others, he could support the proposed decisions.

Mr. Fujino remarked that following unprecedented hyperinflation and consecutive declines in real output since 1980, the Bolivian authorities had initiated a bold adjustment effort in August 1985, an effort that had been commended by the Executive Board on the occasion of the discussion of the 1985 Article IV consultation. The economy had responded favorably to that effort, as evidenced by the sharp reduction in the rate of inflation and the improved supply of goods. The principal objective of the program was to help reduce further the rate of inflation, to less than 85 percent in 1986 and less than 40 percent in the program period. The task was a challenging one and would require the continued successful implementation of a comprehensive package of financial improvements, ranging from drastic consolidation of public finances to tight wage and employment policies. Another objective of the program was to lay the foundation for a sustained reactivation of the Bolivian economy, a growth-oriented element that was appropriately stressed and reflected in the program's structural and institutional reforms and in the endorsement of an investment program.

Needless to say, the keystone of the adjustment effort was a substantial improvement in public finances and the securing of resources for high-priority investment projects that would promote exports and economic growth, Mr. Fujino continued. A reduction in the public sector deficit could also leave increased room for the expansion of credit to the private sector. The staff had rightly focused on three main policy areas for achieving the necessary improvement in the public finances: the exchange rate and the domestic prices of petroleum products; taxation and tax administration; and wage policy. He joined the staff in urging the authorities to monitor closely the implementation of necessary measures in those areas in line with the program.

Following five years of decline in real output, the Bolivian economy had recently experienced a sharp decline in the prices of its major export commodities, tin and natural gas, Mr. Fujino commented. Those unfavorable terms of trade developments were expected to result in a significant deterioration in the external account in 1986. The resumption of some moderate growth in the second half of 1986 would be dependent on arrangements for an adequate amount of external financing together with growth-oriented adjustment measures. It was of vital importance that the adjustment program be carried out as planned in order to secure necessary creditor cooperation. The medium-term outlook for the economy was not very promising, with a continuous external financing gap projected over the next several years, even when a considerable increase in long-term capital disbursements was envisaged. In the circumstances, the importance of growth-oriented investment and export diversification could not be overemphasized. He noted with satisfaction that the authorities had worked closely with the World Bank in formulating a public sector investment program, and it was heartening to observe that multilateral development banks had committed themselves to fast disbursing loans, which were projected to more than double between 1985 and 1986. While recourse to that rescheduling from both commercial and offical creditors would help to alleviate the debt servicing situation of Bolivia, it was important for the authorities to eliminate Bolivia's arrears by early 1987. In that connection, because of the close collaboration between the authorities, the Fund, and the World Bank, Bolivia could be a good case for use of resources under the structural adjustment facility, and he would welcome comment by the staff on any progress that might have been made toward that end.

Over the medium to longer term, the utilization of domestic resources should contribute to higher growth in the economy, Mr. Fujino said. In that respect, he welcomed the flexible interest rate policy adopted by the authorities in August 1985. Bank deposits had grown rapidly during the fourth quarter of 1985, although the level of those deposits had been equivalent to only 1.5 percent of GDP at year end, a level substantially lower than that registered four years previously. The maintenance of the flexible interest rate policy should serve to strengthen domestic savings significantly.

The auction market system for the determination of the exchange rate seemed to have operated reasonably well in Bolivia, Mr. Fujino commented. The continued pursuit of a flexible exchange rate policy, with a view to maintaining the competitiveness of Bolivian exports, was crucial to the attainment of the objectives of the program, as was the liberalization of the trade system begun in August 1985. Finally, on the expectation that the Fund-supported program and financing through the stand-by arrangement would work effectively to encourage the necessary cooperation from the international community, he could support the proposed decision.

Mr. Lankester observed that one could not help but be struck by the enormity of the problems facing the new Bolivian Government when it had taken office in August 1985. Those included raging inflation, a national income that had been falling for six consecutive years, uncontrolled public sector finances, and a disastrous external position. Moreover, poor economic management had compounded the problems caused by falling tin prices. The authorities had however avoided incurring prolonged arrears to the Fund, and in so doing had set a good example for other hard-pressed countries.

The problems facing the new Government had been so large that they could not have been remedied in a short time, Mr. Lankester continued. The authorities had clearly made a courageous attempt to reverse the sliding economy and, while they had experienced some difficulties implementing the adjustment program--including some policy slippages toward the end of 1985--they deserved to be warmly supported for the measures they had taken to lay the groundwork for renewed growth. It was appropriate that the international financial institutions, particularly the Fund, should be able to assist the Bolivian authorities in their stabilization effort through the provision of much needed technical assistance as well as financial support. However, the very difficult external situation facing Bolivia underlined the need to ensure that any foreign borrowing was productively used so as to enhance the country's debt servicing capacity.

Despite the significant measures that had been adopted by the authorities, much remained to be done if the progress toward achieving a return to growth was to be consolidated, Mr. Lankester said. On the fiscal side, the improvements in the deficit had thus far relied heavily on higher hydrocarbon taxes; while such reliance was understandable as a short-term expedient, there was a clear need for a widening of the tax base in future. The tax reform package recently passed by the Congress was an important step toward increasing the elasticity of the tax system, and it was essential that the package should be fully and rapidly implemented.

On the external side, the adoption of a flexible exchange rate policy had made a major contribution to improving the competitiveness of the Bolivian economy and the prospects for the external position, Mr. Lankester observed. It was important for the authorities to continue to monitor the exchange rate carefully to ensure that it remained competitive, particularly as there was a pressing need for greater export diversification to reduce the current reliance on tin and hydrocarbon exports. In that regard, he wondered whether the Bolivian authorities had given any thought to unifying the official and parallel exchange rates. As he understood it, the two markets were only about five percentage points apart. He had noted that the authorities, apparently with Fund support, had decided on a Dutch auction system for the exchange market. The issue of what form auction markets should take under Fund programs was an interesting one, and he wondered whether it might usefully be considered in the Board's discussion of the design of Fund programs. He would also be interested in staff comment on the appropriateness of a Dutch auction as opposed to a more common auction.

Remarking more generally on the vulnerability of the external position, Mr. Lankester noted that the situation would apparently remain quite difficult in the medium term; indeed, the staff had projected no additions to the level of reserves until 1990. To improve the external prospects, generous creditor support and the maintenance of competitive exchange rates must be assured. He was happy to note that the authorities were aware of the contribution that direct investment could make to the external position and that they were apparently maintaining fairly liberal policies to ensure an increase in such investment. Moreover, they had recently signed the Multilateral Investment Guarantee Agency (MIGA) convention.

Like others, he warmly commended the cooperation shown by the World Bank and the Fund in supporting the Bolivian adjustment program, Mr. Lankester said. The import reconstruction credit--recently approved by the World Bank--together with the stabilization program supported by the Fund fit neatly together, and the staffs of the two institutions should be congratulated on their cooperative efforts. He warmly endorsed the Bolivian authorities' policy reform measures to date and supported of the proposed stand-by arrangement. It was to be hoped that the authorities would be able to maintain the momentum of the adjustment effort and that it would not be too long before the Fund and the authorities could begin discussions on a structural adjustment facility program.

Mr. Ercel said that he was happy to note that the Bolivian authorities were continuing to implement a comprehensive program of adjustment in an economy plagued by severe internal and external imbalances. Fund assistance in the framework of a stand-by arrangement was thus appropriate and timely, although it was clear that such an arrangement would be only a first step toward addressing Bolivia's severe economic problems. In view of the medium-term outlook and the gravity of the problems, it was to be hoped that the relations between Bolivia and the Fund would continue to be constructive and would provide an appropriate basis for the needed adjustment.

Since the initiation of the adjustment effort in August 1985, the main objective of the Bolivian authorities had been to reduce the exceptionally high inflation rate, Mr. Ercel continued. It was worth noting that the approach chosen by the authorities was rather different from that launched by Argentina, Brazil, and, more recently, by Israel to fight hyperinflation, and it was difficult at present to judge whether the path chosen by the Bolivian authorities was the most appropriate. The program set an inflation target of 84 percent for 1986, with an annualized inflation rate of 20 percent in the final quarter of the year. As he saw it, the target was an optimistic one, even in light of the recent favorable price performance. For one thing the program included a number of upward price adjustments, which, although necessary, could fuel inflation. Moreover, inflationary expectations had not yet been eliminated, and uncertainties surrounded the upcoming wage negotiations. As he saw it, continued tight monetary and fiscal policies and other steps would be required to reach the inflation rate target set for the program period, and he was happy to note from Mr. Nebbia's opening statements that the authorities were cognizant of that requirement.

A second goal of the authorities was to reactivate the economy following five years of decline, Mr. Ercel continued. As the staff had rightly noted, the expected deterioration of the current account was the major obstacle to obtaining required amounts of imported investment goods. Moreover, the weak financial condition of the banking sector interfered with the supply of domestic credit necessary for private sector investment. Any delay in obtaining adequate amounts of external financing would also adversely affect investment performance. In the circumstances, it might not be appropriate at such an early stage of a comprehensive adjustment program to take simultaneous aim at such conflicting goals as a drastic reduction in hyperinflation and a quick recovery of economic and investment activity. Still, the Bolivian program should provide the Fund with interesting examples of approaches to those two main objectives.

The determination of the authorities to continue their stabilization effort and to implement the policy measures embodied in the program were vitally important to the achievement of economic stability, Mr. Ercel considered. The decisive beginning that had been made even before the request for a stand-by arrangement was grounds for confidence in the program. The need for more efficient utilization through more appropriate relative pricing and the elimination of structural weaknesses called for additional forceful measures to be taken soon. Also, as the staff had noted, Bolivia would continue to need additional external financing to cover the sizable financing gaps forseen for the years ahead. Good economic performance and the observance of program targets during the program period would be essential to mobilizing that support. In conclusion, he could approve the proposed decisions.

Mr. Massé remarked that in the present difficult situation, the Bolivian authorities should be commended for their undertaking to liberalize prices and interest rates, for the steps they had taken to attract foreign investment and strengthen the financial market, and for their implementation of a flexible exchange rate policy. In addition, the significant success that they had achieved in decreasing the public sector deficit and, consequently, the financing requirements--especially from the central bank--should be underlined. However, there remained some matters that concerned him.

While he was impressed with the authorities' effort to decrease the public sector deficit, particularly in the area of expenditures, he noted that improvement on the revenue side was concentrated overwhelmingly on increased taxes on the oil and gas sector, Mr. Massé continued. In the circumstances, there had perhaps been few apparent alternatives to satisfy the very pressing short-term need for resources; nevertheless, he joined the staff in urging the authorities not only to improve tax administration and carefully to implement the tax reform package but also to commit themselves to broadening the tax base in order to enhance the reliability of government revenue sources. Such an approach was essential for the long-run improvement of the Bolivian economy because, in his view, it was crucial to permanently reduce government recourse to central bank financing.

Also impressive in the program was the degree of improvement in the inflation rate, which had accompanied what appeared to be a changed economic regime, Mr. Massé continued. The very dramatic and wide-ranging policy changes recently implemented by the Bolivian authorities seemed to have changed private agents' views about the future value of the Bolivian peso. Central to that changed view, as noted by a number of previous speakers, had been a sharp curtailment of the public sector's access to central bank financing, as had been the case in other successful efforts to curb inflation. He agreed with Mr. Nebbia and others that the Bolivian experience provided interesting and perhaps compelling elements of analysis for future studies on hyperinflation. However, given the success in the fight against inflation and the fact that a considerable degree of price stability had been achieved in Bolivia in the past few months, he was curious and somewhat concerned about the target of a 40 percent inflation rate by the end of the program period, a target which suggested a rather rapid acceleration from the recent very low inflation rate. He understood that the Bolivian authorities believed that it was necessary to provide sufficient liquidity to accommodate the public sector investment program and the shift in the price level resulting from the new taxes. Also, the loosening of monetary conditions could help to make room for the recent wage increase granted to teachers, notwithstanding the imposition of the special tax intended to finance the increase. The implied monetary accommodation had been usefully illustrated in the staff report, which showed that during the second half of 1986, the expansion of central bank liabilities was matched much more closely by credit extended to the public sector by comparison with the first half of the year, when most of the increase in the monetary base appeared to have financed the increased demand for real balances through the banking system. His concern was that the hard-won credibility of the Bolivian adjustment effort, established through the dramatic and decisive actions of the Government, might be undermined by the increase in inflation from recent low levels, which could weaken the development and maintenance of positive expectations of monetary stability in the private sector and in the international financial markets. As a result, the authorities would find it even more difficult to establish price stability in the future and to maintain the exchange rate.

Another area of concern was the external balance in the medium-term outlook, Mr. Masse remarked. Not only did Bolivia face difficult prospects; the staff projections for those prospects were based on some rather favorable assumptions, and he would appreciate staff comment on the rationale behind some of the major assumptions presented in Appendix IV and on the likelihood that they would be realized. For example, he was curious about the assumption of a sharp increase in nontraditional exports and nontin mining activity. Also, how important to those assumptions was the establishment and maintenance of a competitive exchange rate? It would be useful if the staff could comment as well on the likelihood that Bolivia and its private creditors--especially the commercial banks--would reach agreement and on what terms. Given the difficult and uncertain circumstances faced by the Bolivian authorities, some sensitivity analyses would have been helpful, especially since they could result in the development of useful contingency plans. In that connection, he wondered whether the Bolivian authorities had established any plans for maintaining fiscal responsibility and balance of payments viability in the event that circumstances remained disadvantageous.

In sum, Mr. Massé said, the Bolivian authorities had taken a number of bold policy moves that had yielded great progress, but more remained to be done, and the adjustment program faced many risks. Moreover, given Bolivia's present difficult position, financing on advantageous terms and from a number of sources would be required, and the Fund would have to continue its involvement in the years ahead in order to support the adjustment effort and to help establish for the longer term a strong and growing economy. In light of those factors, he could support the proposed decisions.

Mr. Vasudevan said that, like others, he could support Bolivia's request for a stand-by arrangement with the Fund. The staff had described how Bolivia's unfortunate economic performance over the past five years had been caused by adverse external factors and political events as well as by some domestic factors. Unfortunately, the external factors remained at play: the recent sharp dip in the prices of Bolivia's main export items--tin and hydrocarbons--and the uncertain prospects for recovery in those prices were matters for serious concern. However, since August 1985, the new Government had announced, and in some cases had undertaken, economic policies of a wide-ranging nature. The result had been considerable improvement in terms of prices, exchange rates, and the stock of international reserves. The authorities had also agreed on a comprehensive economic program for 1986 aimed at containing inflation and reactivating the economy without a major loss in international reserves.

The support of his chair for the request of the Bolivian authorities was based on a number of factors, Mr. Vasudevan continued. Some adjustment had already been effected, and the authorities had committed themselves to further adjustment. A stand-by arrangement would facilitate the successful implementation of the public sector investment program for 1986, a program which relied heavily on concessional financing from multilateral development institutions and offical bilateral sources. In the circumstances he was in general satisfied with the objectives and the content of the 1986 program.

Apart from pursuing strong demand management policies, structural reforms, and planned investment priorities, the Bolivian authorities would need to seek debt relief and exceptional financing in the medium term, Mr. Vasudevan noted. The success of the program depended critically on the amount and terms of rescheduling that could be obtained from the Paris Club and from the coordinating committee of the commercial banks for arrears and debt service falling due in 1986. Given uncertainties about the movements in the prices of tin and natural gas, export diversification would also be necessary and must be effected over the medium term. In that context, he noted that the World Bank would be looking to projects that were export oriented and required short gestation periods. Of course, export diversification was often a long and drawn-out process that required sustained financial assistance for a number of years. The access to Fund resources provided in the proposed stand-by arrangement was barely 55 percent of Bolivia's quota, and the period of the program was for only 12 months. He wondered whether larger access and/or a more extended period of support had been considered.

In general, his chair had no difficulty with the specified performance criteria, Mr. Vasudevan said. However, the limit of 5 percent in the premium in the parallel exchange market transactions over those in the official could unnecessarily complicate matters, particularly since the exchange rate policy under the program was fairly detailed. Also, the "additional" criterion of establishing a reporting and monitoring mechanism for short-term public debt--which might be subject to review at the time of midterm review of the program--could prove to be burdensome. As it stood, the scope of the midterm review seemed rather wide, considering the fact that the program was one with rather limited financial support from the Fund and with most of the policies either implemented or being readied for implementation. What was needed was flexibility in the implementation of the program and sympathetic support for the bold measures to which the authorities had committed themselves.

He had found interesting Mr. Nebbia's remark that the Bolivian stabilization effort might provide useful elements for analysis in future studies on countries with hyperinflation, Mr. Vasudevan commented. That remark had significance in light of the fact that Bolivia had achieved virtual price stability during the months of March and April 1986, compared with an average annual increase in consumer prices of over 11,500 percent in 1985. Consumer prices had risen by only 0.9 percent in May 1986, which was an important accomplishment of the Government and which led him to urge the authorities to persevere with their intended policies in future so that inflation could be contained and the growth process reactivated. He also encouraged the Fund to maintain its involvement with Bolivia in the years ahead through direct financial support, technical assistance, and policy advice. It would be helpful if the Fund could persuade other international organizations and official creditors to come forward with large amounts of concessional financing in support of Bolivia's adjustment effort.

Mr. Ortiz congratulated the Bolivian authorities for the efforts they had made thus far in tackling their country's economic problems. As the new Government had begun setting up a coherent economic program, Bolivia had faced a new major external shock in the form of a very sharp drop in the prices of its major export products, tin and natural gas. It was thus all the more commendable that the Government had decided to persist in its efforts to adjust. As Mr. Nebbia had noted, the fall in real income associated with the collapse in the price of tin--by about 50 percent in relation to its previous price--posed enormous problems for the design and implementation of the adjustment program in a country where per capita income had fallen by more than 25 percent over the past 4-5 years.

The authorities' main objective was to reduce the rate of inflation from the highest in the world in 1985 to somewhat below 40 percent at the end of the program period, Mr. Ortiz continued. In fact, what the authorities were attempting to do was to restore economic viability to the country, a task that involved several stages. The first step was the reconstruction of a revenue base for the public sector and the resumption of an adequate degree of control over government expenditures. In that respect, it was worth noting what the authorities had already accomplished. The public sector deficit in 1985 had been reduced to one third of the level in the previous year, implying a decline of about 20 percent of GDP. On the revenue side, the main element of the program was a sharp increase in the domestic price of petroleum products, brought about mostly by a marked depreciation of the exchange rate and the decision to price petroleum products in dollar terms. On the expenditure side, most of the effort was based on reducing the wage bill of the public sector through employment cuts and salary reductions.

On the strategy of correction of the fiscal situation, Mr. Ortiz indicated his agreement with the staff that, although the urgent need to boost revenues in the short run had dictated the need for sharp increases in the domestic price of petroleum products, it would be necessary eventually to secure a more permanent revenue base through the implementation of the tax plan. The staff paper provided a broad outline of the tax reform package, but he would appreciate additional comment from the staff. Given the enormous erosion in real income and living standards of the vast majority of the Bolivian population, it would seem that the authorities must direct most of their efforts to improving tax collection and increasing property or wealth taxation. The accompanying macroeconomic policies--namely, interest rate, credit, and exchange rate policies--seemed broadly consistent with the program's objectives.

Remarking on external policies, Mr. Ortiz observed that the authorities intended to ensure that public enterprises built up enough deposits to cover debt repayments under an anticipated debt service schedule and that the Central Bank would increase the quarterly international reserve targets by the U.S. dollar equivalent of the deposit accumulations if the expected restructuring agreements had not been reached by the end of June. Those requirements must imply that the anticipated debt service schedule should be quite advanced, and it would be interesting to hear from the staff any more recent news on the status of those negotiations and on the terms of payment of principal and interest. The staff had indicated its expectation that no amortization payments would be made to the commercial banks and that interest payments would be limited to those corresponding to the restructured debt. Did that include all interest payments on the debt, or were the Bolivian authorities negotiating a partial interest rate rescheduling?

The terms of the external debt negotiations were central to the success of the current program, and that success was necessary not only for financial reasons but also because it would imply a zero net transfer of resources to commercial banks for a number of years, Mr. Ortiz commented. A positive inflow from multilateral organizations and other creditors could strengthen the ability of the Government politically to carry on with its strong adjustment program. In fact, Bolivia had not been paying principal or interest to commercial banks for several years, and the Government could thus rightly claim that the domestic costs of the difficult adjustment to the very adverse external circumstances facing the country were being shared by Bolivia's creditors.

It was evident that the program was a comprehensive and strong one and that the Government was deeply committed to its implementation, Mr. Ortiz said. As Mr. Wijnholds had noted, the role of the Fund in the Bolivian case was of paramount importance and, in his view, required significant flexibility in gauging economic performance under the program's quantitative performance criteria. Finally, he noted that the total amount of money from the Fund that would be used by Bolivia during the program period was on the order of $20 million, which was little more than 20 percent of Bolivia's quota. He wondered how the staff had arrived at a decision on the amount; considering that Bolivia's situation was not particularly buoyant, he was certain that it could have been helped by somewhat greater Fund generosity, which would not have been unreasonable, given Bolivia's excellent track record in making repayments to the Fund.

Mr. Di Mauro noted like others that the Bolivian economy in recent years had been characterized by negative economic performance. Increasing public sector deficits, together with accommodating monetary policy, had brought the economy into a vicious circle of hyperinflation, lower or negative growth, and deepening external imbalances. The staff seemed to support the view that, since the end of 1985, there had been some improvement in Bolivia's awareness that such a difficult and explosive situation could be dealt with only through strong and decisive action. In the circumstances, and even if the success of the economic program for 1986 relied heavily on rather optimistic assumptions about crucial economic variables, he could go along with the proposed decision and support Bolivia's request for a stand-by arrangement.

The staff had rightly noted that developments in public finances were at the root of Bolivia's current economic troubles, Mr. Di Mauro continued. Although generally in agreement with the measures aimed at correcting the imbalances--both on the revenue and the expenditure side--he had some reservations about their adequacy and appropriateness. For example, the program seemed to rely heavily or nearly completely on the collection of increased transfers from state enterprises to central and local governments in the form of production or sales taxes on hydrocarbons; however, the increase in revenue from that source was subject to some uncertainties. First, the enlargement of the tax base due to the increase in the domestic price of the composite leader could be reversed; in fact, although the revenue projections of the staff were based on the tax base evaluated six months after the increase in domestic price, one could expect that the current recession, together with sluggishness in private demand, could further shrink the tax base. Second, the sustainability of the current domestic dollar price of the composite leader could be placed in doubt if a further reduction in the international market price of hydrocarbons should occur. The intrinsic volatility of such a revenue source should therefore be counterbalanced by greater recourse to other forms of taxation. In that respect, although the recently approved tax reform package could be considered as a step in the right direction, it seemed rather limited in scope.

Second, Mr. Di Mauro continued, the increase in tax revenue due to the tax reform--expected to be less than 2 percentage points of GDP--seemed to be rather modest in view of the serious public financial imbalances. In 1985, public sector wages had been four times total tax collections. Third, the tax package did not seem directly to address the problem of radically reforming the tax system for the purpose of guaranteeing larger stability of revenue and a better distribution of the tax burden. The increase in revenue due to the tax reform was in fact mostly attributable to the 1 percent tax on property and wealth, the increase in sales tax on oil transactions, and, to a lesser extent, the increase in sales tax on luxury goods. The tax system seemed thus to rely too much on certain taxes that were easy to collect, whereas the stabilization of the tax revenue through time and the enlargement of the tax base should be dealt with in a longer-term perspective. In that respect, he welcomed the introduction of a more sophisticated form of taxation--the value-added tax--which should be accompanied by a substantial improvement in tax administration. The means of achieving such improvement should be seriously addressed, including in the design of an income tax as a means of guaranteeing a more equitable and less variable system of tax collection.

On the expenditure side, Mr. Di Mauro commended the commitment of the authorities to curb the growth of public sector wages and employment. The freeze on hiring and the restraint on total wage bill increases--i.e., inclusive of all forms of payments for fringe benefits--were appropriate ways of beginning expenditure control. Obviously, the high social cost imposed by its expenditure control policy would place the Government under strong pressure and require it to act firmly to improve the effectiveness of, and confidence in, its actions. Any departure from the belt-tightening approach, such as the recent increase in salaries granted to teachers, should be avoided. Only a strong monitoring of the expenditure process through the recently introduced congressional and technical control panels system could guarantee a successful completion of the adjustment effort. In that respect, he wondered whether capital expenditures--which had been the major causes of increase in total nonfinancial public sector expenditure from 20.1 percent of GDP to 24.1 percent of GDP--would be subject to the same type of control, and he wondered what role the World Bank might play in such monitoring.

Commenting on monetary policy in Bolivia, Mr. Di Mauro considered that it was crucial for the authorities to re-establish a climate of confidence in the value of the domestic currency. The high real interest rates--7.7 percent per month on loans--and the large 3-4 percentage point spread between the interest rate on deposits and that on loans clearly demonstrated the presence of strong inflationary expectations. In that respect, the recent commitment of the authorities to avoid any domestic monetization of the public sector borrowing requirement and the establishment of ceilings on net domestic credit should be seen as commendable measures. However, an improvement in domestic financial markets should be regarded as a necessary next step toward the effective conduct of monetary policy. In fact, the almost exclusive reliance on reserve requirement ratios as the means of controlling monetary expansion should be regarded as unsatisfactory. In the Bolivian case, the instrument had a relatively slow impact on monetary aggregates, and it tended to widen the spreads between lending and deposit rates. He would appreciate hearing from the staff what steps the authorities were taking to better articulate the financial markets with a view to conducting monetary policies through open market operations.

Like others, Mr. Di Mauro said, he favored the adoption by the authorities of a flexible exchange rate policy. Bolivia's medium-term balance of payments scenario remained troubling, and the improvement in that scenario was directly related to the rather rosy outlook for foreign investment and aid. It would seem crucial in the circumstances for the Bolivian authorities to act to safeguard the improved confidence in the economy by diligently implementing the measures outlined in the program. An enhanced adjustment effort by the Bolivian authorities supported by the international community constituted the only viable recipe for redressing Bolivia's current economic difficulties.

Mr. Romuâldez remarked that the efforts of the Bolivian authorities over the past ten months to confront the massive economic and political problems facing the country in recent years were welcome. The authorities had taken important initial steps to make the economy more responsive to market forces, and those formed the foundation on which the proposed program was expected to build. In particular, the adoption of a more flexible exchange rate system, the increase in prices of goods and services produced by public enterprises, the freeing up of other enterprises and of interest rates, and the liberalization of the external sector had been major factors in the improved economic performance of the past six months. It should nonetheless be recognized that the actions taken to date were only a beginning to what must undoubtedly be a long and difficult adjustment process.

In examining the Bolivian program, one must be mindful of what the authorities were attempting to achieve and what roles must be played by the Fund, the World Bank, major donor countries, the commercial banks, and the Bolivian authorities themselves, Mr. Romuáldez continued. The program's key aims included a significant reduction in the rate of inflation and the size of the nonfinancial public sector deficit. At the same time, the authorities wanted to lay the foundation for future economic growth without any loss of international reserves. In order to achieve those objectives, the authorities were being asked to embark simultaneously upon a major reform of the organizational structure and financial arrangements of the nonfinancial public sector, comprehensive tax reform, increased investment in export-oriented projects to diversify the export base, the control of wage pressures in the public sector, and reforms and liberalization of the financial sector. They were also attempting to secure long-term concessional assistance to finance their efforts. There might be those wondering whether the proposed program could be successfully implemented, given the enormity of the task and Bolivia's track record. However, he saw the program as the only real option open to the authorities that would enable them to break out of the economic malaise of recent years and to begin to restore economic growth and balance of payments viability. He therefore urged the authorities to adhere to the program targets.

He could support the staff's emphasis on a reduction in the public sector deficit and on tax reform and improved tax administration, Mr. Romuáldez said. The authorities should make every effort to control wage pressures and other areas of government spending as well. The experience of late 1985 and early 1986, when slippages in policy implementation had threatened the stabilization effort, highlighted the need for flexibility in policy implementation and the risks of loosening the reins for even a short period. Given the difficulties facing Bolivia and the uncertain medium-term balance of payments outlook, he appreciated the effort of the authorities to continue timely repayments to the Fund. He presumed that the regularity of repayment was the reason why the staff had not addressed in its report as fully as he would have liked the question of Bolivia's ability to repay the Fund's resources on time.

Commenting on the specifics of the program, Mr. Romuáldez remarked that he would welcome any comments from the staff on the use of oil revenues as a means of ensuring the attainment of Bolivia's fiscal objectives. He wondered about the likely inflationary consequences of the policy if there were to be a blowout in the size of the budget deficit, possibly combined with a significant devaluation of the peso brought about by the deindexation of oil prices to the U.S. dollar. The staff had painted a somewhat uncertain medium-term outlook for the balance of payments and, in view of Bolivia's high debt repayments in the coming years and the importance of a sustainable and improved external position as the basis for continuing the adjustment effort, he would be grateful for staff elaboration of its remarks concerning potential export growth. Specifically, he would appreciate staff views on the likely areas of and reasons for improved performance as well as an explanation of the major risks. Finally, he could support the proposed decisions, noting that the actions taken by the Bolivian authorities to date and their commitment to the proposed program were welcome. In order for the authorities to maintain the pace of their adjustment effort, they would need the continued cooperation of the Fund, the World Bank, donor countries, the commercial banks, and others in the international community.

The staff representative from the Western Hemisphere Department remarked that when the staff had shaped the Bolivian program, it had been faced with great uncertainty arising from a weak statistical base, high inflation and political and social turmoil, all of which made accurate forecasting difficult. For that reason, the staff would be relying heavily on the midterm review, which might well indicate the need for adjustments to the program; the answers to questions by Directors should be understood in that context.

A number of Directors had expressed concern about the heavy reliance on revenues from taxation in the hydrocarbon sector, the staff representative continued. The staff itself deplored that approach, but it recognized that it might the only way in the short term to collect sufficient revenue. Of course, the increase in revenues from that source--from 0.3 percent of GDP in 1983 to 8.5 percent of GDP in 1986--was rather an exaggeration. Greater transfers from the hydrocarbon sector to the Treasury should have been registered in 1983, but a number of the enterprises had failed to comply with their obligations and had used the resources that were to have been passed on to the Treasury to finance their own expenditures. In that respect, even in the past, there had been a higher dependence on hydrocarbons than was apparent from the statistics. Moreover, the 1986 figure was inflated somewhat in that it included some taxes due in 1985 but not collected until 1986. Furthermore, the revenues to be collected from other sources, projected at 3.3 percent of GDP, might be somewhat understated, in the sense that the projection was based mainly on taxes that the staff felt would be relatively easy to collect after the tax reform. No specific allowance had been made for collections from the value-added tax, which was more difficult to administer. Hence, it was possible that 1986 would produce greater revenues than had been projected. In that respect, Directors should perhaps not be concerned that the tax base was shrinking. Despite evidence of a recession, sales of hydrocarbons in the first few months of 1986 had been rather higher than sales in the similar period in 1985. Moreover, prices for exports of hydrocarbons to Argentina and Brazil had been negotiated for the entire year of 1986; in that respect, tax revenues from hydrocarbons should be fairly firm.

With regard to the limitation on the parallel exchange market premium over the official rate, the staff representative noted that the technique of reducing the premium over a certain period had been applied in other cases, particularly where an effort was being made to unify the exchange rate. The staff had employed the technique in the Bolivian case out of concern that, with the quarterly reserve test, too much time might be allowed to pass before the staff had evidence that the exchange rate path was off track. The staff wanted some early warning signal, and in Bolivia this was provided by the parallel exchange market. Hence, if that market were to increase, the staff wanted to be sure that the official market rate was brought into line. The staff had chosen not to rely on some indicator like the real effective exchange rate, noting that other factors had an effect on the proper level of the exchange rate. That rate in Bolivia was supposed to be freely determined; unfortunately, when the price of tin had collapsed in October 1985, the exchange rate had begun to depreciate rapidly, and the purchasing power parity indicator would not have provided the early warning signal required by the staff and might even have suggested an incorrect exchange rate level.

Unification of the parallel and official market rates would certainly be desirable, and the staff would be discussing the possibility of unification with the authorities as a step to be taken in future, the staff representative said. It should perhaps be noted that the adoption of a freely determined rate through an auction system was itself a quantum jump in economic thinking for the Bolivian authorities. The Fund and World Bank staffs had for many years been encouraging the Bolivian authorities to move toward more flexible exchange rate arrangements, not least because the distortions that had emerged during the hyperinflation period had been due largely to a lagging exchange rate. Thus far, the staff was happy with the adoption of the auction system as a second-best approach. The Fund had not insisted that the authorities adopt specifically the Dutch auction system; that choice had been the authorities' own, and the Fund staff had lived with the choice, given that the spread between maximum and minimum bids had narrowed rapidly over time.

He agreed with Mr. Almeida and others that Bolivia was an ideal and obvious case for a purchase under the structural adjustment facility (SAF), the staff representative commented. The proposed stand-by arrangement provided a good basis for a SAF program paper, and it was hoped that a purchase under the structural adjustment facility could be discussed with the authorities on the occasion of the midterm review in August 1986 with a view to bringing a request to the Board by mid-November.

While agreeing with Mr. Wijnholds that the drop in investment in Bolivia had been due to the high rates of inflation, the staff representative observed that other factors linked to inflation had also affected investment levels. For example, political upheavals and changes in government, social problems and labor unrest, and earlier price controls had all discouraged investment in certain areas, as had the existence of a large underground economy. In that latter respect, the statistics in Bolivia showed private sector investment as having been zero in the past few years, but those numbers referred only to the visible and measurable economy; a quite vibrant and lively underground economy of unknown dimensions existed in Bolivia.

He noted that most speakers had not been greatly concerned about the large current account deficit in Bolivia, the staff representative commented. The staff had gone along with the small projected increase in the deficit in part because of the very sharp drop in external prices. Very few countries--except perhaps those entirely dependent upon petroleum--had been so hard hit as Bolivia by falling prices for their major exports. Also, the staff believed that the only way for Bolivia to extricate itself from its very difficult position was to grow; and growth required investment goods imports and a restocking of the economy. In any event, the current account deficit would diminish automatically if certain of the staff's assumptions regarding the investment program were not to materialize.

Also of concern to some Directors was the size of net intervention in the official exchange market permitted under the program, the staff representative recalled. A smaller deficit had initially been targeted, but external events had forced the exercise of greater flexibility. Still, given the gross reserves of the country, the net drop of $50 million had seemed tolerable, and the latest data showed an increase in net international reserves.

With regard to the plans for public sector wage increases, the staff representative noted that the authorities would base increases on future rather than past inflation. An enormous reduction in the real wage bill was targeted, although it was not possible to gauge precisely what effect that would have on average salaries, because there had been some reduction in the labor force. Still, there was no doubt that the decline in real wages would be significant.

In response to those who had expressed concern that the improvement in the fiscal situation had been due mainly to revenue increases rather than expenditure cuts, the staff representative observed that the projected 4 percentage point increase in expenditures was due entirely to the investment program, and the increase would be less if the authorities did not manage to spend the full amount on investment in 1986. Of the remaining increase, a small proportion--1.1 percent of GDP--had been set aside to reduce domestic arrears and lay off surplus labor, which meant that all the traditional components of the budget were compressed by comparison with the previous year.

The extension of credit to agriculture in late 1985 had in the staff's view been "untimely" because it had occurred too late for the growing season, and there had been evidence that the money had not gone into buying seeds and other inputs but had fed directly into the parallel market, the staff representative continued. On a related matter, he was not aware of any subsidies on the export credit facility, the implementing guidelines for which had not been issued when the staff mission had been in Bolivia. However, it was not in the philosophy of the present Government to extend subsidies.

The question had been raised by Mr. Suraisry of whether a price freeze was needed in Bolivia, the staff representative remarked. Speaking only for the small group of staff members involved in the Bolivian program, he would argue that a price freeze, while the orthodox way of tackling hyperinflation, tended to perpetuate distortions because it tended to freeze prices at a moment in time when some prices had already risen while others, about to rise, had not yet done so. The flexibility employed in Bolivia had served that economy well, and he could truthfully answer that a price freeze was not a prerequisite for the fight against inflation in the Bolivian case.

Concern had been raised that the targeted 40 percent rate of inflation for the program period was rather "soft," especially given current indications of the rate, the staff representative observed. As he had mentioned earlier, the target might have to be tightened somewhat on the occasion of the midterm review, although it should be remembered that the results of the upcoming wage negotiations and the introduction of the value-added tax might have some impact on prices that could make the target seem more reasonable.

In response to those who had questioned the staff's assumptions regarding nontraditional exports, the staff representative recalled that nontraditional exports had reached a level of $150 million in 1980 but had been at only $30 million in 1985. Part of the explanation for the drop might be that the level of production had remained unchanged but that the exports had not all passed through official channels. Also, of course, the exchange rate provided an important incentive for nontraditional export activity, an example of which could clearly be seen in Bolivia's coffee market. Furthermore, the staff was reasonably optimistic with regard to nontin mining exports such as gold, much of which in the past had leaked out of the economy because of an inappropriate exchange rate and had thus shown up in the export statistics of Brazil and other neighboring countries.

Reporting on the status of the agreement Bolivia was attempting to reach with the commercial banks on arrears, the staff representative commented that the amounts of both principal and interest in arrears were large, and some of the refinancing schemes could represent a dramatic increase in banks' exposure. Discussions had been in progress for some time, but the moment was not right to press Bolivia to conclude those discussions. Besides, the banks, which had been prepared to consider innovative or imaginative approaches, were concerned about the precedent such approaches might create for discussions with other major debtors. The Bolivian authorities felt that the best approach was to reach agreement first with the Fund and then with the Paris Club and to wait in their dealings with the banks until after the wage negotiations had been concluded. They were concerned that if they came to terms with the banks at the present stage, and if payments were made to the banks, the unions might press for higher wage increases. In that respect, there was no question of the authorities wanting to come to terms with the debt; the issue was only one of timing.

It was rather premature to give any precise answer about the effects of the tax package on the population, the staff representative said. That package relied heavily on wealth and property taxes, and certain of the changes should introduce some greater equity into the system. For example, the tax on land would in future be graduated according to land use, size, and location. The value-added tax tended to be regressive, and the proposed VAT of 10 percent was perhaps ambitious. The effect of that tax and of others introduced in the package would be looked at in greater detail at the time of the midterm review.

The amount of Fund resources proposed for purchase under the stand-by arrangement might appear modest to some; at the same time, as a percentage of quota, the amount proposed was the highest put forward for a one-year arrangement in the past 18 months under the current access policy. It must be remembered that Bolivia had high repurchase obligations relating to purchases under the buffer stock and compensatory financing facilities in recent years, the staff representative observed. The staff considered that the role of the Fund in the Bolivian case should be primarily catalytic, in view of the size of the problem and the likelihood that the Fund would need to remain involved for some time with Bolivia, probably through follow-up programs. On a related matter, he noted the concern of some that the staff had not proposed an extended arrangement; a longer program at the present stage might have been premature, particularly given the weak statistical base and the lack of any track record of performance under longer programs. Of course, the possibility remained open for a purchase under the compensatory financing facility and under the structural adjustment facility.

As to Bolivia's ability to repay the Fund, the staff had perhaps been remiss in not discussing that matter in its report, the staff representative remarked. However, all evidence suggested that Bolivia would be able to repay the Fund. The gross reserve level was necessarily high because Bolivia had no trade credits and must fully prepay its imports; and even at that high level, gold was accounted for at a rate of $42 per ounce. At market prices for gold, the level of reserves would be even higher. Moreover, the use of Fund resources outstanding during the program period would be low, and the staff was optimistic about export growth as plans to exploit certain new products and to provide incentives for others bore fruit.

On monetary policy, the staff had great hopes that the introduction of an interbank market would permit the monetary authorities to exercise influence as necessary on the liquidity situation and interest rates in the economy, the staff representative said. In response to questions on investment spending, he noted that investment expenditures were subject to the same controls as other types of spending in the Bolivian economy. Passing through the two monitoring units recently established, every type of spending would have to be reflected in the budget. Finally, in response to those who had asked about contingency plans in case the economy did not perform as expected under the program, he observed that the Bolivian authorities had gone a long way in developing and implementing one plan; to insist on others might be asking too much at present.

The Deputy Director of the Exchange and Trade Relations Department, responding to questions on proposed access to Fund resources under the stand-by arrangement, observed that the proposed amount was related to the speed of recovery expected in the balance of payments. While the program was a bold one, the process of achieving balance of payments viability was likely to take several years, during which time the Fund was expected to be financially involved with Bolivia. Those had been the key considerations behind the determination of level of gross access deemed to be appropriate to support the program. His colleague from the Western Hemisphere Department had already explained why a period longer than one year for the financial arrangement had not been envisaged; in general, it had been felt important in present circumstances to begin with a decisive attack on inflation and to provide an opportunity for the policies for the first year to yield their effects. Of course, a longer-term relationship between Bolivia and the Fund remained under serious consideration.

In raising a question on use of Fund resources, Mr. Ortiz had referred to "net" use by Bolivia, the Deputy Director recalled. In that connection, he pointed out that normally, access policy was formulated in "gross" terms, although repurchases were taken into consideration in the general design of the program and its financing. References to "net" access could carry implications that might conflict with the monetary character of the Fund. On a related matter, and in response to Mr. Romuáldez's concern that the staff had made no direct reference in its report to Bolivia's ability to repay the Fund, he would argue that the strength of the program itself represented one of the most important indicators of Bolivia's ability to repay the institution.

On exchange rate policy, the Deputy Director agreed with his colleague from the Western Hemisphere Department that the use of the parallel market as a reference point to gauge official exchange rate policy was not unique to the Bolivian case, nor was the establishment of a specific maximum differential between the exchange rates in the official and parallel markets. Given the boldness of the Bolivian program, it was necessary to ensure that the gap between the two markets was kept relatively narrow; and while the staff would like to see unification of the exchange markets, it recognized that in the circumstances of the Bolivian economy, the first order of priority was to put in place the appropriate policies that would enable any move toward unification to be sustained.

While the staff had supported the auction mechanism as an instrument to aid the implementation of a flexible exchange rate policy in Bolivia, the staff was not necessarily enthusiastic about auctions generally as a mechanism for conducting exchange operations, the Deputy Director continued. The preference of the staff was for reliance on arrangements where fewer administrative procedures were required. And, if attention had to be focused on an auction system, one based on marginal pricing would be preferable. The so-called Dutch auction provided the Bolivian Government with a mechanism for absorbing the consumer surplus of demand in foreign exchange; the question was how durable the ability of the Government would be to absorb that surplus. Experience suggested that scope for discrimination in prices that existed under a Dutch action system was not large; and in Bolivia, the price differentials were becoming narrower.

On the most appropriate strategy for dealing with hyperinflation, the Deputy Director agreed that the establishment of a price and wage freeze was not a necessary condition for stabilizing an economy. As to whether such an approach would have been an appropriate or preferable strategy in the Bolivian case, much depended on two elements. The first was the degree of indexation in the economy, and the second was the extent to which the Government could ensure that an appropriate relative price structure prevailed in the economy prior to the freeze. If there was a large measure of indexation across the economy, and if a judgment could be made that, at the time of the freeze, relative prices were broadly in balance, then it could be argued that a wage/price freeze was a good component of a stabilization strategy. In the Bolivian case, however, the incidence of indexation had not been great, and it would in his view have been difficult to reach the judgment--given the extremely high rate of inflation experienced by the economy--that the initial structure of relative prices had been such that a price freeze would have been appropriate.

Finally, in response to those who had expressed concerns about the short-term public debt reporting mechanism in Bolivia, the Deputy Director of the Exchange and Trade Relations Department considered that it was important for the Bolivian authorities to establish a mechanism by which they could monitor the incurrence of short-term debt. Many cases had occurred in which less than properly monitored access to foreign borrowing in the short term had made it difficult to spot imbalances in time. Such monitoring was particularly important in the Bolivian context, and while it might entail some work on the part of the authorities to establish the monitoring mechanism, the instrument was in his view one that fit well within the general strategy of policy management of the Bolivian economy. Once the monitoring mechanism was at the stage where it would be possible to set quantitative performance criteria on the incurrence of short-term debt, such a criterion would be included in the program. It might take some time before that stage was reached, but progress toward that end would be assessed during the midterm review.

Mr. Dallara remarked that, like others, he had noted a lack of analysis in the staff paper of Bolivia's ability to repay the Fund. While agreeing with the staff that the underlying policies and boldness of the program were the best assurance of repayment, he was troubled by the implicit notion that such a safeguard should be an adequate substitute procedurally for analysis in the staff papers, the inclusion of which he thought had been agreed. He took the point that one should be cautious about employing too uniform an approach to such an analysis, but some standardization of procedure should be established.

The Chairman replied that he had recently received a proposal from the staff aimed at setting out guidelines for the analysis of a country's ability to repay, and he had suggested some amendments that were in line with Mr. Dallara's concerns. In the coming weeks, the Board would be able to review and, he hoped, approve a procedure that could be applied to all cases.

Mr. Ortiz recalled the indication by the staff that two essential conditions were required for implementation of a wage/price freeze. The first was a correct structure of relative prices prior to the launching of the freeze; and the second was pervasive indexation, which he presumed meant something like price synchronization. He himself saw the need for a third element in the picture, namely, the prospect of balance of payments viability. After all, the public needed to be convinced of the feasibility of the maintenance or fixing of the exchange rate, which in turn required the perception of a resolved balance of payments picture for the near term. In addition, if there were existing financial contracts denominated in local currency, it might be necessary to effect a currency reform for technical reasons, particularly if the contracts that were binding and which established a certain interest rate had to be nullified and replaced with other contracts based on the new currency and new interest rates. Of course, the public must then be willing to accept the new currency, and savers must be persuaded that they would not be taxed heavily in the course of the currency reform. Those were a few of the additional considerations involved in assessing methods to counter hyperinflation.

Mr. Nebbia considered that the Bolivian Government had rightly been commended by his colleagues for the courage and determination employed by the authorities in dealing with the enormous imbalances in the economy during the past year. It was particularly noteworthy that Bolivia had been implementing the program for several months without any financial support. Unfortunately, some slippages had occurred in late 1985 and early 1986, owing to the sharp reductions in prices of Bolivia's main export items. Moreover, the agricultural sector had experienced severe blight and other problems that had complicated the country's economic difficulties. It had to be remembered that the agricultural sector employed nearly 50 percent of the population, and the Government had had to take some action. Mr. Dallara had been worried that the decision to extend credit to the agricultural sector had been "untimely." As he himself saw it, the decision had been a highly political one on which the very existence of the Government had depended. On a related matter, Mr. Wijnholds had asked for comment on whether hyperinflation was a consequence of political stability or vice versa. Of course, the case could be argued both ways, but in the end the answer might well be irrelevant. The fact was that in the Bolivian case at present, political stability existed, and the authorities were fighting hyperinflation.

He agreed with the Deputy Director of the Exchange and Trade Relations Department that cases of hyperinflation must be dealt with individually: what was good or appropriate for Bolivia, might not be appropriate for other countries experiencing hyperinflation, Mr. Nebbia said. While some general lessons might be learned, each individual country was different, and those differences had to be taken into account in attacking the problem.

On fiscal policy, Mr. Nebbia considered that the approved tax reform was an important and far-reaching measure that should serve to broaden the tax base and improve tax administration. While the system was not sophisticated, it might well be that Bolivia was an economy in which a very sophisticated system would not work; and in the end, the workability of a system or an approach was its most important asset. In that respect, he agreed with the staff that the use of the petroleum tax at the beginning of the program period was appropriate because it worked, although it might not be a desirable approach to maintain over time.

The Bolivian authorities were eager to negotiate with the commercial bankers on their debt, but they wanted first to conclude arrangements with the Fund and the Paris Club, Mr. Nebbia commented. The Bolivians had proposed informal discussions with the bankers in July and a more formal meeting in early August. It was his understanding that the bankers did not wish to meet in August, which was why they were pushing for a shorter timetable.

A number of Directors had mentioned the possibility that Bolivia might take advantage of the structural adjustment facility, Mr. Nebbia recalled. The authorities were anxious to use the facility and were looking forward to discussions on that matter in the next few months. In the meantime, he had no doubt that the proposed stand-by arrangement, if agreed, would restore confidence in the Bolivian economy and improve Bolivia's relations with the international financial community.

The Chairman observed that the expression "shock treatment" had special significance in the case of Bolivia, which had endured not so much the shock of a stabilization program as the shock of a rate of inflation of 8,000 percent, a 30 percent reduction in real wages, a massive deterioration in the terms of trade, and six years of falling GDP. Against that background, the fight against inflation was appropriately the main element of Bolivia's economic strategy and he was encouraged by the fact that prices for the past several months had been relatively stable, a remarkable development. In those circumstances, the authorities might be advised to be somewhat more cautious in monetary and credit policy than had earlier been planned. Like Mr. Massé, he had wondered whether the target of an 85 percent inflation rate for 1986 and a 40 percent rate for the end of the program period were not, given recent tendencies in the area of prices, somewhat on the high side. He would not wish the design of monetary policy to be tailored to that predetermined set of figures; one had to be prepared to adapt financial policies to the fight against inflation as the existing situation evolved rather than to a fixed target that might turn out to be insufficiently ambitious in the price area.

It was important to look at wage policies in a similar light, the Chairman continued. He understood that the authorities were planning to gear wages more toward future rates of inflation rather than toward past inflation, a move that was necessary if one wanted wages to contribute to the stabilization effort.

A reduction of the fiscal deficit was required if growth in Bolivia was to be resumed and a better allocation of savings was to be achieved, the Chairman commented. Also important was the timely availability of significant international financial support; based on what had been achieved in only a few months by the Bolivian Government, international support from all areas seemed fully justified.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of Bolivia has requested a stand-by arrangement for the period from June 19, 1986 to June 18, 1987 in an amount equivalent to SDR 50 million.

2. The Fund approves the stand-by arrangement as set forth in EBS/86/120, Supplement 1.

Decision No. 8306-(86/98), adopted
June 19, 1986

Exchange System

1. Bolivia maintains an exchange restriction evidenced by external payments arrears. In addition, a multiple currency practice may arise from the operation of Bolivia's exchange markets, as described in EBS/86/120. The Fund approves the exchange restriction and the multiple currency practice described above until November 15, 1986 or the next Article IV consultation with Bolivia, whichever is earlier.

Decision No. 8307-(86/98), adopted
June 19, 1986

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/97 (6/18/86) and EBM/86/98 (6/19/86).

2. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAP/86/144 (6/17/86) is approved.

APPROVED: March 3, 1987

LEO VAN HOUTVEN
Secretary