MASTER FILES

ROOM C-130 04

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/106

10:00 a.m., June 30, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	M. K. Bush
	H. G. Schneider
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
	Song G., Temporary
J. E. Ismael	
A. Kafka	H. A. Arias
	M. Foot
H. Lundstrom	
M. Massé	
	A. Abdallah
	J. Abramovich
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	
	S. de Forges
J. J. Polak	
C. R. Rye	
	O. Kabbaj
A. K. Sengupta	
S. Zecchini	

L. Van Houtven, Secretary
A. Akanda, Assistant

Also Present

Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; IMF Institute: S. El-Khouri. Legal Department: J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; J. G. Borpujari, S. H. Hitti, Z. Iqbal, H. E. Jakubiak, B. A. Karamali, G. Tomasson, S. von Post, M. Yaqub. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, W.-R. Bengs, M. B. Chatah, L. P. Ebrill, G. D. Hodgson, J. Hospedales, H.-S. Lee, A. Ouanes, D. C. Templeman. Assistants to Executive Directors: B. Bogdanovic, F. Di Mauro, J. J. Dreizzen, V. Govindarajan, S. King, W. K. Parmena, M. Rasyid, J. E. Rodríguez, S. Simonsen.

1. SAUDI ARABIA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Saudi Arabia (SM/86/118, 5/29/86). They also had before them a report on recent economic developments in Saudi Arabia (SM/86/131, 6/16/86).

Mr. Nimatallah made the following statement:

At the outset, my authorities wish to express their appreciation to the staff for the informative papers on Saudi Arabia. They are in general agreement with the staff's appraisal of the economic and financial situation in Saudi Arabia.

The adjustment process

The Saudi Arabian economy has adjusted gradually and successfully to the recent steep decline in oil revenues. Since 1981, oil revenues have fallen from a peak of about $110 billion to about $26 billion in 1985. In response to these developments, my authorities have pursued an adjustment policy aimed at contracting the economy to a more manageable and sustainable level. Therefore, reducing the large fiscal deficit has taken first priority. The question has been how fast to proceed with the reduction in the deficit. The answer has had to take account of two important, though conflicting, policy considerations. It has been very important to my authorities to avoid an abrupt impact on the economy, and particularly on the private sector. It has also been important for them not to deplete external reserves, as the Saudi Arabian economy is still heavily dependent on oil exports.

Thus, the pace of fiscal retrenchment has had to be reasonably slow so as to allow the private sector to adjust to the fall in government expenditures and the associated reduction in aggregate demand. A strong and competitive private sector is a key element to the Saudi Arabian development strategy as contained in the Fourth Development Plan. Furthermore, the pace of fiscal retrenchment has had to allow for an orderly process of international adjustment. It is important not to curtail imports and the use of expatriate labor services too sharply.

Yet, adjustment has had to be reasonably fast so as to avoid a sharp reduction in foreign reserves. Given the limited diversification of the economic base and the country's overwhelming dependence on a single commodity, it has been essential not to deplete foreign reserves too rapidly. This consideration has been all the more important in view of the recent instability in the oil markets, and the heightened uncertainty about future developments.

My authorities have been successful in striking a balance between these two considerations, and in bringing the size of the economy, in a smooth and orderly fashion, to a more manageable and sustainable level.

This adjustment process has been facilitated by two important developments. First, Saudi Arabia has built a reliable, up-to-date infrastructure that can support its economic growth for decades to come. With the completion of the major infrastructural projects, large reductions in capital spending became possible. Second, following several years of large annual appropriations to the Specialized Credit Institutions (SCIs), the revolving character of the SCIs' resources has substantially reduced the need for new budgetary appropriations.

My authorities are pleased with the pace and smoothness of the adjustment process. Their pragmatic approach has been proven successful. The economy is now approaching the point at which it can resume growth at a sustainable rate. In the process of contraction, the economy has also become more efficient. In general, waste has been reduced, consumption patterns have become more realistic, and, most importantly, costs, notably labor costs, have been significantly reduced. In particular, increased competition and low inflation in the economy have led to a large reduction in labor and other costs in the private sector. In sum, the Saudi Arabian economy is emerging from this period of transition stronger and leaner.

The medium-term outlook

Looking ahead, it would be clearly desirable, as the staff suggests, to establish a medium-term fiscal policy. It would be useful to insulate public sector expenditures from fluctuations in oil revenues and from developments in foreign assets. My authorities recognize the importance of adopting a medium-term fiscal policy. Unfortunately, however, it is extremely difficult for countries like Saudi Arabia that rely overwhelmingly on oil exports to formulate medium-term fiscal policies in today's exceptionally unstable oil markets. It has even been difficult for Saudi Arabia to issue the annual budget for this year on time. My authorities, however, have taken the opportunity of this delay to establish a new beginning date for the fiscal year, and a budget will soon be issued.

For effective medium-term fiscal planning, it is essential to reduce the sharp fluctuations in the oil markets. But improved stability in the markets requires the full cooperation of all producers. In the past, Saudi Arabia has been able to maintain price stability through its role as a swing producer. However, while Saudi Arabia has come to produce far below its total productive capacity, non-OPEC, as well as some OPEC producers, have been producing at maximum capacity levels. This has had two disadvantages. First, Saudi Arabia's market share has been substantially eroded. Second, Saudi Arabia has been, in effect, "subsidizing" the high-cost producers by supporting a high price for oil. It has become clear that Saudi Arabia cannot afford to continue this policy. It has instead decided to protect its market share within OPEC of 4.353 million barrels per day.

Some have argued that if Saudi Arabia protects its market share, the result will be lower oil prices, increased demand for oil, and elimination of high-cost producers from the market. This is not the intent of Saudi Arabian policy. If, however, in the process of defending our market share, the structure of the oil market changes, it can only be attributed to the working of market mechanisms. The defense of one's market share is a basic feature of market mechanism. My authorities want to confirm that our objective continues to be a stable oil market. However, it is up to all producers to cooperate to achieve this stability. And until price stability can be restored, medium-term financial planning will continue to be very difficult.

While my authorities wait for restoration of stability in the oil market, they are making progress on two fronts which will, inter alia, facilitate medium-term fiscal planning, namely, diversifying the export base, and strengthening the private sector.

First, Saudi Arabia has used its oil revenues effectively to diversify its export base. For example, substantial progress has been made in this direction with the development of a capital-intensive, export-oriented petrochemical industry. The emphasis on petrochemicals reflects the irrefutable comparative advantage that Saudi Arabia enjoys in this industry. However, Saudi Arabia's efforts to step up diversification of its exports have been hampered by protectionist measures imposed by our trading partners. It is very unfortunate that some of our important trading partners continue to impose stringent trade barriers against our exports. We have always adhered to free trade practices based on the principle of comparative advantage. It is, therefore, essential that our trading partners open their markets to our exports as we open our markets to their exports. In the absence of a collective effort to resist protectionism, it would be difficult for us to diversify our exports. In addition to facilitating medium-term financial planning, a well diversified Saudi Arabian economy will also be good for our trading partners, as it will stabilize the flow of imports, the outflow of remittances to foreign labor, and profits to foreign capital.

Second, a strong private sector is also essential to the conduct of fiscal policy within a medium-term framework. My authorities' objective continues to be the promotion of the private sector. Many measures have already been taken to strengthen the private sector and to enhance its participation in economic activity. The comprehensive and modern infrastructure now in place has provided the private sector with an appropriate environment in which to grow. Further, provision of credit by the SCIs, protection, when needed, for some infant industries, strengthening financial institutions, and legal recourse to action in cases of overdue obligations and other positive measures, all have helped channel private sector investments into viable activities. More importantly, business viability has been enhanced by actions taken by the Government to enlarge the domestic market. Saudi Arabia and other Gulf countries have established the Gulf Cooperation Council (GCC) which aims, among other things, to create an integrated regional market with free flows of labor, capital, and trade. Good progress has been made in that direction, and now citizens of the six GCC countries have the right of doing business freely in any of these countries.

The contribution of the private sector to GDP has grown very rapidly in the past decade, increasing from about 13 percent to well over 40 percent. With a strong private sector, the scope for a meaningful increase in government domestic revenues is enhanced as the tax base is broadened. In the process, the overall impact of government expenditure on aggregate demand, on growth, and on the external sector will also be proportionately reduced.

As I have indicated, framing fiscal policy in the medium term would be difficult in the absence of oil price stability, a diversified economic base, and a strong private sector. This does not mean that my authorities are not aware of the importance of adopting medium-term planning. That is why we have five-year economic plans. Like the previous plans, the present plan indicates clearly the direction of the economy. The annual budget, at this stage, is used as a means to implement medium-term objectives and targets of the plans in a flexible way. We hope the time will come when total government and private expenditures coincide more closely with the targets of the five-year economic plans.

In conclusion, my authorities would like to reiterate that in pursuing their domestic policies, they continue to take into consideration the interests of the international community. They will continue to pursue their prudent policies on oil and foreign asset investments. They will also continue to help the developing countries directly through the Saudi Fund for Development, and indirectly through regional and international organizations.

Finally, Saudi Arabia believes that the Fund plays an effective role, not only in helping individual members to adjust, but also in promoting the smooth functioning of the international financial system. My authorities will continue to cooperate with the Fund and its members.

Extending his remarks, Mr. Nimatallah said that, with the recent large fluctuations in oil revenues, it was very difficult to undertake fiscal planning for the medium term. The Government had agreed with the Fund on the need for a fiscal planning approach, which had been initiated by a reduction in expenditure albeit not proportionate to the reduction in the oil revenue.

His authorities had recently presented a paper in Vienna on Saudi Arabia's official development assistance (ODA) which had amounted to over $49 billion in total disbursements from 1970 to 1985, Mr. Nimatallah said. Although Saudi Arabia was second only to the United States in terms of absolute volume of ODA, it was ahead of the United States in ODA relative to GNP. Saudi Arabia's annual ODA had averaged close to 5 percent of GNP over the past decade, and about 40 percent of disbursements comprised grants; the grant element of Saudi Arabian ODA commitments had averaged about 70 percent.

Mr. Finaish said that the Saudi Arabian authorities had followed a largely successful policy of gradual adjustment to the continued decline in oil revenues since 1982. Although the dramatic developments in the international oil market over the past few months had added a considerable element of uncertainty and again brought up the issue of the proper pace and form of adjustment in Saudi Arabia, there was every indication that the authorities with the advantage of the availability of official foreign assets and the completion of major infrastructural projects, were responding in an appropriate manner. Nonetheless, it was clear that authorities would have to deal very delicately with important policy questions during the current period.

An important policy issue was Saudi Arabi's oil production and pricing policy, which was not only the main determinant of the economic performance of Saudi Arabia itself but clearly a major variable in the international market as a whole, continued Mr. Finaish. He was in agreement with the Saudi Arabian authorities that the price of oil had fallen to a level that would have serious consequences for oil exporting countries, including Saudi Arabia, and would have an adverse impact on the global energy market in the long run. He also shared the view of the authorities reported in the paper that "in order to restore the price to a more reasonable level on a lasting basis, it was imperative for all major oil exporting countries to reach agreement on production and export levels." The decline in OPEC's market share over the past few years strongly indicated the need for the cooperation of non-OPEC exporters for a successful stabilization effort.

The Saudi Arabian authorities appeared to have struck a reasonable balance in fiscal policy despite oil export earnings having fallen by

75 percent between 1981 and 1985, Mr. Finaish observed. The availability of large foreign assets had clearly given the authorities some flexibility in moderating the pace of expenditure cuts over the past few years. However, the magnitude of the fiscal deficit the previous year--13 percent of GDP--and the uncertainty of future revenue prospects suggested that greater caution be exercised in the further drawdown of foreign assets, particularly as the Saudi Arabian economy was still heavily dependent on revenue from a single commodity.

The Fund's suggestion to control government spending by reducing subsidies was valid not only as a means for easing the burden on the budget but for providing an appropriate and more self-reliant basis for the long-term development of the private sector, Mr. Finaish said. It was to be noted, however, that the magnitude of subsidies, though rising as a percentage of total expenditure, had in fact fallen steadily over the past few years. Whether a faster pace of subsidy reduction would be advisable at the present time--when incomes and profits were falling--was a matter for both economic and political judgment.

The staff had also suggested that, to mitigate the impact of expenditure cuts on the private sector, steps should be taken to channel the large private sector assets abroad into domestic investment, Mr. Finaish noted. Given the fall in government revenue and the fact that the infrastructural support for private sector initiatives was already in place, the emphasis on the role of the private sector was appropriate, although, as the authorities recognized, the private sector would not be able in the near term to compensate fully for the reduction in government expenditures. Moreover, the private sector would have to operate under more realistic conditions than those prevailing in the past. Although, it would not be smooth, adjustment to a different environment would be necessary to avoid the waste that had occurred during the past decade and to lay the basis for an efficient and more productive economy.

Regarding the manner in which fiscal policy was conducted, the authorities clearly recognized the desirability of adapting a medium-term fiscal policy, Mr. Finaish noted. It would be difficult, however, to formulate such a medium-term fiscal policy because oil revenue was subject to so much uncertainty. The problem was not unique to Saudi Arabia but common to nearly all oil exporters; they were finding it difficult to plan ahead under such extreme uncertainties.

Turning to monetary policy, Mr. Finaish said that the monetary authorities had recognized the potential problem of the quality of bank asset portfolios associated with the increase of nonperforming loans and the steep fall in the commercial banks' profit margins. The authorities appeared confident that there was no cause for concern, owing to the adequate provisioning by the commercial banks and continuing relatively favorable profit margins. The authorities' confidence was supported by data indicating that in 1985, the volume of provisions made against loan losses had increased by more than 60 percent on average, and that only two small banks had declared losses.

The balance of payments prospects could not be projected with any degree of confidence in the short or medium term, Mr. Finaish observed. Nonetheless, the tentative projections for 1987 were useful, not necessarily because of the validity of the oil price assumptions, but because they provided a benchmark against which alternative projections based on different assumptions could be compared. A recurring issue in the balance of payments prospects was the difficulty encountered by both Saudi Arabian petrochemical products and the products of other oil exporting countries in entering European and North American markets; it appeared that the trend was for higher barriers to be erected against those products. In light of Saudi Arabia's liberal trade policies, the development of such barriers would be very unfortunate, and would hamper the country's diversification efforts; they might also invoke protectionist measures in Saudi Arabia and other countries in the Persian Gulf region.

Given the magnitude of its oil reserves and its production capacity, Saudi Arabia's role in the international economy was probably perceived to be related primarily to its oil policy, Mr. Finaish continued. However, Saudi Arabia and other Gulf and OPEC countries had played another important international role since the early 1970s as a major provider of foreign aid to developing countries. The size of Saudi Arabia's ODA was impressive. During the period 1970-85, ODA disbursements totaled $49 billion, which in absolute terms was second only to aid provided by the United States. In 1981, Saudi Arabia provided some 16 percent of total international ODA, which was the same amount provided by the United States. As a percentage of GNP, Saudi Arabia's aid record was even more impressive, averaging close to 6 percent over the past 15 years, with a grant element of close to 70 percent. Moreover, according to UNCTAD estimates, Saudi Arabia and other OPEC countries had earmarked an average of 22 percent of identified investible surplus for concessional assistance during 1974-83. It was noteworthy that 70 developing countries had received aid from Saudi Arabia, including 38 countries in Africa and 25 countries in Asia. That assistance was in addition to indirect assistance provided through regional and international organizations, including the World Bank and the Fund, to which Saudi Arabia had made substantial contributions.

The reason he thought it pertinent to mention Saudi Arabia's ODA in the current discussion was not only to commend the country for its exceptional aid record but also to bring attention to the fact that many low-income countries, particularly in Africa, which had benefited from Saudi Arabia's assistance in the past decade were currently going through a very difficult period, Mr. Finaish said. Not only had many of them been hard hit by sagging commodity prices, but they had also suffered from the general contraction in aid and capital flows over the past few years. It was ironic that the countries which had been affected the most were those that had already been the neediest. The expectation that Saudi Arabia would continue its generous aid program appeared to be justified by the figures in the staff report, which suggested that despite some decline in the absolute amount, official foreign aid had constituted about 12 percent of total exports in 1985, which was significantly higher than the 9 percent registered in 1983, even though incomes and expenditures in the country had declined substantially during the period; the ratio of assistance to exports for 1986 was projected to be maintained at 12 percent.

No country could provide foreign assistance beyond its means, and Saudi Arabia's foreign aid program could not proceed independently of the country's income and balance of payments situation, Mr. Finaish observed. The rich industrial countries--and certainly the surplus countries--should contribute significantly more than their current external development assistance. The enormous transfer of resources from developing countries to the industrial world associated with the sharp decline in oil prices should give industrial countries an added incentive to be more forthcoming, particularly in relation to the low-income countries. Saudi Arabia, a developing country that generated most of its income from drawing down on a finite asset, should be an example for other countries that had a greater ability to provide ODA.

Mr. Kabbaj said that the economy of Saudi Arabia was slowly adjusting to the downward trend in oil revenues from the peak period of the early 1980s when both production and price per barrel were at a record level. The downward trend had begun when most infrastructural projects had been completed and a diversified nonpetroleum sector had been developed jointly with private initiative through careful management of foreign resources and a farsighted approach in planning. Nonetheless, it was difficult to predict the precise behavior of the international oil market that determined global Saudi Arabian export revenues. It was for that reason that budgetary planning had remained elusive, and fiscal measures would have to be introduced to reduce the level of the deficit. The authorities had responded firmly to the continued deterioration of oil revenues and had implemented several cutbacks in government expenditure. However, that had not prevented the budget deficit from widening in 1985/86 due to government commitments in current expenditures and the large fall in revenue. The cutback had affected mostly project outlays and maintenance; consequently the non-oil sector's growth had slackened.

While some beneficial effects could be expected from a competitive non-oil sector, the loss of government contracts had had a negative effect on the dynamics of private enterprise, and had contributed to the decrease in non-oil revenues, Mr. Kabbaj continued. The balance was difficult, given the uncertainties characterizing the value of oil exports. The authorities should avoid a drawdown of external reserves, and prevent the slowdown of the non-oil sector that was dependent on the level of government expenditures, themselves subject to severe cutbacks. The staff's suggestion to raise revenues by charging public and private institutions for full services rendered by the Government and reducing the producer subsidy program, thereby further strengthening the competitiveness of the private sector, would not be easy to implement, particularly at a time of falling incomes.

Fiscal measures should be supported by specific monetary policies which would enable the Saudi Arabian Monetary Agency (SAMA) to intervene in the money market and help regulate the level of credit to the private sector, Mr. Kabbaj said. Under the present circumstances, the contraction in government contracts and an increase in delinquent loans was leading to a cautionary stance by commercial banks. SAMA could act to reinforce banks' reserve buildup against losses and provide credit checks for risky undertakings.

As with several other predominantly hydrocarbon economies, the alternative to oil was private sector exports, which had to be strengthened through fiscal and monetary measures, including tariff incentives to stimulate import substitution, Mr. Kabbaj observed. In that context, SAMA had effectively used the exchange rate to enhance the competitive edge of local industries by introducing several adjustments on the rate of the riyal in relation to the dollar. However, Saudi Arabian exports of petrochemicals had been subject to protectionist measures from trading partners, a situation which was not in the interest of international free trade. Further incentives should be developed to improve the domestic investment climate and encourage the repatriation of private funds. Such incentives might include sectoral benefits and tax advantages on capital equipment. Confidence in the private sector should be strengthened regardless of the oil market situation.

The overall external situation, however, was not a cause for concern since reserves had remained strong, Mr. Kabbaj remarked. The difficulty encountered in projecting a viable balance of payments for the medium term was due to the uncertainties of the oil market.

The pace of the adjustment process was deliberately cautious so that the activity of the domestic private sector would not be disrupted, and that there would be a smooth transition at the international level, Mr. Kabbaj said. The cautious pace also explained the persistence of deficits in the current account and the balance of payments. However, it would eventually lead to a leaner, more efficient economy. Saudi Arabia's role in providing ODA should be commended because, despite uncertainties on the external front, it had continued to provide a generous level of aid.

Mr. Grosche commended Saudi Arabia for its successful adjustment policies and pointed out its most important and constructive contribution to global efforts to deal with problems in the international monetary system, particularly through its prudent management of foreign assets and the generous level of assistance it had continued to provide to developing countries despite losses in foreign exchange earnings.

Saudi Arabia was going through a very difficult period, having experienced a fall in export earnings of about 75 percent in only four years, Mr. Grosche said. The authorities had reacted prudently to those developments, thus avoiding the major problems that would normally have accompanied such a drastic adjustment process. While their task had been facilitated by the large stock of foreign assets accumulated in the 1970s, the authorities deserved credit for displaying flexibility and farsightedness.

He welcomed the authorities' implementation of a gradual but substantial reduction of public expenditures, thereby avoiding an excess drawdown of foreign reserves, Mr. Grosche continued. Although that had had certain effects on domestic activity, some contraction of the economy to a more manageable level had been needed to attain sustainable growth in the medium term. The completion of major development projects had made possible a reduction in capital outlays and associated imports, which would further assist the authorities in the transitional period. On the further containment of the budget deficit, there seemed to be scope for further savings through cutbacks in nonessential capital expenditures and subsidies, and a move toward cost-related charges for public sector services. If the situation with regard to oil revenues continued to be tight in the coming years, further consideration should also be given to introducing an income or sales tax. The uncertainties in the oil markets had led the authorities to postpone the issuance of the 1986/87 budget; working with monthly appropriations in the interim seemed understandable and adequate.

Turning to medium-term prospects and development policies, Mr. Grosche said that he fully supported the general thrust of expanding the role of the private sector. In the short run, the private sector would not be able to fully substitute for the losses resulting from the decline in oil exports. In the long run, however, the dependence of domestic activity on the fluctuations of the oil market could be overcome by the development of a strong domestic private sector. To this effect, the authorities should be encouraged to intensify their efforts to develop Saudi Arabia's domestic human resources as well as to promote the return of private capital from abroad for investment purposes. The recent real effective depreciation of the riyal would have a positive impact on the diversification efforts being undertaken by the authorities.

Mr. Pérez commended the Saudi Arabian authorities for their prudent economic management in the past few years. Saudi Arabia had had an excellent record in implementing both cautious domestic and highly cooperative international policies. Recent economic developments in Saudi Arabia had been marked by the drastic change that the oil sector, the cornerstone of the country's economy, had undergone in recent years. Oil receipts, the main source of budget revenue, had fallen sharply by 75 percent in only four years. Despite the enormous reduction in public outlays that Saudi Arabia had experienced with the fall in oil prices, a growing budget deficit had obviously emerged, reaching 17 percent of GDP in 1985/86. As with the previous one, the current deficit had been financed by a drawdown of public sector deposits with SAMA. Fortunately, the significant foreign assets accumulated through the 1970s and early 1980s had allowed the country to adjust smoothly to new circumstances.

The policy mix adopted by the Saudi Arabian authorities in response to the sharp decline in oil exports and revenues over the past four years had been remarkable, Mr. Pérez said. First, expenditure--both current and investment--had been reduced by more than 36 percent, taking advantage of the completion of major infrastructural projects. Second, budgetary revenues other than oil and investment income had been increased by more than 100 percent through the period. Third, the reduction in government expenditure had helped the decline of monetary aggregates from 22 percent in 1982/83 to 3.5 percent in 1984/85, coinciding with the commercial banks' adoption of a more cautious stance in lending operations to prevent further deterioration in the quality of their domestic loan portfolio. The combined effect of those developments had resulted in a sharp decline of total credit to the private sector.

The fall in oil prices, along with the uncertainties surrounding the international oil market, had seriously limited the range of policy options open to the Government, Mr. Pérez continued. The current challenge for the authorities was to encourage both an expansion of the private sector and the development of a more diversified productive base in the context of fiscal restraint. Although expenditure cuts would be inevitable, given the continued decline in oil revenues, they should be carefully weighed to prevent a major disruption in private sector activities. Under the current circumstances, the basic strategy and goals of the Government were adequate.

For some time, the stimulus to private sector activities had been provided by government expenditure through a growing public sector demand and different forms of subsidies, Mr. Pérez observed. If that stimulus were suddenly curtailed, private sector activities might be hampered, thereby further complicating the adjustment process. However, that did not mean that the Government should avoid any reduction in categories affecting the private sector. There was ground for rationalizing and increasing efficiency in the use of public incentives. The case of wheat production was as an example of how public subsidies and natural resources were still being wasted in Saudi Arabia. Reduction and rationalization of public support to the private sector could be compatible with maintaining public stimulus through a relatively stable public sector demand and being selective in the evaluation of investment projects--thereby ensuring that activities complementing private sector investment were not cut back too sharply--and by keeping a set of selective and transitory subsidies. In that regard, Saudi Arabia was in a position that would allow it to run a moderate public sector deficit.

Since the scope for further reduction in government outlays was narrowing, the authorities should attach more attention to mobilizing additional domestic revenues by broadening the tax base of the economy, Mr. Pérez said. In that context, the authorities' efforts during the past few years had been commendable; however, despite the increase in relative terms, the amount of budgetary revenues other than oil and investment income was still very low. The authorities should pass on to the consumers the cost of some public services, increase the range of commodities subject to import duties, and introduce a general income or sales tax.

Even though the level of external reserves had declined in the past three years, Mr. Pérez said that it was still comfortably high and would allow for gradual adaptation to new circumstances within a program of adjustment and diversification in the medium term. A more flexible approach to exchange rate management could contribute to increasing export activity, diversifying the economy, and neutralizing the fiscal gap. The devaluation of the riyal the previous year, although appropriate, had been the by-product of the current policy of keeping the riyal pegged to the U.S. dollar and not the result of a more flexible exchange rate policy. Although it was true that a depreciation of the riyal could endanger Saudi Arabia's inflationary prospects, the decline in both the GDP deflator and the cost of living index by about 3 percent in 1985/86 presented some scope for absorbing the inflationary impact stemming from the implementation of a more flexible exchange rate policy.

Mr. Massé said that substantial structural changes in the international petroleum market during the past two years had created an enormous challenge for all countries which relied heavily upon oil for exports and for government revenues. Saudi Arabia itself had not been exempted from the need for fundamental changes in policy. Despite the rapid decline in its oil revenues, exports, and international market share, Saudi Arabia had been able to adjust in a very orderly fashion. Large foreign assets had helped to smooth the adjustment path, but fiscal, monetary, wage, price, and exchange rate policies had all been changed in a prudent manner to reflect the new external environment.

During the previous Article IV discussion (EBM/85/113, 7/26/85), the Saudi Arabian authorities had set out an apparently cautious and correct policy framework, Mr. Massé remarked. However, the fall in petroleum prices to well below $20 a barrel and the consequent revenue losses had not been anticipated. Currently, the medium-term outlook was clouded by such uncertainty that it had been difficult for the Saudi Arabian authorities to formulate a budget for 1986. In view of the uncertainty, he would focus his remarks on a few principles which might be useful for the Saudi Arabian authorities in planning for the medium term.

Speaking of the trade-off between fiscal retrenchment and foreign reserve reduction, Mr. Massé said that a concept to keep in mind was the distinction between permanent and transitory revenue sources, which was analogous to the distinction between the application of the permanent income hypothesis to individuals and to countries such as Saudi Arabia that were dependent on one major export. The concept might be applied to fiscal planning in countries producing commodities that were important to the economy, the budget, and the balance of payments, and whose prices might fluctuate widely. To the extent possible, the authorities could base their medium-term fiscal plan on permanent sources of revenue, using some notional perception of a floor price for petroleum and adjusting basic current expenditures to the permanent revenue. A base-line budgetary scenario could be developed setting out permanent revenues plus basic current expenditures. As petroleum prices rose above the price floor, thus adding what might be called a transitory aspect to revenues, additional current and/or capital expenditures could be introduced. Under the base-line scenario, foreign revenues could be more clearly earmarked for capital expenditure, which should help reinforce the need for efficient investment of those foreign assets. Such a fiscal framework should in no way prevent or delay the necessary broadening of the tax base, which the authorities had already begun to address. As the economy began to diversify, available resources of domestic revenue should be tapped. Similarly, there was no reason to delay measures to streamline maintenance and other expenditures. However, putting a base-line scenario into a medium-term framework would improve fiscal forecasting, introduce clarity and consistency to the budgeting process, and help ensure that foreign assets would be used as productively as possible.

Monetary policy in Saudi Arabia must be determined by developments in the real economy and variations in the prices of exported commodities have to be significantly neutralized, Mr. Massé emphasized. The authorities were already setting credit policy according to the real demand for credit and were urged to continue that cautious approach. The arbitration procedures that had been established to resolve disputes between banks and borrowers were welcome; however, the staff report had suggested that commercial bank lending was still not based on a full examination of risk and return. The staff was asked whether it had any specific measures in mind for putting lending on a sounder footing, beyond the risk system established at SAMA.

There was a need for greater efficiency and diversification in production and distribution in the face of weaker petroleum markets, Mr. Massé said. Reduced subsidies and economic pricing of public services could together strengthen the fiscal balance and improve allocative efficiency. More open access to financial resources and a flexible approach to wage and labor policy were crucial elements in the expected growth of the private sector under the Fourth Five-Year Plan.

Until recently, the authorities had made good use of expatriate labor to speed their economic diversification and stimulate the economies of other countries in the region, Mr. Massé continued. During a period of economic contraction, it would be natural for the demand for that labor to decline. However, the authorities should pay due regard to the demand for skills and wage pressures in developing their manpower policies since too rapid a decline in foreign workers might be as costly as too slow an adjustment.

Tariff policies should be used carefully and selectively, Mr. Massé said. Experience elsewhere had shown that it was easier to create so-called infant industries than it was to nurture them to a mature and self-reliant status.

The staff's medium-term balance of payments estimates served to reinforce the view that the authorities should continue to be cautious in setting the medium-term policy stance, even if there were no need for significant concern over the balance of payments figures, Mr. Massé observed. The present direction of exchange rate policy, which balanced the authorities' concerns regarding imported inflation and capital movements, had served Saudi Arabia's interests well. He commended the authorities for maintaining foreign aid at generous levels despite a weakened external position.

Mr. Ismael noted that economic adjustment in Saudi Arabia, undertaken in response to the steep decline in the world oil price, had continued in a relatively smooth and orderly manner. The availability of large official foreign assets and the completion of major infrastructural projects had facilitated sound economic management.

The authorities' general adjustment strategy of striking an appropriate balance between the desirability of maintaining a comfortable level of official foreign assets and the need to avoid the disruptive effects of adjustment on demand contraction was welcome, Mr. Ismael said. With the recent sharp fall in oil revenue, on which the Government was still overwhelmingly dependent, further restraint in expenditure was required to contain the fiscal deficit and prevent a sharp reduction in official foreign assets. The gradual approach to economic adjustment seemed appropriate, given the contractionary impact of such retrenchment on private sector activities, and would allow the adjustment to take place in a smooth and orderly manner. With official foreign assets equal to more than four years' imports, and with interest rate and exchange rate policies continuing to be flexible, there was still some room for maneuver. Nevertheless, the rationalization of expenditures and expansion of the revenue base should be given high priority.

His chair shared the authorities' view that the restoration of a stable and adequate price for oil was not only in the long-term interests of Saudi Arabia but also of the world as a whole, Mr. Ismael said. With Saudi Arabia's recent decision to abandon its swing-producer role and to regain its market share, the responsibility for restoring price stability would have to be shared by all producers, both within and outside OPEC. It was hoped that Saudi Arabia would continue to play a major role and would remain flexible in further efforts together with other producers to restore price stability.

The shift in policy emphasis to strengthen the private sector by gradually phasing out subsidies and protection was appropriate, Mr. Ismael observed. Excessive protection and permanent subsidies tended to develop noncompetitive and nonviable undertakings. However, in the Saudi Arabian context, where the very narrow resource base had led to relatively high costs in most non-oil related industries, an abrupt reduction of subsidies and protection might have disruptive effects. In the meantime, serious efforts should be made to rationalize subsidies and protection to minimize their distortional effects on resource allocation; that appeared to be particularly urgent in the agricultural sector. Transparency of subsidies should also be an important aim of the rationalization exercise. Emphasis should be put on creating a general environment that was conducive to the growth of private business; that environment would include political and financial stability as well as an appropriate legal and administrative framework. The proposed privatization of major public enterprises would also provide a better climate for private sector development.

The planned reduction in Saudi Arabia's dependence on expatriate labor by developing indigenous labor was entirely justified, Mr. Ismael said. In this, Saudi Arabia must maintain a flexible policy with regard to foreign labor to avoid labor shortages and upward pressure on wages, besides minimizing the negative economic impact of such a policy on the country supplying the labor.

Mr. Foot said that in a fluctuating economic environment it was inevitable that Saudi Arabia would face a difficult choice concerning the speed and extent of its adjustment effort. In general, the authorities had prudently sought to rely on expenditure restraint and had drawn down some of their external reserves to ease the adjustment process. They had also placed appropriate emphasis on increasing the strength and relative importance of the private sector. The further fall in oil prices in the current year had increased both the scale and importance of the adjustment effort needed by the authorities. Despite the significant steps that had already been taken, the current account deficit was expected to be $9 1/2 billion in the current year, which would result in a further substantial fall in Saudi Arabia's external reserves; deficits of that magnitude would be unsustainable over the medium term.

Expenditure restraint would need to be continued, Mr. Foot remarked. Thus far, expenditure cuts had fallen mainly upon capital expenditure, following the completion of major infrastructural programs. The proportion of project expenditure in total public spending had fallen from nearly 60 percent in 1980/81 to about 30 percent in 1985/86. Current spending had been much less affected and had remained broadly constant in nominal terms over the past three years. Furthermore, the proportion of current expenditure taken up by salaries, wages, and allowances had been rising gradually. Reducing subsidies would be a particularly appropriate way of controlling expenditure, given the authorities' desire to develop a competitive private sector which would be independent of government support. The new budget, when available, would no doubt clarify the authorities' priorities.

Although the authorities had correctly placed emphasis on expenditure reduction in their adjustment efforts, other policy instruments could also play an important role, Mr. Foot continued. For example, the exchange rate regime in recent years and the lack of monetary instruments available to the authorities had limited the role of an active monetary policy. The recent devaluation, however, might presage a more active exchange rate policy to promote greater private sector activity, which would imply the need for a more active monetary stance. The introduction of a Bankers' Security Deposit Account (BSDA) scheme had been a useful step forward, particularly in its encouragement of a secondary market in BSDAs which itself would open the possibility of open market operations conducted by the authorities.

Some press reports had expressed concern about the number of non-performing loans in the banking system, Mr. Foot observed. The welcome initiatives taken by the authorities to control that problem, included the establishment of the credit risk information system and the commission for the settlement of commercial disputes, which should help strengthen confidence in the banking system; nonetheless, continued vigilance would be desirable.

In seeking to adjust to the changing economic environment, the authorities had placed great emphasis on strengthening the role of the private sector to reduce the vulnerability of the economy to fluctuations in the oil market, Mr. Foot continued. The authorities should seek to avoid excessive protection for domestic producers whether through selective protection or subsidies.

As he had mentioned during the recent discussion on Kuwait (EBM/86/96, 6/13/86), the impact of the Kuwaiti economy and a fortiori the Saudi Arabian economy on the Persian Gulf region was considerable, Mr. Foot said. The authorities were well aware of the impact and had taken it into account in assessing their policy stance. He encouraged the staff to consider ways in which the regional impact of a country's policies might be better captured, not only in the Persian Gulf region but elsewhere. It was a general problem, which in Saudi Arabia was of particular importance.

There appeared to be some minor difficulties with the production of data by the authorities, Mr. Foot noted. He hoped that they would soon be able to improve the flow of information to the Fund since data on the economy were of considerable importance. Saudi Arabia's record of development assistance was commendable.

Mr. Sengupta commended the authorities for the successful implementation of their gradual contractionary policy in adjusting to the steep decline in oil revenues since 1981.

Economic developments in Saudi Arabia were of considerable interest to developing countries because in its era of rapid expansion, the country had provided employment to large numbers of expatriate workers, awarded contracts to exporters from developing countries, and provided generous official assistance to those countries both bilaterally and through active financial participation in multilateral institutions, Mr. Sengupta remarked. Developments in oil markets, on which Saudi Arabia had considerable influence, were also of great interest to all oil importing and exporting developing countries. The way in which Saudi Arabia had maintained its generous development assistance policy, despite the instabilities in oil revenue, demonstrated its identification with the developing countries' needs and interests. Saudi Arabia would provide leadership to the developing countries through its pre-eminent financial strength.

Receipts from oil had fallen from a peak of $110 billion in 1981 to about $26 billion in 1985, Mr. Sengupta continued. The authorities' measures to contract the economy by reducing fiscal deficits in a gradual and sustainable manner were correct. They had gradually used the large foreign exchange assets as a buffer so that the impact of contraction on the growth of the private sector was not too drastic. He assumed that, to avoid depleting their reserves too fast because of their dependence on oil, the prices of which continued to be uncertain, the authorities had drawn down their foreign exchange reserve assets by only $35 billion in the past three years and had retained assets equivalent to four years of imports.

For countries like Saudi Arabia, which depended overwhelmingly on oil exports, it would be difficult to formulate medium-term fiscal policies because of the highly volatile oil market situation, Mr. Sengupta said. The delay in the submission of the annual budget for the current year was a clear manifestation of that problem. He observed that there were two fronts on which the Saudi Arabian authorities were moving to facilitate a medium-term fiscal plan once oil price stability was attained: diversifying the export base so that the country's external resource requirements could be met without being heavily dependent on oil revenues, and strengthening the private sector to give a stimulus to growth of the non-oil sector. For Saudi Arabia to expand its exports, it was necessary that its trading partners keep their markets open. The stringent trade barriers imposed by some of Saudi Arabia's trading partners would have to be removed as early as possible if the country were to successfully achieve the much needed diversification of its exports. The strengthening of the private sector could, to some extent, offset the withdrawal of growth incentives by the Government in the current period of falling revenues. However, it would take a long time before the private sector would be sufficiently developed enough to efficiently absorb shocks due to external factors. In the meantime, the authorities would have to continue to use the foreign assets in an appropriate manner so as not to unduly reduce expenditures, at the same time ensuring that these reserves were not depleted to unacceptably low levels; in that context Saudi Arabia still had some room for maneuver. The speed at which reserves would be utilized was also dependent on expectations relating to the oil market.

Saudi Arabia should be commended on its generous foreign economic assistance policy and its role in supporting multilateral organizations, such as the Fund, which reflected an outstanding commitment to international cooperation, Mr. Sengupta concluded.

Mr. Fujino said that the authorities should be commended for their continued skillful economic management in the face of the steep decline in oil prices. Saudi Arabia had served as a swing producer in a difficult period of declining oil prices; even after the discontinuation of that role in 1985, the basic objectives of its oil policy had remained unchanged, with high priority being attached to the long-term stable supply of oil. Oil had never changed its basic character as a resource of limited supply, and a long-term approach was crucial in meeting the requirements of the international economy in a sustained way. Saudi Arabia had proceeded with its adjustment in an orderly way and had been successful in achieving the dual objectives of avoiding an abrupt impact on the economy and a quick depletion of the external reserves. Although Saudi Arabia itself had been severely affected by the recent fall in oil prices, appropriate adjustment policies adopted by the authorities had helped minimize its disruptive effects.

In the fiscal area, considerable constraint had been exercised over expenditures, which had been curtailed by 16 percent in 1985/86 after cuts of 6 percent in each of the two preceding years, Mr. Fujino said. Although the budget for fiscal 1986/87 was yet to be formulated, the authorities intended to continue expenditure restraint in an effort to contain the drawdown of official foreign assets. Given the uncertainty of future oil revenues, it was desirable to reduce the rate at which official foreign assets were run down. The authorities' willingness, in principle, to reduce subsidies and move toward pricing on a full cost recovery basis was welcome. The move would be beneficial not only for the further curtailment of expenditures, but also the long-term development of private sector. The authorities' long-term development plan rightly emphasized the promotion of the private sector as a primary source of economic growth; to encourage such development, the Fourth Five-Year Plan aimed at expanding the manufacturing sector, improving social services, and developing manpower resources. In the long run, industrial diversification was one of the most important goals for Saudi Arabia and the recent weakness in oil prices, although unfortunate, might be seen as providing an excellent opportunity for a desirable change in the industrial structure. He hoped that the authorities would take advantage of that opportunity and proceed to dismantle any impediments to developing the private sector.

With the general economic slowdown, it was not surprising that there had been an increase in nonperforming loans in commercial bank portfolios, Mr. Fujino observed. However, the authorities had reacted quickly and effectively; a credit risk information system was being established at SAMA. Procedures had been introduced to resolve disputes between banks and borrowers; and criteria had been established for calling bank guarantees. Those measures, coupled with the relatively strong financial position of Saudi Arabian banks prior to the nonperforming loans, had helped to maintain confidence in the financial system in a difficult period.

Although uncertainties made balance of payments projections difficult, tentative estimates by the staff showed current account deficits of \$9.5 billion for 1986 and \$8.5 billion for 1987, which would be financed by a drawdown of official reserves, Mr. Fujino remarked. It was highly commendable that the authorities intended to provide generous foreign aid despite much deficits. Official reserves had been managed prudently and continued emphasis on liquidity was appropriate under the current circumstances.

Although the link to the U.S. dollar had worked well for the balance of payments adjustments during the period when the U.S. dollar had depreciated sharply, the recent exchange rate measure was evidence of the continued adherence by the authorities to a flexible exchange rate policy, which would be essential for the diversification of the economy, Mr. Fujino concluded.

Mr. Rye said that Saudi Arabia's gradual and successful adjustment to the recent steep decline in oil revenues had been facilitated by a number of elements, such as the ready scope for reducing fiscal outlays following the completion of the infrastructure; the extremely high level of international reserves, and the fact that the specialized credit institutions had now been built up into viable ongoing concerns. However, it should be remembered that those conditions had been brought about by the farsightedness of the authorities, and, in that respect, Saudi Arabia served as an object lesson in a world where, all too often, the benefits of favorable years were frittered away in short-sighted policies of expediency or in creating social and economic systems which in the long run proved to be unsustainable.

Fiscal retrenchment in Saudi Arabia still had further to go, Mr. Rye continued. The continued deterioration of the fiscal balance over the past five years to the point where the 1985 deficit had exceeded 17 percent of GDP, could not be contemplated with equanimity for much longer. While most of the measures of fiscal retrenchment were welcome, the authorities should consider further reduction of subsidies and a move toward full cost recovery of some public sector services. Opportunities to broaden the tax base should also be taken as they arose.

With regard to the necessity for a medium-term expenditure plan, Mr. Rye expressed some skepticism. Provided that a government had appropriate broad directions and priorities--which Saudi Arabia clearly had--it was not clear whether the resources required to formulate detailed yearly plans would be wisely spent, particularly if the result would be to hamper a flexible response to rapidly changing circumstances. He also remarked that the staff had conceded (though perhaps understated) the difficulties in preparing meaningful balance of payments projections for the medium term. Having regard to the close links between the external and fiscal positions, it was contradictory to argue that a projection was needed in one case while it could not be meaningful in the other.

Like other economies, Saudi Arabia needed to diversify, Mr. Rye continued. The possibilities for such diversification were obviously limited. That there existed high barriers to Saudi Arabian exports that further reduced those possibilities was deplorable for the protected countries themselves as well as Saudi Arabia; a collective effort would be needed to resist protectionism.

The authorities were to be commended for their extraordinarily generous overseas development effort, and for their continued strong support of the multilateral organizations, particularly the Fund, Mr. Rye concluded.

Mr. Song said that Saudi Arabia continued to be successful in carrying out the adjustment process which had been put into place in 1982. The previous year's achievements, such as the further reduction in government spending, the narrowing of the current account deficit, the maintenance of an appropriate exchange rate and price stability, the suitable contraction of the scale of construction, and the promotion of development in the non-oil sectors, were especially noteworthy, given the extremely unfavorable external conditions of the weakened oil market and the sharp decline in oil prices. The authorities were to be commended for careful planning and a consistently flexible and prudent policymaking stance.

Among the economic policies pursued by the authorities that Mr. Song observed, three were particularly important for the world economy: oil policy; reserve policy; and aid policy. The intention of the authorities to maintain orderly and stable conditions in the world oil market, taking account of the interests of both producers and consumers, reflected a cooperative and responsible attitude to the uncertain and complicated world oil situation. In view of the huge crude oil reserves and the large-scale capacity in petroleum recovery enjoyed by Saudi Arabia, the potential impact of that oil policy should not be ignored. The authorities' intention with regard to reserve policy to limit further recourse to official foreign assets for financing government expenditure was a wise policy consideration and was not only in keeping with the long-term interests of Saudi Arabia but it would also facilitate the stability of the international financial market. Saudi Arabia's generous aid policy was well known and was particularly noteworthy since there had recently been a sharp decline in foreign exchange earnings and a continuing drawdown of official foreign assets. Nevertheless, Saudi Arabia's concessional economic assistance to developing countries had remained substantial, particularly in terms of its proportion of GDP. Foreign assistance had contributed to alleviating the financial strains suffered by certain developing countries and had promoted the structural adjustment policies followed by some of them.

Saudi Arabia had successfully accomplished the initial fundamental task of building a modern diversified economy and completing major infrastructural facilities, as well as putting into place the newly developed manufacturing and agricultural sectors, Mr. Song said. However, there still remained much room for consolidating past achievements and recovering of the momentum for sustained growth. Therefore, it was appropriate that the authorities had accorded increased priority under the Fourth Five-Year Plan to expanding the commodity producing sectors, further improving social services, and developing indigenous manpower resources. That appeared to be a better way to further rationalize the use of natural, human, and financial resources in the light of the present uncertainties in oil markets and revenues and larger fiscal deficits. The recent reforms on subsidies were welcome; further subsidy reductions in the agricultural and manufacturing sectors, energy, water, and so on, should be undertaken to reduce government expenditure and to conserve those valuable resources.

With regard to the dilemma in reviving public sector activity and containing reserve losses, Mr. Song considered that the authorities had taken the appropriate course by continuing their efforts to create a more favorable environment for the repatriation of the private sector's holdings of foreign assets.

Mr. Kafka said that Saudi Arabia was an example of intelligent adaptation to adverse changes in external circumstances. The authorities had continually refrained from basing policies on unrealistic expectations about the demand for oil.

Developments in the world oil markets had affected the Saudi Arabian economy from both the demand side and the supply side, Mr. Kafka noted. The consequent reduction that had taken place in government demand in Saudi Arabia had affected the non-oil sector in that country, and the severe cuts in oil exports that Saudi Arabia had accepted for a while had reduced the supply of "associated" gas required by Saudi Arabia's own economy.

The authorities' policies had been entirely appropriate, Mr. Kafka continued. The staff seemed to feel that more could have been done to eliminate various subsidies following the decline in revenues. However, the authorities were well advised to proceed carefully, since the completion of important infrastructure projects had provided a natural reduction in expenditure; the authorities should not undertake excessive retrenchment in the official sector pending the further growth of the private sector.

The promptness with which problems in the banking sector had been met by institutional reforms was impressive and the financial system appeared to be weathering well the complicated period which Saudi Arabia was undergoing, Mr. Kafka continued. Monetary policy had been carefully designed to put adequate pressure on demand to lower the cost structure and, in combination with the exchange policy, strengthen Saudi Arabia's international competitiveness without creating a depression. Together with adequate policies on the remuneration of capital, it should be possible to continue and intensify the promotion of private domestic investment in both human and material resources in Saudi Arabia. The staff's recommendations for medium-term policy formulation appeared to have been adopted already by the authorities insofar as the uncertainties and the fluctuations of the world oil markets made that possible.

The economic integration of the states in the Persian Gulf region was a welcome undertaking; so too were the liberal trade and remittance policies which Saudi Arabia continued to follow, Mr. Kafka said. It was noteworthy that the country's official foreign aid and particularly grant aid continued to represent a high proportion of its GDP and export revenue, despite the decline in both GDP and export revenue. Saudi Arabia's unstinting collaboration with the multilateral institutions, particularly the Fund, deserved praise.

Mr. Polak said that, given the development of the world oil market, it had been inevitable that Saudi Arabia's economy would go through the current contraction, the pace of which was being set by carefully balancing the need to stretch reserves against the desirability of not giving too negative an impulse to the private sector. Not surprisingly, the decline in oil revenue, which had started in 1982/83, had first reduced the rate of growth in non-oil GDP in the same year and then, with a lag, had been producing negative growth in non-oil GDP over the past two years.

The need for the Government to reduce spending not only on imported goods and services, but also on the domestic supply of goods and services, had had a negative impact on the business climate in Saudi Arabia, Mr. Polak observed. That had had beneficial and much needed efficiency effects. For example, it had reduced wage rates and wage costs, and the price level had declined by a few percentage points in the past few years. However, those changes, even though helped by an effective depreciation of the Saudi Arabian riyal through its peg on the U.S. dollar, were hardly substantial enough to make Saudi Arabia competitive in tradables other than oil and petrochemicals.

It was imperative to curtail government spending on investment, Mr. Polak stated. With the completion of a substantial infrastructure in record time, the need for government investment had been greatly reduced. The private non-oil sector was expected gradually to take the lead in the development of the country, financing part of the development by bringing home its foreign assets for investment in the economy. Although there was no question that that would be a highly desirable development it was not clear whether in a contracting market, defined by declining oil revenues and the consequent reduction of government expenditure, private investors would be strongly inclined to increase their investment. Although the staff report had stated that the authorities should induce increased investment by generating investment opportunities, the only concrete suggestion provided had been that the authorities should formulate a medium-term expenditure policy, which might be very difficult to do in a strongly credible way. The authorities had not accepted that possibility until uncertainties in the oil market had been reduced and the adjustment of private sector activity to a sustainable level had been completed. Thus, what the staff viewed as a precondition for resumimg adequate private sector investment, the authorities viewed as a possible effect of such investment. In that connection, the decline of credit by the banks to the private sector resulting from increased nonperforming loans should be seen as a negative factor.

The ability of the private sector to take over from the Government as the driving force behind the growth of the Saudi Arabian economy was the crucial issue for the medium-term development of the country, Mr. Polak said. It would have been helpful if the staff report had contained more indications of the strategy needed to attain that objective and had provided information on current efforts, for example, the composition of industries, financing efforts, and evidence of economic import substitution. Without such information, it would be hard to predict, despite a contractionary economic setting, a turnaround in private investment.

The recommendations to reduce subsidies, establish full cost pricing of government services, and further develop the banking system were welcome, Mr. Polak considered. Some concern was expressed about the increase in the number of nonperforming loans of commercial banks. Though sudden delays in payments had been explained by a stricter control on the terms and conditions of contracts, he wondered whether more attention should not be given to that problem. The recommendation to involve the specialized credit institutions in equity participation with the private sector was appropriate.

The effective depreciation of the riyal brought about by its link to the U.S. dollar was sufficient, Mr. Polak remarked. In view of the existing contraints in the economy, any greater real depreciation of the riyal would not achieve desired results. It could endanger price stability, at the same time, the non-oil sector would not reap only advantages for a considerable period.

Saudi Arabia should be warmly commended for continuing its generous foreign assistance policy despite its losses in reserves, Mr. Polak concluded.

Mr. de Forges said that the authorities' management of the economy had been commendable, particularly in three areas. First, despite declining revenues, Saudi Arabia had continued to provide assistance to multilateral institutions, including the IMF, and very generous amounts of ODA, thereby contributing to easing the adjustment process in many developing countries and indirectly helping to strengthen the world recovery. Second, Saudi Arabia had taken into consideration the interests of the international community in managing its official foreign assets, being careful to avoid disruptive swings in the composition of its portfolios. Third, Saudi Arabia had continued to implement a liberal commercial policy and promotion of regional cooperation within the Gulf Cooperation Council (GCC).

The authorities had undertaken a smooth transition to relative austerity by taking advantage of the propitious period before 1982 to lay the foundation for a well-ordered reconversion of the economy, Mr. de Forges observed. The flexibility of the authorities had been clearly demonstrated in the areas of the budget, the exchange rate, and development of the private sector. With respect to the budget, the authorities had cut expenditures sharply; from 1981/82 to 1985/86, total government expenditures had been reduced by more than one third, a rate hardly matched by other countries. Given the current uncertainty of the world oil market, some additional retrenchment in government spending appeared to be warranted. On the revenue side, it was appropriate to broaden the tax base and introduce income and sales taxes, considering that domestic revenues, although increasing, accounted for only 16 percent of total revenues. However, such measures would take time to design and implement in a country where the population was not used to being taxed. He added that the present policy of maintaining a relatively stable riyal/U.S. dollar rate was appropriate.

On the development of the private sector, the shift toward non-oil activities was quite impressive, Mr. de Forges said. The staff report showed that the private sector currently represented 40 percent of GDP, compared with 20 percent in 1980. The increased share was the result of an appropriate mix of supply and demand management policies, and liberal trade and immigration policies. However, that strategy, though commendable and far-reaching, faced certain constraints: a small population; the necessity of avoiding permanent oversubsidization of less efficient activities, such as wheat production; the availability of skilled manpower; the difficulties in penetrating external markets. The Fourth Development Plan (1985-90) had been designed to take care of those problems.

The authorities' commitment to make every effort in convincing private contractors to eliminate delays in payments vis-à-vis foreign creditors was welcome, Mr. de Forges remarked.

Ms. Bush said that the Executive Board's review of Saudi Arabia followed similar reviews of Kuwait and Oman. Each of these countries, to a greater or lesser extent, was now passing through a period of transition from very heavy dependence on the oil sector toward a more diversified economy. In Saudi Arabia, the basic infrastructure had been completed, and the chief task was to provide an attractive economic environment for growth and diversification of the economy with more focus on the private sector. The recent fall in oil prices was hastening the process of economic adjustment, which had been inevitable in any event. Although substantial energy resources and the buildup of foreign assets during the oil boom years had eased the impact of adjustment, the generally prudent financial policies followed by Saudi Arabia were commendable.

Saudi Arabia's Fourth Five-Year Plan embodied a shift in focus toward the development of non-oil goods production, social services, manpower resources, cost efficient government, and the maintenance and efficient operation of completed projects, Ms. Bush continued. With the increased role given to the private sector in the development process, it was important that the financial sector become attractive for domestic investment and that the institutional structure facilitate the diversification and modernization of the economy. Key policy tools would be manpower training, exchange rate flexibility, liberalization of foreign trade, and further development of financial markets. In addition, it would be important in both the private and public sectors to have comprehensive economic data along the lines discussed in the staff report. Although involving practical difficulties, a medium-term fiscal framework was needed to facilitate planning by both the public and private sectors. For the public sector, a continued drawdown of reserves over an extended period to finance budget deficits was inadvisable; there should be room for further expenditure cuts in subsidies, and increased revenues by means of full cost recovery for public services.

The financial strains observed in Saudi Arabia's commercial banking sector had also been seen in other countries in the wake of disinflation, debt problems, and falling world oil prices, Ms. Bush said. Maintaining the soundness of the banking sector was a fundamental objective, particularly as sustainable growth became more dependent upon financial intermediation by the banks to facilitate investment. The creation of both the Credit Risk Information system at SAMA and the Commission for the Settlement of Commercial Disputes was appropriate. Together with the elimination of legal and institutional obstacles to commercial bank lending, those steps were important measures in establishing a healthy banking system as well as creating a more favorable environment for the repatriation of overseas private assets. The authorities were encouraged to explore the possibilities for the use of various monetary instruments in the coming years when monetary policy would become more important in the context of an open economy.

Caution should be exercised in further drawing down reserves to finance current account deficits and on the balance of payments over an extended period, Ms. Bush urged. Export diversification and efficient import substitution should improve the current account position and help Saudi Arabia to resist protectionism. It should be noted, however, that the substantial foreign assets owned by the private sector were a promising source of finance for domestic investment and balance of payments support.

Mr. Schneider said that, in view of the sharp decline in oil prices, it was somewhat difficult to assess Saudi Arabia's economic prospects. Nonetheless, the realistic approach and determined efforts of the authorities to adjust their economy were commendable. Thus far, adjustment had proceeded smoothly and should provide for more balanced growth in the medium term. The authorities' assurances to continue to reduce government spending and concentrate on promoting the private sector were welcome. In the new environment, and with lower oil prices, it could not be expected that the real growth rate would continue to increase as it had done in the past. However, the sectoral composition of GDP had changed significantly in recent years, with the oil sector's share having decreased from 66 percent in 1979/80 to about 34 percent in 1985/86, while the private sector's share had risen steadily from 19 percent to 40 percent over the same period. Another positive sign was the increase in the absorptive and supply capacities of the economy. All those developments indicated that there would be a smooth and satisfactory adjustment to more balanced growth in the coming years. The staff's tentative balance of payments projections indicated that, notwithstanding the uncertainties of the oil market, it was possible that the current account balance would improve by 1987 and that official foreign assets would remain equivalent to four years' imports. That would give the authorities the opportunity to make further progress in their adjustment efforts.

The keystone of macroeconomic adjustment in Saudi Arabia's economy was fiscal policy, Mr. Schneider noted. The authorities had followed a narrow and difficult path as they had sought to promote sustainable growth and stimulate the private sector without raising the level of government expenditures or making further inroads on official foreign assets. The authorities' room to maneuver as they pursued those goals would be greater in the future because: first, most of the basic infrastructural projects had been completed; second, they had intended not to undertake any further projects; and third, the revolving character of the specialized credit institutions should eliminate the need to support projects through further budgetary appropriations. However, the successful formulation of fiscal policies with long-term objectives would depend largely on the stabilization of the oil market. The FY 1986/87 budget had not yet been announced due to uncertainties in the oil market. The authorities' plan to make monthly budgetary appropriations based on one twelfth of the expenditures for the preceding 12 months was appropriate under those conditions, but care should be taken to avoid a buildup of domestic arrears. Consideration should also be given to broadening the tax base over the medium term.

The attempt to increase the effectiveness of monetary policy by developing a secondary market in Bankers' Security Deposit Account was welcome, Mr. Schneider continued. However, the emerging difficulties in commercial bank operations owing to an accumulation of nonperforming loans needed to be carefully monitored. The authorities' prompt response to those developments, in particular the decision to establish a Credit Risk Information System, was appropriate.

The exchange rate policy had become more important in macroeconomic management, owing to the increased share of the non-oil and private sectors in GDP, Mr. Schneider said. The recent sizable real depreciation of the riyal, which was closely linked to the U.S. dollar, would help stimulate activity in these areas.

He appreciated the Saudi Arabian authorities' continuing generous foreign economic assistance to less developed countries, despite the weakening of their own external accounts, Mr. Schneider concluded.

Mr. Mawakani commended the authorities for continuing to take measures enabling the country to adjust smoothly to the significant decline in oil export earnings. Not only had earnings from oil exports fallen considerably during the past three years, but the authorities recently had had to deal with a very uncertain market. Although those developments had undoubtedly made the formulation and implementation of economic and financial policies more difficult, the authorities had guided the economy to a lower level of economic activity through appropriate policies and judicious use of the country's ample reserves. He was in broad agreement with the thrust of the staff appraisal.

The cautious stance taken by the authorities on fiscal policy was qualifying, Mr. Mawakani said. Although the fiscal deficit had increased in 1985/86, expenditure had been reduced significantly and measures had been taken to further improve the fiscal balance. However, in view of the uncertainty in the oil market, the authorities should continue their prudent, restrained fiscal policy. It would not be appropriate to continue financing the projected deficit from reserves; in that context, the staff's recommendations to further reduce expenditure and to broaden the tax base should be given careful consideration.

The emphasis that had been placed under the present development plan on the expansion of the commodity-producing sectors and the promotion of the private sectors as a major source of growth was welcome, Mr. Mawakani said. An environment of competition and self-reliance that would ensure a more efficient allocation of resources should be encouraged by the authorities.

The link established between the riyal and the U.S. dollar appeared to be satisfactory, Mr. Mawakani observed. The adjustment in the riyal had certainly contributed to reducing some of the pressure on the current account balance. The continued implementation of a realistic exchange rate policy would, among other things, encourage investment in various sectors of the economy and stimulate export activities. The protectionist tendencies of many industrial countries against petrochemicals were creating difficulties for the export diversification. A measure of reciprocity from industrial countries to Saudi Arabia's essentially open market system would certainly help the country in its adjustment efforts.

The Saudi Arabian authorities should be commended for continuing to provide substantial financial assistance to developing countries, despite the sharp drop in their revenues, Mr. Mawakani concluded.

Mr. Abdallah commended the authorities for continuing to make very good progress with their adjustment program. At the previous Article IV discussion (EBM/85/113, 7/26/85), the staff had recommended more expansionary policies than the authorities' objective of achieving a balanced budget. A number of Directors had supported the cautious stand of the Saudi Arabian authorities. Events had fully vindicated the policies of the authorities since only two thirds of the budgeted revenue had been realized in the past financial year, consequently, the deficit had been higher than planned.

It was encouraging to note that progress in the management of the Saudi Arabian economy had been achieved with the active involvement of the Fund, Mr. Abdallah continued. Since 1975, the Fund had extended technical assistance to Saudi Arabia on an extensive scale; for example, it had undertaken seven pre-budget studies for the country. The Fund had also extended technical assistance to SAMA. In 1981, the Fund had assisted SAMA in establishing in-house capability for economic modeling and simulation, and in 1982, assistance had been given in formulating computer programs for certain statistical series. In 1984 the Fund had contributed to the compilation of statistical formats to facilitate the analysis of economic and financial developments. Since December 1984, the Fund and the World Bank had been carrying out a joint study on the promotion of the private sector in Saudi Arabia. He inquired whether the study had been completed, since it had been scheduled for completion at the end of June 1986.

Although certain weaknesses in Saudi Arabia's progress were noticeable, there were no serious flaws and the staff might have been somewhat overcritical in its report, Mr. Abdallah remarked. For example, the staff report had stated that monetary policy had played only a limited role. Yet the riyal had been depreciated by 26 percent in real terms from March 1985 to

March 1986, and had declined by 17 percent in real terms from July 1985 to March 1986. Also, SAMA had been monitoring the loan portfolio of commercial banks closely, because of the growing liquidity problems which many borrowers had been experiencing.

It had recently established procedures to facilitate the settlement of disputes between banks and borrowers through the Commission for the Settlement of Commercial Disputes, which was an institution of fairly long standing, Mr. Abdallah observed. A Credit Risk Information System was being established to encourage lending on a sounder basis. Moreover, criteria had been established with which creditors had to comply before calling on banks' guarantees to contractors in difficulty. SAMA had also exerted pressure on commercial banks to make provisions for bad loans; consequently, the banks were in a better position to withstand losses.

As he had commented on the occasion of the 1985 Article IV consultation, Mr. Abdallah said that although he agreed with the authorities that the private sector needed encouragement to play a more dynamic role in the economy, he felt that too many incentives and inducements were already being given to the private sector. The Government was providing the following assistance to any private group engaged in industrial activities: interest-free loans from the Saudi Industrial Development Fund for a period of 15 years; subsidies on inputs such as electricity, water, and natural gas; exemption from import duty for equipment, raw materials, and industrial spare parts; exemption from income tax for foreign partners in joint ventures; provision of land for factory sites, and industrial housing at nominal rent; imposition of protective tariffs on competing imports up to 20 percent of their value; subsidies for the training of Saudi Arabian employees; and assistance for the export of products. Similar incentives had been provided to private groups involved in commercial agriculture.

As the Government was already providing too much support for the private sector, Mr. Abdallah considered that additional incentives were not warranted and expressed concern that Saudi Arabian businessmen were becoming too dependent upon Government. Yet, those same businessmen had demonstrated admirable enterprise and dynamism outside the country. He recalled that in December 1985, he had met a number of Saudi Arabian businessmen in Dar es Salaam who were selling building materials under the "own exchange" arrangement. The materials had been from their own stocks because construction activity in Saudi Arabia had decreased considerably. The businessmen had ventured into Tanzania without any export credit guarantees and the parallel market had been the only channel through which they could take in the proceeds out of the country; if foreigners brought in goods under their own exchange, it was only logical that they would use their own methods to get foreign exchange out. More businessmen were currently entering Tanzania with other items for sale.

Another sign of the robustness of the Saudi Arabian private sector was in Islamic banking, in which considerable expansion was taking place, Mr. Abdallah remarked. The initiative for that form of banking was coming mainly from Saudi Arabia, though the activity was taking place mainly outside the country. Although neither the Saudi Arabian Government nor the countries in which the banks were being established offered any guarantees, expansion was continuing at a steady pace, which was significant, considering that Islamic banking relied on profit-sharing rather than on secured lending. There had been inquiries on establishing those institutions in a number of the African countries represented by his chair.

Saudi Arabian businessmen were actively engaged in entrepôt trade and before the coffee quotas had been suspended, sizable tonnages of nonquota coffee had been exported to Saudi Arabia, from where they were re-exported to quota markets, Mr. Abdallah continued. The system could also be called a parallel market operation. Entrepôt trading could be more active if the authorities relaxed their stance on the internationalization of the riyal. Such internationalization was the natural role of the currency and backed by the strongest economy in the region, financing third country trade would be a natural line of development. Since Saudi Arabian businessmen had demonstrated initiative and dynamism, the Government should encourage their activities by withdrawing the protection they had extended thus far.

The authorities should be commended for their very generous official aid, from which a number of countries in his constituency had benefited, particularly his own country, Kenya, Mr. Abdallah said. It was commendable that the aid had been extended through both multilateral development agencies as well as on a bilateral basis. He endorsed the plea made to industrial countries to lower their protective barriers against exports of petroleum products from Saudi Arabia; it was disappointing that only one Director from industrial countries had referred to that particular issue.

Mr. Abramovich said that Saudi Arabia had systematically adjusted to the rapid decline in oil exports through a drastic cut in public expenditure and a flexible exchange rate policy, while the country's prudent policies had taken into account the interests of the international community. However, the uncertainties of the oil market and the fact that the decline in international reserves--which however remained at a high level--could not be sustained in the long run, called for the adoption of structural measures to reorient the economy consistent with the new external environment.

Although public expenditure in fiscal year 1985/86 had been 9 percent lower than the budgeted amount and one third lower than in fiscal year 1981/82, the fiscal deficit had reached 17.3 percent of GDP, Mr. Abramovich said. It was clear that the deficit had been caused by declining oil revenues that could not be balanced by government expenditure cuts. Saudi Arabia had been able to face the external shock owing to its strong international reserve position. However, as for other oil exporters, the shock on fiscal accounts had been very high and it would take some time to reverse. Given the current uncertainties and sharp swings in the oil market, the delay in issuing the annual budget for the current year was justified. From the staff report, it seemed there was a "crowding in" of the private sector by the public sector in the Saudi Arabian economic sector. The staff should indicate that the inevitable further adjustment of the fiscal accounts would not imply a new squeeze on Saudi Arabia's private sector.

While agreeing that efforts should be made toward diversification of the production and export base, the development of human resources, and the rationalization of subsidies, Mr. Abramovich said that he was uncertain whether the staff believed that structural reform and supply policies were easier and less costly to pursue in a recessive environment.

The new negative external conditions had necessitated a depreciated real effective exchange rate to foster import substitution and increase non-oil exports, Mr. Abramovich said. The flexible exchange rate policy that had allowed for a depreciation of the riyal in real terms was a positive development.

Since petrochemical and refined products enjoyed comparative advantages in Saudi Arabia and constituted a key sector for the successful diversification of the export base, Mr. Abramovich shared the authorities' strong dissatisfaction with the protectionist measures imposed by some of Saudi Arabia's major partners. He congratulated the Saudi Arabian authorities for their commitment to continued assistance to developing countries, as well as financial support for the Fund and other international organizations.

Mr. Zecchini said that recent trends in the oil market had been crucial in conditioning the performance of Saudi Arabia's economy. The drastic reduction in oil revenues was reflected in the public sector budget, which had shifted from large surpluses in the early 1980s to large deficits in the past two years. A sharp contraction in economic activity had followed, with real GDP continuing to decrease from 1982 onward. The authorities had dealt with those developments with commendable pragmatism and remarkable flexibility. A timely program of diversification in exports had been implemented and important measures had been taken to minimize the impact that further reliance on oil revenues could have had on the domestic economy.

The authorities' commitment to gradually shift the burden of economic activity from the public to the private sector was welcome, Mr. Zecchini remarked. However, GDP statistics for the 1980s showed that the contribution of the non-oil private sector to the formation of total GDP, although positive on average, had been decreasing, eventually becoming negative in the past two years. That trend indicated weakness in the development of the private sector and in finding good investment opportunities in the non-oil sectors. Moreover, it indicated that government support remained necessary to create the appropriate economic infrastructure and environment in which private initiative could thrive. In that respect, considering the trends in public finances, it appeared that there might still be some space for maneuver.

In such a rich economy which had experienced deep recession together with price deflation, the need to absorb the budget deficit could not be overemphasized, insofar as the deficit was instrumental in reducing the dependence of the economy on oil revenues through an appropriate public investment policy, Mr. Zecchini observed. A better distribution of public expenditures was appropriate. The recent reduction in total expenditures had been due mostly to the strong restraint in expenditure for investment projects and maintenance, which had decreased from SRls 145.7 billion to SRls 75.8 billion between 1981 and 1985. Current expenditure, however, had not adjusted in the same way since it had remained stable at SRls 86.7 billion in the same period. Some adjustments in the structure of public expenditures might be made by reducing current expenditure, while maintaining some support for overall economic activity through public investment. In that respect, however, he wondered if the current predominance of public investments for supporting the petrochemical industry constituted an adequate strategy, taking into account the recent price volatility of its output. The staff should comment on that aspect, together with indications on the extent to which other non-oil sectors were being assisted by the Government.

Revenue policy could also play an important role along the lines of this diversification strategy, Mr. Zecchini said. On the one hand, the tax base could be enlarged by introducing more advanced types of taxation, such as income and value-added taxes. On the other hand, some fiscal incentives could be provided to the private sector's fixed investments. Those tax incentives had not been clearly mentioned in the staff report; the staff was asked to clarify the relevance of the tax incentives under the new budget.

The recent monetary measures taken by the authorities were commendable, Mr. Zecchini stated. The introduction of the Credit Risk Information System would help to reduce the number of nonperforming loans. The development of a secondary market for Bankers' Security Deposit Accounts would enhance the effectiveness of monetary control, although the latter had never been a particular problem in Saudi Arabia. Owing to the limited constraints placed on them, open market operations would be a more flexible and appropriate instrument of control in light of the expected increase in credit demand by a revitalized private sector.

A selective protective tariff of 20 percent still existed and appeared to be fairly high because it applied to a relatively large share of final output price, Mr. Zecchini noted. Although the recent agreement on a free trade area in the region was welcome, a more liberal attitude could be applied to overall trade, particularly with other regions.

Mr. Lundstrom said that since he was in broad agreement with the staff appraisal, he would limit his comments to the role of the private sector, the main problem in Saudi Arabia's economy.

The authorities' response to the sharp decline in oil revenues since 1981 had been impressive, Mr. Lundstrom observed. In 1985/86, budgetary expenditure had been reduced by a remarkable 16 percent; however, the deficit had widened to 17 percent of GDP. In view of the likely continuation of weak oil market conditions, the process of curtailing expenditures would have to continue for some years. Even if Saudi Arabia maintained a relatively comfortable level of international reserves, it could not continue to draw down reserves at the present rate. Nonetheless, there was still some scope for using them as a means of reducing the impact of public expenditure cuts on priority areas. It was reassuring to see that the authorities had acted very cautiously and responsibly in avoiding measures detrimental to private sector confidence.

The main priority of the authorities over the past 15 years had been to try to reduce Saudi Arabia's dependence on oil and to transform it into a modern diversified economy by broadening the role of the private sector, Mr. Lundstrom continued. They had made considerable infrastructure investments over that period. Since some of the projects had been completed and others were nearing completion, Saudi Arabia, despite considerably reduced investments had reached a stage where the infrastructure would provide a solid base for a needed diversification of the economy. Thus far, fiscal adjustment had only taken the form of expenditure cuts, which was understandable since the income side of the budget was almost totally determined by exogenous factors. Domestic budget revenues that could play a stabilizing role accounted for only a fraction of total government revenues. It was difficult to see how Saudi Arabia could reduce its dependence on oil revenues and develop into a modern diversified economy without considerable broadening of the tax base. Increasing non-oil taxes might not be appropriate at the present time, but consideration should be given to the possibility of introducing a general income or sales tax in the medium term. More realistic pricing policies for public services would also have a positive effect on the budget. The ongoing reduction of subsidies, although difficult under prevailing economic circumstances, was necessary from a short-term fiscal point of view. It would certainly have to be sustained and was likely to have a positive medium-term effect on the effective use of private sector resources. The new petroleum export strategy, implying protection of Saudi Arabia's market share, appeared to have laid a foundation for more stability on the income side of the budget, thereby making fiscal planning easier and more meaningful. The continued application of priorities of the former budget on a monthly basis did not seem to be the appropriate way to handle the current difficulties.

The adjustment had taken place in an orderly fashion and had been facilitated by the availability of large official assets, which had been drawn down in a prudent manner, Mr. Lundstrom considered. The staff report indicated that there were ample private sector assets held abroad, activation of which could reduce the negative effect on the private sector of reduced public sector demand. The staff should indicate the level of those assets and the possibilities for activating them.

Saudi Arabia should be commended for its generous official development assistance, Mr. Lundstrom said. While it had been noted during the discussion that Saudi Arabia, over a ten-year period, had been second only to the United States in providing official development assistance, it appeared more relevant and more meaningful to compare ODA/GNP ratios. On that basis, Saudi Arabia was 25 times more generous than the United States, which was all the more impressive since it had maintained that performance despite extremely adverse economic developments.

The Director of the Middle Eastern Department said that bank supervision in Saudi Arabia had improved considerably. In the past year, provisioning for bad or doubtful debts had increased by some 53 percent. Progress had been made toward establishing the credit risk information system in SAMA. The staff's recommendation had been for banks to pay considerably more attention to the balance sheet of the debtor as an important criterion for granting or withholding credit. Date pertaining to the banking system had been reviewed carefully and comparisons made with international banks regarding the nonperforming assets of the commercial banks. The staff had concluded that the rate of return, although declining on equity as well as on assets, still compared very favorably with the rest of the world. Moreover, the capital to loan ratio had risen steadily while the loan to deposit ratio had remained about 50 percent. The recent decline in the profitability of the banking sector was to be expected on account of the lower level of economic activity, the increase in provisioning, and the continued move from demand deposit to income-earning deposits, which had effectively increased the cost of money to the banks. Saudi Arabia had also extended the jurisdiction of the Commission for the Settlement of Commercial Disputes to arbitrate disputes relating to servicing of loans. The difficulties the authorities had faced in expanding the domain of the Commission and the importance they were attaching to its role should not be underestimated.

Responding to the observation that monetary policy had played only a limited role in Saudi Arabia's economic management, the Director of the Middle Eastern Department said that such a role stemmed basically from the dominant role of government expenditures in determining the level of economic activity. However, SAMA believed that the role of monetary policy would need to be expanded into the traditional instruments of monetary policy, such as reserve requirements, quantitative limits on credit expansion where necessary, interest rate policies, and open market operations. He added that the Bankers' Security Deposit Account scheme could form the nucleus for open market operations.

The centerpiece of current Saudi Arabian economic policy was the promotion of the private sector, the Director of the Middle Eastern Department continued. The study of the private sector carried out by the Fund jointly with the World Bank and IFC had been completed and dispatched to the authorities recently for their comments. The authorities had recognized that having the private sector substitute for the decline in government expenditure would not be an easy task to accomplish, although the infrastructure was in place and a number of incentives had been provided, such as provision of inputs at lower than market prices, domestic procurement practices, subsidized credit by the specialized credit institutions, and the regulation that 30 percent of contracts should be subcontracted to Saudi Arabian firms. The authorities planned to use those measures very judiciously. They recognized that the past growth of the private sector at 11-12 percent annually had been unusual and was not sustainable and their policy objective was to create a leaner, more efficient private sector. Further policy action related essentially to exchange rate policy, which was active rather than passive. The Saudi Arabian riyal had depreciated by about 25 percent in real effective terms during the period June 1985-86. Moreover, the movement away from the dollar had accelerated when the riyal was devalued in June 1986 by 2.7 percent against the dollar.

The authorities were aware that some of the previous investments and economic activities would have to be restructured or eliminated to create a more active private sector, the Director observed. For instance, since underground water resources were being depleted rapidly, the authorities were considering a move away from water-intensive crops, such as wheat and fodder, toward fruits and vegetables. Water conservation techniques were also being introduced. In the manufacturing sector, the authorities were encouraging joint ventures and providing consulting services to small-scale enterprises through countrywide project appraisals. The Gulf Cooperation Council (GCC) had recently formed the Gulf Investment Corporation to carry out joint ventures in the region. In 1978/79 total investments by the private sector amounted to SRls 19 billion which had increased to SRls 41 billion in 1984/85, before declining to about SRls 38 billion in 1985/86. Most of the private sector activities had been in construction, services, and import substitutes; the import substitutes included basic manufactures, as well as foodstuffs.

The Deputy Director of the Exchange and Trade Relations Department said that for some years, the staff had been examining techniques for analyzing regional groupings and their internal and external effects. At the suggestion of the Executive Board some years previously, consultations had been bunched on a regional basis. In the Persian Gulf region, Saudi Arabia was the third member of the GCC, following Oman and Kuwait, with which consultation discussions had been concluded in recent weeks. As to Caribbean countries, a suggestion had been put forward for a joint consultation with a number of members. That approach had merit, but was not feasible for lack of staff. The staff was also considering how to tackle the effects upon each member of membership in the two West African monetary areas, which shared certain common institutions. The Exchange and Trade Relations Department, together with the Middle Eastern Department, would be looking at ways in which analysis and procedures relating to regional effects could be improved.

Mr. Nimatallah said that Saudi Arabia's inventory level had gone down far enough to increase demand for domestic and imported goods. Demand for labor had stabilized since there was currently a zero net flow in expatriate labor. Wages and costs were stabilizing, thereby providing stabilized purchasing power for the factors of production. The production and export of oil had been declining and that had made the private sector uneasy about investment decisions. With the export level of oil currently fixed at 4 1/2 million barrels, the price could be guessed at and there would be a minimum income flow, which had given investors more confidence. Thus, with the low inventory, the stabilization of purchasing power and population, and the minimum income expected from oil, the indications were that the economy had reached a level from which it could embark on growth.

Despite the large unpredictable fluctuation in prices and quantities of oil exported, the Government had tried its best to provide incentives for the private sector, Mr. Nimatallah noted. The strong indications that oil producers would cooperate in establishing relative stability in the oil market would help the private sector look for reasonable ventures and investors. There was still more to be done in enlarging the regional market. Saudi Arabia's trading partners should reciprocate Saudi Arabia's open policies. The industrial countries should note that the imports of the Persian Gulf region countries from the industrial countries were significant, ranging from $40 billion to $50 billion. It was important for them to realize that Saudi Arabia, and perhaps others in the region, should be given the opportunity to diversify and the private sector to grow, which would also be in their interest. He cautioned industrial countries against establishing barriers to exports from the Persian Gulf region, particularly Saudi Arabia.

All countries in the world had some form of subsidies, and Saudi Arabia was trying to reduce its subsidies gradually over time, Mr. Nimatallah noted. However, since it was a matter of degree, the subsidies would exist on a temporary basis until the rationale for imposing them no longer existed, a process that might take some time.

On banking, Mr. Nimatallah concluded, not only were banking institutions themselves being strengthened, but measures were also being taken to provide more credit risk information, better means of resolving problems with debtors, stronger and higher provisions for doubtful loans, and selectivity in lending.

The Chairman made the following summing up:

> Executive Directors highly commended the authorities for the smooth and orderly adjustment to sharply reduced oil export earnings, which had fallen by more than three quarters since 1981/1982. The adjustment had been effected through a combination of a reduction in government expenditure, facilitated by the virtual completion of the infrastructural phase of development, and a prudent drawdown of official foreign assets. The reduction in public sector spending had led to a significant deceleration and, more recently, to a decline in the growth of real non-oil GDP. The decline in the level of private sector activity from the nonsustainable levels of the 1970s was noted by Directors, who supported the authorities' emphasis on creating the appropriate environment for encouraging the development of a leaner and more efficient private sector.

Directors observed that the uncertainties and large fluctuations in the world oil market were complicating the authorities' task of financial planning; the delay in announcing the 1986/1987 budget was to be seen in that context. However, Directors endorsed the authorities' intention to maintain a cautious fiscal policy stance. Directors emphasized that, given the limited prospects for any significant recovery in oil receipts in the immediate future, it would be important for the authorities to strike a delicate balance between the twin objectives of reviving private sector activity and containing the drawdown in official foreign assets. In this connection, the adjustments introduced to their budget policies since 1982 were commended. Indeed, between 1981/1982 and 1985/1986, total government expenditure had been reduced by more than one third, and Directors noted that a continuation of fiscal restraint would be necessary, in view of the authorities' objective of curtailing the decline in foreign reserves. It was observed that increased financing of private sector investments by a drawdown of private foreign assets held abroad would ease the pressure on official reserves.

Noting that, for the time being, it was not realistic to expect a substantial increase in domestic revenues, a number of Directors urged the authorities to consider additional revenue measures and to broaden the tax base. Some spoke of the possible introduction of a general sales tax, or an income tax, over the medium term.

Directors generally emphasized the importance of further curtailing subsidies and transfers, for example, to agriculture, and raising charges for public services, not only to alleviate the budget, but also to improve resource allocation and to enhance the efficiency and competitiveness of the private sector.

In commending the emphasis placed by the authorities on expanding the role of the private sector in the development effort, Directors also noted the current need for consolidation and restructuring of that sector. Thus, the future contribution of the private sector to the development process would depend largely on available domestic investment opportunities, the development of the domestic labor force, sound macroeconomic policies, and a price structure that would closely approximate the true economic costs of the factors of production. Several Directors thought that the recent depreciation of the riyal in real effective terms, through its link to the U.S. dollar, would be helpful to the growth of the private sector in the medium term. The authorities' opposition to excessive protection through tariffs as a means for promoting private sector growth was welcomed. At the same time, the adverse impact of protection in the export markets on Saudi Arabia's trade in commodities such as petrochemicals was noted with concern by a number of Directors. The recent moves by the authorities to regularize the private sector loan servicing to commercial banks and the decision to establish the Credit Risk Information System in SAMA were also steps in the right direction. Some Directors saw room for a more active monetary policy, including the development of open market operations. The importance of continued flexible policies with respect to the expatriate labor force was also noted.

Directors recognized that, given the uncertain outlook for the world oil market and the postponement of the budget for 1986/87, Saudi Arabia's balance of payments prospects in the period ahead could be assessed only very tentatively. Given the thrust of Saudi Arabia's fiscal policy, Directors generally viewed the projected balance of payments deficits over 1986 and 1987 as acceptable. Directors noted that Saudi Arabia had continued to follow appropriate reserve management policies.

Directors warmly commended Saudi Arabia for its exceptionally generous program of highly concessional aid to developing countries, which was being continued despite sharply lower oil receipts and a weaker balance of payments position. They also expressed appreciation of Saudi Arabia's continued close collaboration with the Fund. Finally, the authorities were encouraged to continue to improve their statistical data base.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/105 (6/27/86) and EBM/86/106 (6/30/86).

2. NIGERIA - 1986 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1986 Article IV consultation with Nigeria to not later than July 11, 1986. (EBD/86/176, 6/25/86)

Decision No. 8321-(86/106), adopted
June 27, 1986

3. GUATEMALA - 1986 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1986 Article IV consultation with Guatemala to not later than July 18, 1986. (EBD/86/178, 6/26/86)

Decision No. 8322-(86/106), adopted
June 27, 1986

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/86/151 (6/26/86) and by an Assistant to Executive Director as set forth in EBAP/86/153 (6/26/86) is approved.

APPROVED: March 20, 1987

JOSEPH W. LANG, JR.
Acting Secretary