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Minutes of Executive Board Meeting 86/108

3:00 p.m., July 2, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
C. H. Dallara	
	L. Hubloue, Temporary
	M. Z. M. Qureshi, Temporary
H. Fujino	
G. Grosche	
	Yang W., Temporary
J. E. Ismael	
A. Kafka	H. A. Arias
	S. King, Temporary
H. Lundstrom	H. Fugmann
	L. Leonard
	G. D. Hodgson, Temporary
	W. K. Parmena, Temporary
	J. J. Dreizzen, Temporary
	L. P. Ebrill, Temporary
P. Pérez	
	G. Nguyen, Temporary
	J. de Beaufort Wijnholds
C. R. Rye	
	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
K. S. Friedman, Assistant
S. L. Yeager, Assistant

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Also Present

IBRD: G. Koenig, Latin America and the Caribbean Regional Office. European Department: L. A. Whittome, Counsellor and Director; B. E. Rose, Deputy Director; L. M. Beleza, H. B. Junz, A. Leipold, A. López-Claros, D. C. L. Nellor, T. M. Ter-Minassian, H. Vittas. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; M. Guitián, Deputy Director. Fiscal Affairs Department: G. M. Bartoli, E. Namor, N. Rossi. Legal Department: L. Maktouf, J. K. Oh. Western Hemisphere Department: S. T. Beza, Associate Director; E. V. Clifton, J. Ferrán, G. R. Le Fort, B. Fritz-Krockow, C. M. Loser, L. L. Pérez, O. Roncesvalles, S. J. Stephens, E. C. Suss, G. L. Terrier. Advisors to Executive Directors: S. Ganjarerndee, S. M. Hassan, J. Hospedales, A. Ouanes, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, W.-R. Bengs, O. S.-M. Bethel, J. de la Herrán, F. Di Mauro, R. Fox, G. K. Hodges, T. Morita, S. Rebecchini, J. E. Rodríguez, V. Rousset, D. Saha, C. A. Salinas, S. Simonsen, H. van der Burg.

1. ITALY - 1986 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/86/107, 7/2/86) their consideration of the staff report for the 1986 Article IV consultation with Italy (SM/86/121, 6/2/86). They also had before them a report on recent economic developments in Italy (SM/86/135, 6/17/86; Cor. 1, 7/1/86; and Sup. 1, 7/1/86).

The Director of the European Department, commenting on Mr. Nimatallah's question concerning an increase in the tax on oil products in Italy, said that he could agree with some of the arguments that Mr. Nimatallah had used, but continued to believe that the staff's position was correct. It was true that, given the weight of the Italian tax burden--the ratio of the general government tax revenues to GDP was 40.8 percent--there could be little argument for an increase in the level of taxation in Italy. Italy's tax burden equaled the tax burden of the other main European countries, and almost all those countries considered that their tax burden was excessively large, a view shared by the staff. In addition Italy, like any country, always ran the risk that an increase in taxes would result in an increase in expenditure rather than in a reduction in the fiscal deficit. The logic of the situation therefore led inexorably to the view that the main emphasis in Italy should, if possible, be on expenditure reduction. The Executive Board had long taken the position that there was a need to reduce expenditure in Italy, and the authorities themselves shared that view. However, it had proven very difficult to achieve the desired progress.

Since a first-best solution might not be available, it seemed to the staff to be perfectly reasonable for the authorities to turn to a second-best solution, the Director continued. That approach led the authorities to increased taxation of oil products. In that connection, several points should be made. First, on the economic side, the ratio of energy consumption to GDP in Italy had not declined as much in recent years as it had in other countries, and a tax on energy in general, and on oil in particular, which had a significant weight in total energy consumption, could be expected to be helpful in that regard. Second, there was of course uncertainty about the future price of oil. Given that uncertainty and the risk of some future rise in oil prices, it seemed reasonable to consider avoiding a full pass-through of the present oil price decline to end-users. Third, the competitive disadvantages of an increase in the tax on oil were well recognized by the Italian authorities. They had therefore framed their tax legislation in such a way that the increase in tax would fall on consumption and not on industrial inputs. The staff report on recent economic developments showed that the prices in Italy for diesel oil and heavy fuel oil were as low as the prices in other countries. The increase in the tax on gasoline was in fact a tax on consumption, and the decision to increase that tax had been taken against the background of an expected sharp increase in private consumption of no less than 4 percent in net terms. There was also a significant noneconomic point, namely, that if a

Government felt obliged to raise taxation, there was considerable political advantage in doing so in circumstances which would not raise the final price of the product.

The issue of the efficiency of alternative energy uses had been raised by Mr. Qureshi, the Director noted. That issue covered a field that was not fully within the staff's competence. As the staff understood it, the price of electricity for industrial users would fall more or less in line with the fall in the price of oil. As to the use of electricity by households, the situation had been complicated by the removal of a number of special discounted tariffs, and care was required in drawing any general conclusions. However, broadly speaking, the same conclusions seemed appropriate, namely, that the price of electricity paid by households would move more or less in line with the price of oil. It was important to remember that no less than 40 percent of the electricity generation in Italy was powered by oil. Therefore, on efficiency grounds it was fair to conclude that the taxation approach used by the Italian authorities was evenhanded, in the sense that it had not changed the situation that had prevailed in the recent past.

Some Executive Directors had suggested that the control of expenditure in 1986 might have been more lax than had been intended, the Director remarked. There were some indications that might lead to that conclusion, especially as there had been a greater benefit from reductions in interest rates and in the price of oil than had originally been foreseen. In addition, there had recently been an announcement that the salaries of top civil servants would be increased by some 45 percent.

Commenting on the inflation-adjusted fiscal deficit, the Director said that the update to the staff report on recent economic developments showed a continuing rise in that indicator over the previous several years even though there had been much greater stability in the behavior of the fiscal deficit as conventionally defined. The staff was not yet in the position to provide the data for 1986 in precisely the same way in which the Bank of Italy had been able to do for earlier years. However, the staff's calculations led it to believe that the inflation-adjusted deficit would increase again in 1986 compared with 1985, to roughly 9.5 percent of GDP.

The comment in the statistical issues appendix of the staff report on the delay in the submission of data on finances of local authorities might not have been adequately precise, the Director commented. The staff had data on the general government, and they were provided in the staff report. In the annex to the report, the staff had referred to those data in the <u>Government Finance Statistics</u> format; those data were available only after a considerable delay.

Commenting on budgetary reform, the Director said that, as he understood it, the intention of the Minister of the Treasury was to obtain a general agreement from Parliament during the summer on the principles governing the main aggregates for expenditures and revenues. That agreement would be followed in the fall by a detailed budget. The hope was that members of Parliament would find themselves constrained by their earlier agreement and might be more cautious than was customary when discussing expenditure measures. That approach was being followed, but the timing might have been disturbed by the recent fall of the Government.

On the monetary side, the staff's views were very much in line with the views that had been expressed by Executive Directors, the Director commented. Some concern had been expressed about the future of the so-called divorce between the Bank of Italy and the Treasury.

In reply to a question on the potential wealth effects from the recent surge in stock market prices, the Director remarked that such effects were possibly already evident in the somewhat stronger than expected consumption figures.

In its report the staff had meant to emphasize the need for flexibility in the behavior of interest rates, the Director said. The staff had warned that it could be difficult to achieve the M2 target without some rise in real interest rates, but the staff had been careful not to go so far as to say that that would be required. Such matters were very difficult to judge in advance, and any discussion of real rates of interest was made difficult by problems of definition at a time of sharply decelerating inflation.

The staff had no additional information on the underground economy other than the information that had been provided during the previous consultation with Italy, the Director commented.

The staff had been asked whether there was any contradiction between the discussion in the staff report and in Mr. Zecchini's opening statement on labor market rigidities in Italy, the Director recalled. The evidence showed that the rigidities in part-time work, fixed-time contracts, and overtime were more striking in Italy than in many other industrial countries. As to labor mobility, it was difficult to judge the relative importance of the hindrances that existed in a series of countries, and the staff would not wish to draw firm conclusions with respect to labor mobility in Italy. However, it was clear from Chart 17 in SM/86/135 that part-time employment was still significantly lower in Italy than in other developed countries, despite the relaxation of the regulations on part-time work in Italy. Chart 15 showed that for women, young persons, and persons unemployed for a considerable period, the employment situation was weaker in Italy than in most other industrial countries. In addition, as Mr. Zecchini had emphasized, unemployment in Italy was unevenly distributed on a geographical basis. Those facts had led the staff to conclude that labor market rigidities in Italy remained considerable, despite the progress that had clearly been achieved.

In the exchange rate policy area, the staff sympathized with the authorities, whose policy was basically one of nonaccommodation, the Director said. That policy had led over the years, and particularly since the inception of the EMS, to periods of relative appreciation of the real exchange rate. Nevertheless, it was clear to the authorities and to the staff that such a policy could only be followed for a limited period, as it could lead to circumstances in which the competitive position would virtually force a change in the exchange rate; when that development had threatened, the Italian authorities had been ready to move.

Commenting on the question of import elasticities, the Director said that the aggregate demand elasticity had risen over the medium term and was higher in Italy than in most European countries, although it was not the highest in Europe. That outcome was due partly to structural changes in industry and trade, especially the substitution of semifinished imports for raw material imports. Studies conducted by the Bank of Italy and by ISCO had been unable to trace any direct connection between that phenomenon and nonprice factors. The empirical evidence was less certain with respect to price elasticity; but the elasticity in Italy seemed to the staff to be higher than in most of the European countries.

With respect to the possible introduction of the "new lira," the authorities' intention, as the staff understood it, was to make one new lira equal 1,000 existing lira, the Director commented. A final decision on that matter had yet to be formally taken.

It had been suggested by Mr. Zecchini that the staff's analysis of the Italian economy was pessimistic, the Director remarked. The staff did not feel pessimistic about 1986 and did not feel basically pessimistic about the Italian economy. The industrial sector in Italy showed an underlying dynamism that was not evident in most European countries and which was reflected in Italy's gains in market shares and in Italy's remarkable investment performance. Moreover, many advances on the investment side had been in areas that were not captured or fully captured in the national accounts. There had also been many changes and a significant improvement in incomes policy. It was however fair to say that the staff felt pessimistic about the fiscal accounts and the continuing large public sector deficit. Those items posed a danger to the continuing ability of the Italian economy to grow without inflationary or external pressures. There was a widespread realization in Italian intellectual and official circles of the need to take action to change expenditure trends. Thus far, it had not been possible for those views to be mobilized into effective action through the political process, but the staff was confident that that situation would change.

The Director of the Exchange and Trade Relations Department said that ideally it would be desirable to have a separate paper and a general discussion on the issue of oil taxation. However, it was difficult to compile adequate material on the subject. The Fiscal Affairs Department was preparing a paper on petroleum product prices in the context of Fund programs that would raise some of the topics that had been mentioned during the present discussion. However, he doubted whether the staff had the resources to conduct a full study on petroleum taxation. The staff would further explore the possibility.

Mr. Templeman noted that there had recently been a record rise in stock market values. A comment on that trend would be helpful.

The Director of the European Department said that the sharp increase in the stock market was probably attributable to two factors. First, there had been a widespread development of the equivalent of unit trusts in Italy that had broadened investor interest and the potential field of investors in the stock exchange. Second, the profitability of Italian industry had clearly improved.

Mr. Zecchini remarked that pessimistic assessments of the economy were not credible. Economic trends in Italy were improving dramatically. His authorities paid close attention to notes of warning and caution about the risks and hidden dangers of certain developments and policies.

In analyzing the causes of the recent surge in stock prices Executive Directors should remember that the stock prices had been depressed, and that there had been a substantial improvement in the profitability of the corporate sector over the previous two years, Mr. Zecchini said. The wealth effect of the surge in stock market prices was reflected in the portfolios of the household sector. In 1985, the sum of shares and participations in investment funds and unit trusts by the household sector was about 12 percent of household portfolios; the comparable figure for 1984 was 6.5 percent. The large increase in 1985 in the share of stocks in households' portfolios had undoubtedly reflected a wealth effect. However, the surge in stock market prices was not the most important source of the wealth effect in recent months, as the predominant share of the financial portfolio of the household sector was in government securities. The decline in nominal interest rates in 1985 had resulted in substantial capital gains that might have encouraged a slight increase in the propensity to consume in the household sector. The average propensity to consume had increased from 75.8 percent in 1984 to 76.2 percent in 1985. In addition, it was useful to note that consumption in the household sector had increased more rapidly than the real disposable income of the household sector; a real wealth effect might have played a substantial role in the increasing propensity to consume in the household sector.

Fiscal policy was undoubtedly the crux of the current economic policy problems in Italy, Mr. Zecchini commented. It was difficult to forecast likely future fiscal developments on the basis of experience in recent years, when the authorities had resorted to the so-called fallback course of action when it had become clear that major proposals to cut expenditures drastically and quickly would not be passed by the Parliament. If major changes in fiscal policy in the form of drastic expenditure measures were to prove to be impossible because of parliamentary opposition, the authorities would resort to a contingency plan consisting of a series of smaller measures that over time would lead to the same result. As Mr. Rye had stressed, the issue in the fiscal area was the pace of adjustment, rather than the direction.

The staff's presentation of the inflation-adjusted fiscal deficit did not provide enough guidance to enable Executive Directors to interpret fully the relevant data, Mr. Zecchini said. With a fixed interest rate on the public debt, there was an opportunity for the public sector to levy an inflation tax to redress the public sector imbalance. That phenomenon was clearly evident in the comparison of developments in 1979-81 with developments before and after that period, when the inflation-adjusted public sector position went into and out of surplus. The more important question to ask was the extent to which inflation affected the expenditure and revenue sides, and particularly whether inflation affected both sides of the budget to the same extent. He was not in a position to make a precise estimate of the elasticity of expenditure and revenue. However, it was useful to note that in 1985 the inflation-adjusted deficit of the public sector had not increased as much as the nominal deficit; the inflation-adjusted deficit had risen from 7.6 percent to 7.9 percent of GDP. Accordingly, the inflation-adjusted deficit indicated that the performance of the public sector deficit in 1985 had not been as negative as the nominal indicator suggested. However, he would not suggest that that interpretation should necessarily be made in the present context of fiscal policy in Italy.

The question had been raised whether the reduction in interest payments by the public sector might not be offset by increased expenditure in other areas, Mr. Zecchini remarked. The Government was aiming at reducing the primary deficit--namely, the part of the deficit that did not include interest payments.

The benefits deriving from the decline in oil import prices had been shared roughly in equal amounts among consumers, producers, and the public sector to avoid weakening economic activity while maintaining an encouragement to save energy in the production process and in consumption, Mr. Zecchini said. The authorities' decision to increase the tax on oil consumption was based on a judgment about the duration of the change in the relative price of oil. Not all energy input prices had moved to the same extent in the recent past. If it was assumed that the recent trend in oil prices was not permanent, the authorities should not rush to pass the benefits on to the producing sector; a precipitous move would merely increase the uncertainty about the cost of factors of production and hamper investment by making investment more risky. If it were concluded that the recent change in relative prices was permanent, the authorities would have to act to make the production function consistent with the newly established set of relative prices of inputs, including not only oil, but also capital and labor, whose relative prices had changed dramatically over the previous several years.

It was clearly difficult to manage monetary policy when the public debt was increasing rapidly, Mr. Zecchini commented. At the same time, the rising public debt did not make it impossible to maintain consistent monetary policy management. In fact, there had been no easing of monetary policy in Italy throughout 1985, as was reflected in developments in real interest rates and M2. There had been short-lived deviations from the overall maintenance of a consistent monetary policy stance, but the assessment of the authorities' monetary management should take into account the authorities' reactions to those deviations.

The Bank of Italy and the Treasury had no intention of repealing the so-called divorce between the two institutions, Mr. Zecchini said. Repeal of the divorce was not at issue in Italy.

The administrative controls that had been introduced since January 1986 to tighten monetary management had been fully reversed, Mr. Zecchini commented. As for the room in which to make interest rate reductions, it depended on the progress that would be made in reducing the public sector deficit. In the first five months of 1986 there had been a slight decrease in real terms and a more substantial decrease in nominal terms in interest rates on government financial instruments.

The Government had approved the signing of the currency reform, Mr. Zecchini noted. The authorities were in the process of introducing legislation to gain a mandate to carry out the reform without requiring parliamentary approval of each step of the reform. The intention had been to introduce a new currency unit at the beginning of 1987. There was no certainty that the Government would be able to meet the target date, but the process of currency reform would undoubtedly be completed some time in 1987.

In assessing the possible loss of external competitiveness in recent months Executive Directors should distinguish between a loss of competitiveness within the EEC and on a broader scale, Mr. Zecchini said. In addition, the loss of competitiveness should be adjusted to the prevailing trend in the U.S. dollar. When those elements were taken into account, it became clear that countries in addition to Italy--for example, Germany and Japan--had experienced some loss of competitiveness. Because of its membership in the EMS, any loss of competitiveness by Italy resulting from a movement in the nominal exchange rate for the lira also involved a loss of competitiveness for the other EMS members.

The trade imbalance had been more than halved in the first five months of 1986, Mr. Zecchini observed. Of course, the quantities of imports and exports were affected by exchange rate and terms of trade developments. A number of factors had to be taken into account in assessing the trend in import and export quantities. In his opening statement he had stressed the ability of Italian industry to make innovations, to introduce needed organizational changes, and to specialize in specific segments of the market.

The staff had noted that Italy maintained very few quantitative restrictions on imports from developing countries, Mr. Zecchini said. Some measures had recently been taken to increase the volume of imports from developing countries. Indeed, the share of developing countries' imports in Italy's total imports had increased in 1985. There was no certainty that all the few remaining trade restrictions would be removed in the near future, but the trend toward trade liberalization would undoubtedly be continued. In addition, his authorities attached considerable importance to the liberalization in the financial sector and planned to maintain it.

Unit labor costs had declined by 2 percentage points in 1985, Mr. Zecchini noted. In addition, the staff had noted that in early 1986 the new indexation mechanism apparently had contributed to a further slowing in the growth of labor costs. Moreover, hourly wages in the private sector had increased more slowly in the first quarter of 1986 than in the first quarter of 1985.

Unit labor costs were the result of several variables, Mr. Zecchini continued. One of the variables was productivity, and there had been some decline in productivity growth in Italy from the peak that had been reached in 1984. Another factor was wage costs. The Government was trying to increase social security contributions in order to share more equitably the burden of responsibility within the social security system. In addition, profitability had increased rapidly in 1985. Unit labor costs were not out of line with the scenario that he had described in his opening statement.

There was some inconsistency between the many caveats that the staff had mentioned in its extensive description of rigidities in the labor market in Appendix I of SM/86/135 and the conclusions concerning that subject in SM/86/121, Mr. Zecchini considered. In the Appendix the staff commented that Italy's labor market rigidities compared unfavorably with some major industrial countries and favorably with some other industrial countries. Recent studies conducted by the Economic Research Department of the Bank of Italy showed that in absolute terms there was a high degree of mobility among employed and self-employed persons across the various sectors of the economy. There was not sufficient evidence to argue that Italy was at a disadvantage compared with other major industrial countries with respect to labor market rigidities. The increase in unit labor costs--which were obtained by adjusting unit labor costs for increasing productivity--in the private sector was 18.2 percent in 1982, 16.1 percent in 1983, 8.1 percent in 1984, and 7.9 percent in 1985. For industry as a whole, excluding construction, the increase was 14.8 percent in 1983, 4.3 percent in 1984, and 7.3 percent in 1985. In the services sector, unit labor costs had risen 18.6 percent in 1983, 11.3 percent in 1984, and 7.2 percent in 1985.

The Chairman made the following summing up:

Executive Directors generally endorsed the thrust of the staff appraisal in the report on the 1986 Article IV consultation with Italy. They regretted the pause that had occurred during 1985 in the improvement of Italy's economic performance. In that year, the rate of growth of GDP had decelerated slightly, inflation had virtually ceased to decline, the current account deficit of the balance of payments had widened, and, toward the end of the year, there had been some pressure on international reserves. Directors considered that an important role in these developments had been played by the renewed deterioration in the public sector finances, which had severely constrained the conduct of monetary policy. On the positive side, there had been some further improvement in the profitability of enterprises and a significant increase in productive investment.

Directors welcomed the improvement in prospect for 1986, when GDP growth is expected to recover, the rate of inflation in consumer prices is expected to fall significantly, and the current account of the balance of payments is likely to shift into a surplus. Directors noted that this improvement reflected in part a firmer stance of monetary policy, the steps taken in the 1986 budget to reduce the public sector deficit in relation to GDP, and the further moderation of the degree of wage indexation. Directors considered, however, that an important role in the prospective improvement in Italy's economic performance in 1986 would be played by external factors, such as the decline in oil prices. It was therefore important to take this opportunity to make the more fundamental adjustments in policies which would be necessary to secure the further progress in 1987 and beyond, so as to better align Italy's performance, especially with regard to inflation, with the performance of its main industrial partners.

Directors reiterated the view they had expressed in previous consultations that the adjustment effort needs to center on the public finances. Directors welcomed the authorities' medium-term fiscal adjustment program and stressed the importance of undertaking promptly the reforms, especially in the area of social expenditures, which would be necessary to rein back the growth of noninterest expenditures to rates at least in line with the medium-term program. Many Directors, moreover, took the view that the magnitude of the fiscal imbalances called for more ambitious targets in both the short and the medium term. Since it was recognized that the ratio of revenue to GDP had increased sharply since 1980, reaching the EEC average, Directors felt that the efforts to reduce the deficit in the near term should concentrate on government expenditures. In this context, Directors emphasized that reductions in real terms in noninterest current expenditure were called for. The seriousness of the situation made it appropriate at least in the short term to take advantage of special opportunities to seek a reduction in the deficit also through increases in taxation. Directors also encouraged the authorities to continue their efforts to rationalize the tax system and to make the administration of the tax system more efficient and to raise charges for public services to levels more closely in line with those in other European countries.

Directors welcomed the deceleration of the growth of the monetary aggregates in recent months and supported the authorities' decision to revert to indirect methods of credit control in the second half of 1986. They expressed the need to pursue a flexible interest rate policy geared to securing a development of the credit and monetary aggregates consistent with the targets for the year. Adherence to these targets was seen as a minimum condition for lasting progress on inflation. The scope for reduction of interest rates would be determined by progress in reducing inflation and the fiscal deficit. Directors generally cautioned against attempts to reduce the burden of the public debt through bank portfolio coefficients or changes in the relationship between the Bank of Italy and the Treasury. Such measures, in the view of the Directors, would show adverse consequences on the money supply, interest rates, and the external current account. The need for flexibility in interest rates was seen to be enhanced by the steps taken in recent months to liberalize capital controls. Directors welcomed these steps and expressed the hope that they would be followed soon by further measures to promote the full integration of Italy into international capital markets.

Directors welcomed the gradual modification of the wage indexation mechanism in recent years, which has significantly reduced the impact of this rigidity in the labor market. Directors noted, however, that the labor market in Italy, as the labor market in other countries in Europe, continued to be characterized by relatively strong rigidities, which could be seen as partially responsible for the relatively high rates of unemployment in the South and among young people, and they encouraged the authorities to make faster progress in removing these rigidities. Directors welcomed the deceleration in labor costs and the improvements in productivity which had led to a marked strengthening of enterprises' profitability and a restructuring of industry. Further wage moderation was seen as an essential condition for the long-term viability of the authorities' exchange rate policy within the EMS. In that context, a number of Directors welcomed the authorities' decision to maintain virtually unchanged the lira exchange rate in the recent EMS realignment as it emphasized the priority that they rightly attached to improving domestic cost and price performance. At the same time, many Directors urged Italy to take advantage of the present favorable circumstances to abolish the remaining import restrictions. In addition, Directors urged the authorities to use their influence within the context of the European Community trade arrangements to press for greater trade liberalization.

In sum, Directors noted that the pace of adjustment in the Italian economy in the first half of the 1980s has lagged somewhat behind that of other major industrial countries. They welcomed the commitment of the Italian authorities to completing the adjustment process and to closing the gap in economic performance with respect to its main partners. They stressed, however, that the magnitude of the imbalances, particularly in the fiscal field, and of the structural rigidities, particularly in the labor market, called for a faster and a more determined pace of action now and in the medium term than is presently contemplated. They urged that the fairly buoyant economic prospects for the near term be used to secure a lasting improvement in economic performance. It would be most unfortunate if present prospects were used instead as an excuse to postpone determined action.

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

2. PANAMA - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report on the review under the 21-month stand-by arrangement for Panama approved on July 15, 1985 (EBS/86/114, 5/28/86; and Sup. 1, 7/1/86).

Mr. Arias made the following statement:

On behalf of my Panamanian authorities, I would like to express their appreciation for the work done by the Fund mission during the negotiation of the 1986 economic program. My authorities are in broad agreement with most of the views and suggestions set forth in the staff paper.

The presentation of the 1986 economic program to the Board has been delayed owing to the time required to complete internal consultations to arrive at a consensus on the economic measures to be implemented. My authorities give a great deal of importance to these consultations because they reflect the feasibility of complying with the objectives proposed.

The Government is aware of the need to further strengthen the economy and make it more dynamic. At the same time, my authorities feel that every measure taken must be viewed both in the context of the political and social realities of the country and the economic necessities.

The Government of Panama has continued its policy of further reducing the public sector deficit both by decreasing expenditures and by increasing revenue collection, based on a financial adjustment program that began in May 1983. Under this program, Panama has reduced its overall public sector deficit from 11 percent of GDP in 1982 to 6 percent of GDP in 1984 and to 1.7 percent of GDP in 1985. This effort has been accompanied by the perseverance and determination of the authorities to increase the overall efficiency and competitiveness of the economy.

The attainment of a public sector deficit in 1985 that was less than half of that programmed (3.5 percent of GDP) was not intended. Rather, it was the result of a shortfall of external financing, including financial resources from the World Bank, which were not disbursed because of delays related to the negotiation of the second structural adjustment loan and also the postponement of the first two tranches amounting to $60 million of the new credit facility from commercial bank creditors. Thus, capital expenditures were lower than programmed because external financial disbursements started only by midyear (by the time of the stand-by approval) and thus resulted in a lack of counterpart funds for investment. Also, owing to these financial shortfalls, part of the fiscal deficit had to be financed by credit from the National Bank.

Central government revenues fell short of the projected target under the program owing to administrative delays in implementing the revenue package introduced in 1985. However, that shortfall was largely offset by higher revenues from Petroterminal de Panama.

Even though there were delays in implementing some of the revenue measures, efforts were made to alleviate the shortfall by reducing current expenditures of the Central Government. The new rigorous administrative controls applied by the Office of the Comptroller General, which, among others, entails the pre- and postaudit of central government expenditures as well as those of the decentralized agencies, has been a decisive factor toward these results. Consequently, public sector savings have doubled the 1984 level and reached their maximum level since 1981, in spite of the substantial revenue shortfalls mentioned before. The Government could not reduce public sector employment as planned, mainly owing to their concern that any action in that direction was going to be counterproductive to the entire process and schedule of adjustment measures that had to be taken under the program. My authorities feel that under the special and particular circumstances which sometimes emerge in the political scene, there are priorities and decisions that have to be taken to maintain general stability of the economy and, therefore, it was not a simple matter of being unsuccessful by not taking the actions programmed as described by the staff in their report.

As part of the 1985 economic program, the Government concluded negotiations for official credits for the refinancing of \$9.0 million and \$14.0 million for 1985-86 respectively with the Paris Club and \$581.0 million debt repayments to commercial banks falling due in 1985-86. Also Panama successfully completed a bond placement for \$20.0 million (the first one made by a Latin American country since 1982). The Government has at all times been current in both its interest and amortization payments to creditors. The structure of the external debt has been improved further as envisioned under the program by reducing the share of debt from commercial sources in total debt. From 1984 to 1985, total external debt contracted with commercial sources was reduced by 3 percentage points of GDP, whereas the debt to the multilateral and bilateral agencies has been maintained at the same level in terms of GDP.

My authorities feel that designing the 1986 economic program has demanded a great deal of effort; they are confident and determined to closely monitor the need for any action to fulfill their objectives.

The Government's plan is to continue consolidating previous gains to foster growth in output and employment. To this end, the Government has been making every effort to strengthen public finances, which constitute the engine in Panama's economic strategy to further reduce the public sector deficit to 1.2 percent of GDP and to increase the level of public sector savings to 4 percent of GDP. The plan also aims at improving further resource allocation by encouraging investment in the private sector as well as to promote savings in the public sector, and last but not least, to further reduce the debt service burden.

Under the program approved by the Board on July 15, 1985, the limit on the overall deficit of the nonfinancial public sector was \$120 million, equivalent to 2.6 percent of GDP. Owing to the Government's desire to repay fully to the National Bank of Panama the financial credit made available in 1985, the deficit of the public sector will be limited to \$62 million in 1986 (1.2 percent of GDP).

Based on the revenue measures taken in 1985, which are mentioned in the staff report, and on the performance of the fiscal revenues (shown in the table) as of May this year, my authorities feel confident that the Government's revenue projections will be met.

(In millions of U.S. dollars)

	(1) Revenue Projections 1986	(2) Revenue Collected 1986	(3) Percentage Change (2):(1)	(4) Revenue Collected 1985	(5) Percentage Change (2):(4)
January	73.5	76.1	3.5	52.8	44.1
February	66.1	68.5	3.6	50.4	35.9
March	124.1	124.8	0.6	101.4	23.1
April	67.2	67.6	0.6	59.5	13.6
May	64.6	65.0	0.6	62.6	3.8
Total	395.5	402.0	1.6	326.7	23.0

The higher than projected revenues reflect to a large extent tighter administrative controls, including:

- A substantial increase in the number of auditors and fiscal inspectors. Special attention is being given to improving job effectiveness and reducing overdue payments in all areas of fiscal revenues.

- The information system has been improved with a view to detecting as soon as possible any fiscal nonfulfillment. The number of computer terminals, has been increased, so as to improve statistical information and the service given to the public.

Current public sector expenditures are projected to decrease by about 1 percent of GDP. The labor force in the public sector is to be reduced by not filling vacancies; this would result in savings of about $8 million. Also, the Government plans to continue with its policy of not granting any general wage increase. Furthermore the Government has already announced the closure of some public enterprises as described in the letter of intent. Such action would rasult in further savings of about $3.0 million. Owing to a reduction in the U.S. quota for sugar and low international sugar prices, the Government is selling a sugar mill and this sale will be completed before August 1, 1986.

The Government of Panama has formulated a medium-term strategy which will have the support of a second structural adjustment loan (SAL II) already negotiated with the World Bank. The loan is to be considered by the Bank's Executive Board during the last quarter of 1986. The cornerstone of the policy changes envisioned under SAL II refer mainly to changes already approved by the legislature in the areas of industry, agriculture, and labor. While Panama continues to benefit from its locational comparative advantage of its supply services, the adverse effects of changes in the world economic environment have prompted the Government to call upon other sectors of the economy to participate more actively in the expansion of the economic base. It is envisaged that new laws will provide incentives that would result in improved resource allocation to the more productive sectors. In the industrial area the Government's intention is to improve overall competitiveness by reducing protectionism by rationalizing the tariff structure and eliminating quantitative import restrictions for all but 20 products. In the agricultural area changes have been introduced to make production more responsive to market forces, and various subsidies will be reduced. In the labor area the new policy will aim at reducing current rigidities so as to increase and generate employment.

To conclude, I would like to stress that many of the adjustments implemented have required legislative approval. As we all know, to make that step, first a dialogue must be established to reach an internal consensus, if effective and durable solutions for the economic development of the country are desired. Thus, the consultation process was very complex and demanded a great deal of time and work. My authorities feel, and I assume the Fund and World Bank will recognize (given the magnitude of the policy changes proposed under SAL II), that these efforts required a special resolve; but to a large extent these effects made it possible for the legislature to approve the laws in a much shorter period of time than expected.

Extending his remarks, Mr. Arias reported that he had recently received information from Panama indicating that, with regard to the cumulative limits on the deficit of the nonfinancial public sector, the deficit at end-May was $1 million compared with a programmed deficit of $25.9 million for the first half of 1986. Moreover, Panama had complied with the ceiling on net credit of the National Bank to the nonfinancial public sector as of June 30, 1986; the ceiling for net credit to the nonfinancial public sector was $36.1 million, while actual transactions were $35.7 million. Those performance criteria had been met even though Panana had not made scheduled purchases of SDR 22 million under the stand-by arrangement; if those purchases had been made, the performance criteria would have been met with a larger margin.

Mr. Dreizzen made the following statement:

The Panamanian economy has performed successfully under the current stand-by arrangement despite negative external developments such as the shortfall in external financing that occurred in 1985.

The program for 1986 includes appropriate measures both on the demand and the supply sides to continue the consolidation of the important gains already achieved.

For a country without an independent monetary policy and where the U.S. dollar circulates as the medium of exchange, the improvement of the fiscal accounts is one of the key means to eliminate imbalances in the external sector. Therefore, as Mr. Arias has remarked, it is important to fully recognize the efforts that the Panamanian authorities have made in the fiscal area, where the overall deficit has been dramatically brought down from 10.8 percent of GDP in 1982 to 1.7 percent of GDP in 1985. As a result of these positive developments in the public sector, the current account deficit of the balance of payments has been reduced by almost one half.

On investment, we are concerned about the implications of recent developments in economic activity for Panama's future growth prospects. In particular, gross domestic investment has declined by 10 percentage points in terms of GDP since 1982, and the decline has taken place both in the private and the public sectors. It is regrettable that the shortfall of external financing in 1985 has delayed the implementation of investment projects in the public sector. In this respect, we share the view of the World Bank staff that further reductions in public investment would not be appropriate.

Given the limited macroeconomic policy instruments available in the Panamanian economy, improving productivity through a more efficient allocation of resources constitutes the critical means to improve external competitiveness and strengthen the external accounts. In this context, we welcome the second structural adjustment loan already negotiated with the World Bank, which aims at providing financial support for structural reform in the areas of industry, agriculture, and the labor market.

We are satisfied to see that current policies, by fostering structural reform and growth, are in line with Panama's development strategy. In this respect, we fully agree with Mr. Arias that dialogue and internal consensus are necessary steps to assure the durability of the reforms. Finally, let me express my support for the proposed decision.

Mr. Pérez remarked that the review of the stand-by arrangement with Panama was taking place at a time when the Panamanian authorities were implementing a set of measures aimed at consolidating the progress already achieved and when financing adjustment was proving difficult. In fact, the program had gone off track precisely because of a shortfall in external financing. Consequently, purchases from the Fund had been interrupted and no purchases had been made in 1986. Indeed, striking a balance between the progress made in the adjustment process and the resources available to finance it was difficult.

Nonetheless, the Panamanian authorities had made great advances in important areas, Mr. Pérez continued. For example, inflation had been brought under control, with the wholesale price index declining to 1.5 percent during 1985 compared with a programmed rate of inflation of 3.8 percent. Measures taken in the public sector had been most effective, resulting in a deficit well below the program target. In addition, the current account deficit of the balance of payments had narrowed substantially in 1985. However, to consolidate the progress made under the program, a tight policy stance would be needed for some time. In that regard, the framework provided by the stand-by arrangement and cooperation with the World Bank seemed to offer an appropriate approach to achieve better results.

In the area of fiscal policy, the results had far exceeded the program targets, Mr. Pérez observed. The public sector deficit, which had been expected to be equivalent to 3.5 percent of GDP, had been reduced to 1.7 percent. Although some deficiencies still remained on the revenue side, the measures implemented by the authorities the previous week constituted the proper element to reinforce tax receipts. Favorable results were already emerging, as evidenced by the higher than budgeted receipts accruing to the Central Government as reported by Mr. Arias and in the supplement to the staff paper. That improved revenue performance should help alleviate somewhat the excessive debt service burden. As both the Fund staff and the Bank staff had pointed out, cuts in investment expenditure might have gone too far. The policy of postponing investment projects must be applied with caution to avoid indiscriminate choices. However, Mr. Arias's statement that "capital expenditures were lower than programmed because external financial disbursements started only by midyear" raised some doubts about whether cuts in investment reflected a deliberate policy or if they were the consequence of delays in receiving external financing. He invited comment on that point.

On current expenditures, he agreed with the staff that, in the absence of an exchange rate policy, the only way to improve competitiveness was through wage restraint and higher productivity, Mr. Pérez continued. Indeed, the freeze on public sector wages exemplified a good policy measure. Reduction of the public sector labor force would also result in lowering the fiscal deficit through a lower rate of expenditure without depressing public investment levels.

In the external sector a substantial improvement had taken place in the current account since 1982, Mr. Pérez noted. Nevertheless, the trend had recently been reversed, and that deficit was expected to widen in 1986. That trend was aggravated by the medium-term scenario. The most delicate issue was how to finance domestic and external imbalances in the face of a difficult financial situation. Rescheduling agreements reached by Panama with its creditors had been fairly successful. In the coming years, rescheduling would play an important role, as would debt relief, in the country's external policy. Another key element would be financial support from multilateral institutions; indeed, the success of the program would depend importantly on financial support from the Fund and even more importantly on World Bank assistance. U.S. aid and commercial bank financing, which also constituted an essential part of the necessary financial package, were linked to the approval of the World Bank structural adjustment loan.

The adoption of a fiscal program financed mostly by external credit indicated the importance of a shortfall in external financing, Mr. Pérez observed. The counterpart of the fiscal program consisted of a number of measures--many of them structural in nature--which needed to be implemented strongly. He understood that the proposed second structural adjustment loan would not be considered by the World Bank's Executive Board until the last quarter of 1986 and invited the staff representative from the World Bank to comment on the possibility of accelerating the procedure. He believed that unnecessary delays in providing agreed financing to Panama could precipitate setbacks to the progress already made and seriously jeopardize the entire adjustment process. Finally, he supported the proposed decision.

Mr. Hodgson made the following statement:

We are in broad agreement with the staff appraisal and can support the proposed decisions. The momentum of adjustment has generally been maintained despite the delay in completing the program review, and since the main objectives of the stand-by arrangement appear attainable, we agree that no reduction or rephasing of purchases is required.

Panama has made some important gains so far under this arrangement. Economic growth in 1985--at 3 percent--was considerably faster than originally forecast; inflation has fallen to about 1 percent; the current account deficit has narrowed more rapidly than programmed; and the overall deficit of the nonfinancial public sector was reduced well below the program target. In fact, the overall fiscal deficit has been reduced from 6 percent of GDP to under 2 percent in only one year, which under most circumstances would be commendable.

Unfortunately, fiscal adjustment more rapid than originally planned was made necessary by a shortfall in external financing during 1985, and in turn led to the ceiling of net credit to the public sector being missed. The shortfall in foreign financing can itself be traced to inadequate progress in negotiations with the World Bank on a second structural adjustment loan, to which other financing from commercial and official sources was linked. Mr. Arias has spoken of the need to build consensus within Panama on the economic program, which has led to delays. From a political perspective, building national consensus on economic policies is certainly desirable, but an earlier start on consensus building might have been more efficient and less costly for the Panamanian economy. In particular, it was disappointing that capital expenditures had to be cut in 1985 in order to reduce the overall fiscal deficit, since Panama had already experienced a sharp fall in domestic investment in the previous two years. Similarly, it was disappointing that legal barriers prevented the complete implementation of new revenue measures.

As to the program for 1986, emphasis has rightly been placed on restraining current expenditures to achieve a further reduction in the overall deficit to 1.2 percent of GDP. I welcome the planned increase in public investment, as well as the World Bank's active role in evaluating the public sector investment program and in supporting structural policies. The wage freeze and reduction in the public sector labor force planned by the authorities are commendable. These measures will provide important signals not only with respect to the fiscal balance, but also regarding Panama's external competitiveness. Strict management of public sector enterprises and reform of the Social Security Agency, as described by the staff, appear to be appropriate and necessary measures. On the revenue side, improved tax administration through changes such as those outlined by Mr. Arias should help the revenue measures introduced in 1985 to become more effective.

As for the external sector, it is clear that Panama will return to a sustainable external position only in the medium term. With debt service ratios projected to be well in excess of 35 percent for the next four years, debt rescheduling will in all likelihood be required until the end of the decade. Under these circumstances, Panama will need to be prudent in its external borrowing, since it has little capacity to carry more external debt.

A clear, unambiguous, and sustained commitment to strong adjustment policies will be required if balance of payments stability is to be firmly re-established.

Mr. Jayawardena said that he was in broad agreement with the staff analysis of the situation in Panama and therefore endorsed the proposed decision, which reflected a welcome continuation of the adjustment process that had been briefly interrupted by extenuating circumstances toward the end of 1985.

Panama was a small, middle-income country with certain unique characteristics, Mr. Jayawardena observed. The economy was a very open one with a strong outward orientation as evidenced by the Colón Free

Zones and offshore financial activities. Panama maintained an exchange rate policy based on a one-to-one relationship with the U.S. dollar; consequently, the recent depreciation of the dollar and the worldwide recession had transmitted substantial problems to the country's outward-oriented economy. Moreover, it was difficult to foresee an independent monetary policy in Panama. Hence, adjustment in the short term would have to be achieved through the public finances.

The role of the public sector in Panama was relatively small, with public investment accounting for about 4-5 percent of GDP, Mr. Jayawardena noted. The burden of fiscal adjustment would therefore fall primarily on current expenditures, which evidently kept the public sector working and had contributed to the increase in external debt. The saving/investment gap in both the public and private sectors had been financed through borrowing abroad, which further strained the country's debt-servicing capacity especially after international commercial bank lending had slowed down. Thus the adjustment effort had to begin with measures to ease the debt burden and the expectation that structural reforms would yield additional revenues.

That analysis was perhaps oversimplified, but if it was correct, he would not only welcome the adjustment measures that had been taken in 1985 under the present stand-by arrangement and were being implemented in 1986, he would also ask why those measures had not been contemplated earlier, Mr. Jayawardena continued. The wisdom of hindsight led to the conclusion that all domestic economic activity in a country with such a strong outward orientation was counterproductive. He was therefore encouraged to note the structural adjustment measures intended to reform tariffs, reduce price controls, improve agricultural and industrial incentives, and eliminate rigidities in the labor market--all of which would help to reduce price distortions.

In the past, the policy package described by the authorities would have supported a longer-term arrangement with the Fund, Mr. Jayawardena observed. Nonetheless, he welcomed the active collaboration between the Fund and the World Bank on structural adjustment as well as the Bank's second structural adjustment loan, which would partly compensate for the diminished level of Fund financing in support of Panama's adjustment effort. The medium-term balance of payments outlook suggested that Panama would be facing serious difficulties for some time because of the debt situation, and he hoped that the active collaboration between the authorities and the Fund and the Bank would be strengthened in the coming years.

The delay in completing the review under the stand-by arrangement was unfortunate, Mr. Jayawardena remarked. Although progress in curtailing the fiscal deficit had been better than anticipated, it was inadequate to offset the shortfall in external financing, which had led the National Bank to exceed the credit limits agreed under the program. The shortfall in external credit disbursements had been precipitated by a chain of cross-conditionalities, which served as a caution to those who believed cross-conditionality was necessary in order to thrust good economic policies on recalcitrant countries. While he was not opposed to conditionality per se, he wished to emphasize the need to develop a consensus in agreement with member countries on the wisdom of the economic policies to be implemented. The interruption of Panama's adjustment program clearly illustrated the difficulties faced by countries implementing such programs when all forms of external support were made conditional on each other. The Fund and the Bank should endeavor to avoid that pitfall in future programs.

The coming on stream of the World Bank structural adjustment loan toward the end of 1986, with the first disbursement expected to take place some time in the last quarter and the second disbursement to be made in 1987 had already caused problems for Panama's adjustment process, Mr. Jayawardena remarked. He wondered why negotiations with the World Bank could not be accelerated. Expediting that loan would greatly help the structural reform effort that was under way. Finally, he welcomed the resumption of the stand-by arrangement and supported the proposed decision.

Mr. Dallara made the following statement:

Certain aspects of economic performance have turned out quite favorable in Panama. In particular, real economic growth in 1985 was stronger than had been expected, and inflation remained low. Certain aspects of policy developments, however, were more mixed, in a somewhat unusual fashion. For example, performance criteria relating to credit to the Government were not met at end-December, yet the budget and current account deficit targets were met with wide margins. These developments are explained by a shortfall in external financing that led the authorities to moderate their credit needs by restraining expenditures instead of compensating completely for the shortfall with higher levels of domestic credit. That action helped ensure the continuation of the basic fiscal adjustment effort, for which the authorities deserve recognition. Nonetheless, the credit ceilings were exceeded, and the shortfall in external financing was not entirely beyond the authorities' control.

It appears that the targets set for the remaining period of the arrangement will continue and strengthen the adjustment effort, with a fiscal deficit target now set at 1.2 percent of GDP instead of the 2.6 percent expected when the program was formulated. This deficit is expected to be more than fully financed by external credits, permitting the elimination of the end-December excess of National Bank credit to the public sector.

Several elements of the fiscal program warrant particular mention. Restraint on wages clearly is crucial to maintaining international competitiveness. Thus the commitment to grant no civil service wage increase is important, as are renewed efforts to reduce the size of the civil service through attrition--an effort that did not fully materialize in 1985. The proportion of revenues and expenditures to GDP in Panama remains relatively high, and thus expenditure restraint, particularly with respect to current expenditures, is appropriate. In fact, we wonder whether further consideration needs to be given to tax reform, including reductions in the Government's absorption of revenue, so as to strengthen incentives for both private savings and production.

It appears that infrastructure remains the first priority of the Government's investment program. With public investment fairly low--at 5.4 percent of GDP--this appears appropriate. In addition, the measures being implemented in conjunction with the World Bank structural adjustment loan will strengthen incentives for private sector investment--investment that could then be concentrated in the productive sectors. Such incentives are particularly important, given the relatively low growth in exports projected over the medium term. Mr. Arias has indicated that the recent reforms in industry, agriculture, and labor laws could lead to stronger export growth over the medium term. The changes embodied in those actions are impressive, and we indeed hope that they will produce the desired results.

As to the public enterprises, improvements in operating performance are expected, and we welcome in particular the commitments to scale back the activities of several entities and their intervention in domestic markets. Such efforts not only enhance the fiscal adjustment effort, but strengthen the medium-term outlook by broadening the role of competitive forces and increasing the likelihood that export projections can be met or exceeded. The inclusion of these measures--which were worked out in close association with the World Bank--in the authorities' letter of intent indicates the importance of structural adjustment measures to the overall Fund-supported adjustment program.

Regarding the trade liberalization which is under way, it appears that under the tariff reforms, new industries will be subject to lower tariff rates than old industries. In light of the authorities' desire to stimulate diversification and growth, any disincentives should be avoided. He wondered whether higher rates of protection might lead investors to invest in old industries rather than encourage investment in newer industries.

External developments in 1986 are expected to be less favorable than in 1985, largely owing to the large decrease in receipts for transshipments of oil. While that decrease might have little relationship to the underlying competitiveness of the Panamanian economy, it illustrates the vulnerability of Panama to exogeneous events and to the need for strong, comprehensive structural adjustment measures if such vulnerability is to be reduced over time. Capital account developments are also crucial, as shown by the large outflow of private capital in 1985. A strong growth of inflows is expected in 1986, and with a continuing Fund program and renewed World Bank assistance, private sector confidence could be restored. On this matter we would be interested to hear if there are any preliminary indications on capital flows in the first part of 1986.

With respect to some procedural issues, we noted that two previously scheduled purchases will become available upon Board approval of the proposed decision, even though performance criteria have not been met since last September. The rationale for this approach appears to be that Panama adhered on the whole to its adjustment effort even though it lost access to external financing in 1985. While we join other Directors in commending the Panamanian authorities for their efforts in the face of these unexpected adverse developments, we would also note that the lack of external financing was not wholly beyond their control. It was due in part to the time that was required to develop the political consensus to enable the authorities to move ahead in the areas of structural reform that were key to negotiation of the structural adjustment loan from the Bank. Thus, the delay in the disbursement of external financing was to some extent due to internal delays. In that light, we have some doubts concerning the approach taken by the staff with respect to phasing and disbursements. However, we believe that their approach is acceptable in this instance and would be prepared to support it.

We have also noted the important linkages which exist between commercial bank financing, the program with the Fund, and the World Bank structural adjustment loan in the financing of this program. We have also noted the comments of other Directors, in particular, Mr. Pérez and Mr. Jayawardena, concerning the anticipated timing of disbursements under the structural adjustment loan. We had the impression that the basic policy actions called for in the loan have been taken or committed. Yet, we also have the impression that the loan will not be presented for consideration by the Bank's Board until this fall. There are perhaps complexities which we do not fully understand, but my colleagues in the U.S. Executive Director's office at the World Bank have also had some difficulty in understanding the timing of this loan and, like Mr. Pérez, we believe that it is important that the financing in support of adjustment move ahead as expeditiously as is possible. We would welcome comment by the Bank staff representative on this issue.

I also noted with interest and some concern, the approach to financing that has been taken in the medium-term scenario. According to the staff report, "the medium-term scenario assumes that all new external borrowing by the public sector will be from multilateral and bilateral agencies at terms similar to those received in the past...." Perhaps this statement simply reflects the prudent thinking of the staff that no new negotiations on net new commercial bank credit have commenced and, therefore, it would be perhaps ambitious to assume that new borrowing would materialize. However, if the staff feels that a modest amount of net new commercial bank financing might be needed in the future to sustain Panama's adjustment effort, it would be appropriate to mention that point in the medium-term scenario.

We welcome the active financial and policy support of the World Bank in Panama, and we welcome the program for 1986 under the stand-by arrangement. But we are somewhat doubtful that the medium-term objectives of Panama can be achieved without some modest additional commercial bank financing. Such amounts could be consistent with the important objective of reducing the debt profile over time. Any comments the staff might have on that point would also be of interest.

In sum, we are pleased to see this program back on track. We are also pleased to see the helpful support which both the Fund and the Bank have provided to Panama, and we support the proposed decision.

The staff representative from the Western Hemisphere Department remarked that the concern expressed by Executive Directors about the decline in public sector investment expenditures in 1985 were shared not only by the authorities but also by the staff of the World Bank and the Fund. Although the Government had envisaged a fairly ambitious investment program in 1985, delays in negotiations and in the disbursement of external credits had left the authorities no other choice but to delay the implementation of some investment projects. In doing so, they were attempting to meet their commitments in the financial program while at the same time dealing with a situation where, in many instances, the domestic counterpart funds needed to carry out investment projects were not available. The authorities' concern about the relatively low level of investment was reflected in the fact that a small increase on investment expenditure had been budgeted for 1986 even though the budget deficit target for that same period had been considerably reduced from the level originally envisaged.

As to the measures taken to reduce tariff protection granted to industries in Panama, the law passed in March 1986 envisaged a reduction of the maximum nominal tariff protection to 60 percent over a five-year period for existing industries, whereas the maximum level of tariff protection for new industries in the manufacturing sector and for agro-industries, would be about 20 percent and 30 percent, respectively, the staff representative continued. While it was true that the maximum protection for new industries was lower, it was also true that reducing tariff protection for existing industries was difficult in all countries. The reform measures were the result of internal negotiations during which strong pressures were placed on the Government by existing industries. The tariff reform being undertaken in Panama was an important one, and in view of the recent achievements, the outlook for tariff reform would continue to be favorable in the future.

The change in the net foreign position of commercial banks during the first quarter of 1986 indicated the beginning of a reversal of capital flight, which had taken place mostly through private banks in 1985, the staff representative commented. The increase in capital inflow during the first quarter was significant, amounting to about $80 million. Thus there appeared to be a return to a more normal pattern of private capital flows in the Panamanian economy.

A cautious policy with respect to external commercial borrowing would have to be followed over the medium term in view of Panama's heavy debt service burden, the staff representative from the Western Hemisphere Department remarked. Although there was not much room to increase commercial borrowing in the medium term, it might be possible that, as part of a policy of maintaining the overall public sector deficit between 1 percent and 2 percent of GDP, Panama might seek some new credit facilities from commercial banks. After all, the authorities still had to make fairly heavy payments not only to commercial banks but also to the holders of Panamanian bonds in the next few years. The staff would be looking into the question of commercial borrowing during the forthcoming Article IV consultation discussions with Panama.

The Deputy Director of the Exchange and Trade Relations Department recalled that doubts had been raised about the phasing of Panama's purchases from the Fund, particularly with regard to the proposal to allow Panama to make those purchases that had been previously delayed because of failure to complete the review and reach understandings on policies and measures for 1986. The staff had made this recommendation on the basis of its conclusion that since the policies in 1986 seemed to be on track and because there was evidence of fiscal improvement in the first quarter of the year, there was no need for rephasing of purchases or for reconsideration of the level of access under the arrangement.

The staff representative from the World Bank remarked that the presentation of the proposed second structural adjustment loan to the Executive Board of the World Bank was in line with the timetable agreed with the Panamanian authorities in February. At that time, the authorities had reaffirmed their desire to negotiate a second loan and the Bank staff had worked out with them a timetable of policy actions that took into account not only the technical preparation that would be needed but also the political absorptive capacity of Panama. The timetable envisioned negotiations of the loan agreements by the end of August and presentation of the proposal to the Bank Board in October 1986. That timetable could be accelerated if the Panamanian authorities were able to accelerate the policy reform measures that they were committed to undertake.

Mr. Dallara said that he sought confirmation of his understanding that acceleration of the second structural adjustment loan required additional policy actions prior to its consideration by the Executive Directors of the World Bank and that those actions were consistent with understandings that had already been reached between the Bank and the Panamanian authorities.

The staff representative from the World Bank confirmed Mr. Dallara's understanding.

Mr. Arias noted that Executive Directors had broadly recognized the efforts made by the Government, which were mainly reflected in the reduction of the public sector deficit since 1982 and the continued progress being made toward economic adjustment. The drastic reduction in in gross domestic investment since 1982, which several Executive Directors had mentioned, reflected Panama's geographical position, the impact of the recession that had started in 1982, and the economic and financial difficulties facing most Latin American countries. As to the reduction in capital investment, he wished to stress that it was primarily the result of a lack of external financing. His authorities recognized the importance of investment expenditure for medium-term growth, and they regretted the outcome in 1985. As he had indicated earlier, the delays encountered in completing the review of the stand-by arrangement, difficulties in negotiations with the World Bank regarding the structural adjustment loan, and the need to develop a national consensus had resulted in a significant shortfall in net external financing.

The program that the authorities had implemented had a twofold objective and focused on both stabilization and structural policies, Mr. Arias continued. With regard to economic stabilization, recent developments showed that fiscal policy had been crucial to the gains achieved thus far. His authorities shared the views expressed by Directors concerning fiscal policy and were aware that more needed to be done in that area. To further improve fiscal revenues, a special working group was studying the auditing system of corporations as well as the process of recovering overdue accounts. The group was to identify areas where problems existed so that the authorities could correct them. Moreover, the authorities were preparing a request for Fund technical assistance in the field of tax administration.

With respect to the structural reforms to be supported by the structural adjustment loan, Mr. Arias remarked, he wished to stress that the Government firmly intended to widen the economic base and foster growth in the productive sectors, particularly by improving prospects for the private sector.

The Executive Board then took the following decision:

1. Panama has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Panama (EBS/85/152, Sup. 1, 7/16/85) and paragraph 22 of the letter dated June 17,

1985 from the Minister of Planning and Economic Policy, the Minister of Finance and Treasury, and the General Manager of the National Bank of Panama, in order to review the progress made in implementing the program and to reach understandings on the policies and the performance criteria for the remaining period of the stand-by arrangement.

2. The letter, with attached tables, dated June 27, 1986 from the Minister of Planning and Economy, the Minister of Finance and Treasury, and the General Manager of the National Bank of Panama, shall be annexed to the stand-by arrangement for Panama, and the letter dated June 17, 1985 shall be read as modified and supplemented by the letter and attached tables dated June 27, 1986.

3. Panama will not make additional purchases under the stand-by arrangement that would increase the Fund's holdings of Panama's currency in the credit tranches beyond 25 percent of quota, or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota, other than purchases not in excess of the amount equivalent to SDR 22 million that Panama may make until July 31, 1986, during any period in which the data at the end of the preceding quarter indicate that:

(i) the cumulative limit on the deficit of the nonfinancial public sector, referred to in paragraph 7 of the letter of June 27, 1986 and set forth in Table 1 thereof; or

(ii) the ceiling on net credit of the National Bank to the nonfinancial public sector referred to in paragraph 13 of the letter of June 27, 1986 and set forth in Table 2 thereof; or

(iii) any of the limits on external and commercial net borrowing by the public sector, or on end-year outstanding debt with a maturity of less than one year, referred to in paragraph 14 of the letter of June 27, 1986, and set forth in Table 3 thereof

is not observed.

4. The Fund finds that the review contemplated in paragraph 4(b) of the stand-by arrangement has been completed.

Decision No. 8323-(86/108), adopted
July 2, 1986

APPROVED: March 20, 1987

JOSEPH W. LANG, JR.
Acting Secretary