NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/168

3:00 p.m., October 10, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	D. C. Templeman, Temporary
	E. L. Walker, Temporary
	L. Hubloue, Temporary
	T. Alhaimus
H. Fujino	M. Sugita
	B. Goos
	Jiang H.
J. E. Ismael	
	H. A. Arias
	J. R. N. Almeida, Temporary
	M. Foot
	R. Fox, Temporary
H. Lundstrom	H. Fugmann
M. Massé	
E. I. M. Mtei	W. K. Parmena, Temporary
	J. J. Dreizzen, Temporary
	J. E. Suraisry
	G. Ortiz
	S. de Forges
	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
	A. S. Jayawardena
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

IBRD: M. Benachenhou, Executive Director; N. M. Gorjestani, Western Africa Regional Office; J. D. Shilling, Europe, Middle East and North Africa Regional Office. African Department: A. D. Ouattara, Director; E. L. Bornemann, J. Harnack, J. R. Hill, S. N. Kimaro, P. Marciniak, J.-C. Nascimento. Asian Department: P. R. Narvekar, Director; R. J. Corker, M. Ishihara, R. Kibria, B. J. Smith. Exchange and Trade Relations Department: M. Guitián, Deputy Director; E. Brau, S. Kanesa-Thasan, C. M. Watson, M. Xafa. IMF Institute: A. Guecioueur, Participant. Legal Department: H. Elizalde, J. M. Ogoola, J. K. Oh, S. A. Silard. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. O. Bonvicini, J. P. Pujol. Bureau of Statistics: E. Fischer, E. S. Heredia, A. Tas. Advisors to Executive Directors: J. Hospedales, G. Nguyen, A. Ouanes, I. Puro, R. Valladares. Assistants to Executive Directors: A. Bertuch-Samuels, O. S.-M. Bethel, F. Di Mauro, W. N. Engert, V. Govindarajan, G. K. Hodges, K.-H. Kleine, T. Morita, R. Msadek, J. K. Orleans-Lindsay, J. Reddy, V. Rousset, S. Simonsen, L. Tornetta, H. van der Burg, B. D. White, Yang W.

1. PAPUA NEW GUINEA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Papua New Guinea (SM/86/231, 9/4/86; and Cor. 1, 9/19/86). They also had before them a background paper on recent economic developments in Papua New Guinea (SM/86/244, 9/22/86).

Mr. Rye made the following statement:

My Papua New Guinea authorities have asked me to convey their thanks to the staff mission; the Article IV consultation exercise was particularly useful in clarifying my authorities' assessment of their policy stance.

The staff report reinforces the concerns and challenges for development policy about which the Government is mindful, notably labor market rigidities, exchange rate policy, public service employment levels, and efficiency in the domestic financial system.

Two significant changes in the medium-term outlook have arisen since the report was prepared. First, the construction of the new gold mines mentioned is thought likely to be delayed by one year with construction of the Misima project expected to begin in late 1987 and of Porgera and Lihir in late 1988. These delays will reduce the current account deficit projected by the staff for 1987 and increase it in 1988 and 1989, but, with compensating movements in private capital flows, the projected overall balance is not greatly changed. Export receipts from these mines will not begin to flow until 1990.

Second, in August 1986 the Australian Government announced a unilateral cut of $A 10 million in the budget support grant for FY 1986/87 and in September proposed a revised aid arrangement to replace the aborted five-year agreement. The Australian proposal guarantees a minimum budget support grant of $A 275 million for 1987/88 and 1988/89 only, with the prospect of top-ups in each year to be negotiated. The Papua New Guinea Government is at present formulating its response to this proposal. It is thought unlikely that official transfers in the next two years will be as high as those projected in the staff report, and considerable uncertainty surrounds the long-term future of the aid relationship with Australia.

On policies, the special circumstances surrounding the presentation, rejection, and revision of the 1986 budget led to the new Government's inability to place that budget firmly within the context of a medium-term economic perspective, as has been the pattern since the late 1970s. Against that background and with general elections forthcoming in 1987, my authorities wish to reassure the Board of the Government's renewed commitment to a medium-term perspective in budget formulation for 1987 and beyond.

Monetary policy in 1985 was reflective generally of the fiscal stance--accommodative at first and tightening somewhat toward the end of the year. The package of measures introduced late in the year was a response, admittedly belated, to the excess growth of bank lending that had occurred throughout the year and that culminated in very tight liquidity in the commercial banking system. The lowering of the minimum liquid assets requirement from 15 percent to 12 percent in December should be interpreted not as a relaxation of monetary policy but as an attempt to ensure continued liquidity of the banking system during a crisis period when other measures were introduced to correct the imbalance. The liquid assets ratio now stands at a comfortable 19 percent, although the minimum requirement remains at 12 percent and close monitoring of bank lending growth remains imperative.

My authorities share the staff's mixed expectations for 1986: an 8 percent real rate of GDP growth deriving mainly from expanded Ok Tedi activity; some recovery in agricultural output--coffee, cocoa, and tea--in spite of sluggish copra and palm oil production; a rise in rural incomes and a 2 1/2 percent increase in domestic consumption; continued uncertainty in business and investments; and a consequent stagnation in employment. Notwithstanding further deterioration in the terms of trade, the authorities project an improved external current account position, with the deficit falling to about 7 percent of GDP. A modest increase in the overall surplus of the balance of payments is expected as net private capital inflows strengthen.

For the medium term, Papua New Guinea's external debt position has improved significantly since Executive Directors examined it during the 1985 Article IV consultation. Private sector debt was reduced by one third with the conversion of Ok Tedi debt into equity early this year. The ratio of debt service to exports has progressively become more manageable, given an improved outlook for foreign exchange earnings. By 1991 it is expected that total outstanding debt levels will decline to about 54 percent of GDP from 76 percent in 1984, and the debt service ratio will stabilize then at 21 percent, some 3 percentage points lower than in 1985.

The country's satisfactory performance in 1985 and its improved prospects for 1987 and the rest of the decade have afforded the Papua New Guinea authorities a wider margin within which to address the most pressing economic problem: high wages and rigidities in the labor sector. To alleviate cost-push pressures resulting from the high wage levels, and thereby improve the export sector's competitiveness, my authorities have initiated a program of reforms designed to raise labor productivity. Prominent in this regard are their efforts to promote efficiency in the public sector. Needless to say, they are fully aware that, when it is possible, more fundamental approaches need to be taken aimed at removing the rigidities currently rendering the wage-determination process intractable and clouding the prospects for productive investment and employment creation.

In this regard, however, my authorities do not fully accept that the kina exchange rate is "unrealistic" (page 22 of the staff report). Papua New Guinea is undoubtedly a high-cost economy, but its problems in that regard are those that face many other more sophisticated resource-rich economies. In my own view, any pressures on the rate, were it to be determined in a free market environment, would undoubtedly be upward in present circumstances--an observation with which the staff would, I think, agree.

At least for the present, it is enough, my authorities believe, that they remain committed to flexibility in the management of the exchange rate. Their success in 1985, and so far again in 1986, is enough to indicate that this is a serious commitment.

To go further--to make a sharp downward adjustment to the exchange rate--would in present circumstances be a risky change in policy. It would put in question Papua New Guinea's access to international capital markets and, in the absence of major institutional reform, would almost certainly ignite inflationary fires that would create major new problems for economic policymaking.

With regard to Annex IV on statistical issues (SM/86/231), my authorities agree that there is much room for improvement in the timeliness and coverage of statistical data. This is a symptom of a much wider problem that is not mentioned in the staff report but that is crucial not only for the provision of statistics but also for the design and elaboration of appropriate policy responses to potentially adverse short-run economic conditions and in the longer run for the design and implementation of suitable development projects. This problem is the acute shortage of highly skilled and experienced economists, and statistical missions are unfortunately not likely to be followed through adequately without a substantial improvement in the country's capacity to perform those functions. The assistance provided by country's the Fund in this regard is gratefully acknowledged.

In conclusion, I would like to assure the Board that my authorities know that the favorable developments Papua New Guinea has been enjoying by no means remedy the structural weaknesses of the economy. They have indicated their willingness to resolve their problems by medium-term macroeconomic measures and by more structural longer-term reforms. In this regard, they have always valued Fund advice, and they look forward to Executive Directors' views and recommendations.

Mr. Ismael stated that he was in broad agreement with the staff appraisal of policies and prospects for Papua New Guinea. That country was very poor and underdeveloped. The statistics for per capita income did not give a fair indication of the level of development in the country or of income distribution. A few prosperous enclaves, particularly the mining sector, provided relatively few employment opportunities but relatively high incomes, according to the paper on recent economic developments. Because development should be the major policy goal of the authorities, he welcomed their intention to reorient programs toward meeting development priorities and promoting economic growth.

The staff had stated on page 8 of the report that "despite being richly endowed with natural resources and having rates of aggregate investment in excess of 20 percent of GDP, real GDP has grown by less than 2 percent per annum in the last decade since independence," Mr. Ismael continued. Those facts suggested that investment in the past decade had been grossly inefficient. It also led him to conclude that additional investment expenditures alone would not lead to more rapid economic development. Important structural problems needed to be resolved, including land tenure incentives and regulatory constraints, and the high cost structure. He hoped that the authorities would give due emphasis to those problems in the following year.

The fiscal outturn in 1985 had been better than expected at the time of the previous Article IV consultation discussion, Mr. Ismael noted. That improvement had been partly the result of the successful efforts of the authorities to contain government expenditures and partly the result of slippages in the implementation of the capital budget. The authorities needed to strengthen their capacity to implement capital programs so that development efforts could be sustained. At the same time, he endorsed the authorities' decision to reduce the size of the public service and to introduce economies in administrative expenditures. He also shared the staff's emphasis on public sector resource mobilization; in particular, he endorsed the staff's recommendation for an import levy on imported food items. Public sector resource mobilization had become even more important in view of Mr. Rye's statement regarding uncertain prospects for budget support grants from Australia. At present, approximately 27 percent of total government expenditures were financed by Australian grants--thereby representing a major structural weakness on the financing side. He urged the authorities to intensify their resource mobilization efforts in view of budgetary constraints in Australia and the uncertain prospects for foreign grants.

The description of monetary developments and the frequency with which monetary instruments had been used to influence liquidity in the past year seemed to give mixed signals to investors over a relatively short period of time, Mr. Ismael commented. That situation would be confusing for businessmen as well as other investors, and he hoped that the authorities would be able to create more stable credit conditions in the following year. The recent decision to regulate interest rates and to lower lending and deposit rates seemed to be a step in the wrong direction. An artificially low interest rate could discourage resource mobilization and lead to inefficient use of resources. While he appreciated the concern of the authorities that the financial markets were imperfect and did not adequately reflect the proper price of money as justified by demand and supply conditions, the authorities should keep interest rates under constant review to ensure that they did not move too far out of line with market conditions. He hoped that in time the authorities would take measures to create a more competitive financial market, which could make conditions more conducive to the deregulation of interest rates.

Performance of incomes policy had been less than satisfactory, Mr. Ismael stated. The authorities had failed to bring about a reduction in real wages, and the centralized wage indexation system left little scope for exchange rate policy to be employed to improve export competitiveness. He endorsed the staff's position that the authorities must face the issue and promote acceptance of an incomes policy that would reduce relative wage costs, improve export competitiveness, and enhance growth and employment opportunities.

In 1985, the ratio of external debt to GDP had been 79 percent, and the debt service ratio had been 24 percent, Mr. Ismael said. While those ratios might not be alarming, they were cause for concern. He therefore welcomed the new Government's initiative to strengthen debt policies and the decision to phase out commercial borrowings by 1990. Although the country's external prospects had improved somewhat, the authorities should be extremely cautious in the management of external debt. Domestic resource mobilization, more efficient utilization of available resources, and the use of soft financing from external sources should be given greater emphasis, while commercial borrowing should be avoided as far as possible.

Mr. Fujino observed that economic performance--as measured by real GDP--fiscal and external current account balances, and the inflation rate had remained generally favorable during 1985-86, after years of unsatisfactory growth. Real GDP was expected to rise to 8 percent in 1986 from the previous low level of 2-3 percent. The overall budget deficit had been held at 2 percent of GDP in 1985 and was expected to be further curtailed in 1986. The current account deficit would decline from 9 percent of GDP in 1985 to 7 percent in 1986, compared with a peak of 21 percent in 1981. Consumer price inflation remained relatively low, and the pursuit of sound financial policies, particularly in the fiscal field, might have contributed to that favorable outcome. To a large extent, however, the improvement in economic performance was due to increased output and exports associated with the Ok Tedi mining project, which had started operations. The remainder of the economy was projected to recover from the decline in 1985, mainly as a result of higher coffee prices, which could prove to be temporary. In addition, there had not been a significant improvement in the employment situation.

During the 1985 consultation discussion on Papua New Guinea (EBM/85/123, 8/7/85), the medium-term prospects had been clouded by a number of uncertainties and difficulties, Mr. Fujino continued. Because of the extreme openness of the economy, the prospects were very sensitive to external developments. The considerable uncertainty that had surrounded the Ok Tedi project had been removed by an agreement between the Government and its foreign partners to accelerate development and production. Although there would probably be a delay in the new gold mine project, the possibility of higher growth in output and exports because of enhanced commercial exploitation of other gold and oil deposits remained. Thus, improved prospects for the external balance, mainly attributable to the changed outlook for the mining sector, should provide valuable time and opportunity to diversify and strengthen the domestic production base. It remained unclear, however, how rapid growth in the mining sector would be translated into the development of agriculture and other industries and into increased employment. Improvement in the overall economic conditions and prospects had been heavily dependent on expansion of the mining sector, and the response of the rest of the economy to such impetus had been weak and was expected to remain so at present. The authorities would be well advised to take advantage of the present favorable environment by drawing up and implementing a development strategy that accorded high priority to balanced growth and job creation.

From that perspective, Mr. Fujino added, wage and exchange rate policies assumed particular importance. The high level of wages had long hindered growth of industries outside the mining and plantation sectors. The 1983 wage agreement limiting indexation had been a commendable step toward restraining wage increases but had proved unsuccessful, as the inflation rate had fallen sharply subsequently. An attempt in late 1985 and early 1986 to agree on a new wage arrangement had resulted in a scheme that was similar to the preceding one. While recognizing the difficulty of addressing that long-standing structural problem, he urged the authorities to make further efforts to limit indexation and to introduce more flexibility in wage setting.

The exchange rate policy also had a role to play in enhancing international competitiveness, Mr. Fujino observed. He therefore broadly supported the exchange rate adjustments that had taken place since 1985. Nevertheless, it was difficult to pass judgment on the appropriate level of the kina at the present juncture, particularly in light of the divergent movements of the exchange rates of Papua New Guinea's major trading partners. The difficulty was well illustrated by the movement of the kina during 1985, when it had depreciated by 7 percent against the U.S. dollar and 27 percent against the deutsche mark and had appreciated by 13 percent against the Australian dollar. On an export-weighted basis, the kina had depreciated by over 18 percent, and on an import-weighted basis it depreciated by only 4.5 percent during 1985. Under those circumstances, he wondered whether the authorities should attach particular importance to the exchange rate vis-à-vis the Australian dollar or the exchange rate in terms of a trade-weighted real effective rate, or any other measure. If an appropriate scale were established, he wondered what exchange rate level the authorities should aim for. He would appreciate the views of the staff on those points.

On fiscal policy, the budget deficit--which had been estimated to rise to 5.0 percent of GDP--had been contained at 2 percent of GDP, Mr. Fujino noted. The authorities were to be commended for that result. However, that achievement needed to be cautiously reviewed. The major portion of that reduction resulted from the fall in capital expenditures, while departmental expenditures had actually exceeded the estimated amount. The change in the framework of budgetary allocation, from one based on departments to one based on functional classifications, would help to clarify priority spending. Also encouraging was the authorities' added emphasis on efficiency and productive use of expenditures and their commitment to maintaining a cautious policy stance.

In view of the importance of the balanced growth of industries, he shared the staff's concern that the exemption of basic foodstuffs from import levies could lead to discrimination against import-competing food production, Mr. Fujino said.

With regard to monetary policy, while the efficiency and competitiveness of the banking sector needed to be enhanced, it was highly questionable whether controls on the bank lending rate that had been introduced in June 1986 were appropriate, Mr. Fujino remarked. Such a policy would not only conflict with the aim of maintaining relatively tight monetary conditions but would also discourage domestic resource mobilization, which was critical to the development of nonmining industries.

Mr. Fox observed that the economic situation in Papua New Guinea had improved appreciably over the previous year, owing mainly to the start-up of production from the Ok Tedi mine, although other factors had contributed. The expected recovery of agricultural production, and commodity prices in 1986 would likely boost agricultural incomes and export revenues. The external accounts should therefore strengthen further, with another overall balance of payments surplus and a further reduction in the current account deficit and debt service ratio. Moreover, the comfortable external position would be further improved by the recent rise in the price of gold. Meanwhile, inflation continued at a low level. In the longer term, the decision to accelerate development at Ok Tedi and promote further mining development had boosted prospective export revenues and had made room for modest, but sustained growth of imports. The overall favorable outlook owed much to the authorities' prudent fiscal management; public finances seemed well under control.

The authorities' task was to take advantage of the improved outlook and to raise the growth of output and employment above the disappointing rates of the previous decade, Mr. Fox continued. The staff had appropriately devoted a large section of the report to the authorities' development strategy and the main structural impediments to medium-term growth. The Government's decision to reduce the direct role of government in the economy and to concentrate on providing support to the private sector, with economic services and infrastructure, was welcome. Their aim of reordering priorities within an unchanged overall level of public spending was also commendable, and he encouraged the authorities to make room for the necessary increase in higher-priority expenditures by reducing the public sector wage bill as they had proposed. He would be interested to hear from the staff or Mr. Rye any information on the Government's plans for privatization.

While the authorities could facilitate private sector growth through an appropriate development strategy, they would not succeed without a more vigorous and sustained attack on the main structural problem facing the economy, namely, the high level of wages and the rigid system of wage determination, including wage indexation, Mr. Fox stated. It was disappointing that the new Government's proposal to the Minimum Wages Board had been for a greater degree of protection of real wages than in the 1983-85 period and had been less ambitious than that proposed by the previous Government. That action was especially unfortunate given the background of low inflation, which should have helped the Government's attempts to gain consensus for a reduction in indexation, if not its complete elimination. Undoubtedly, such a consensus would take time to develop, but that only argued for a more forceful campaign to change existing attitudes at an early stage. He strongly agreed with the staff that the issue should be afforded top priority in the period ahead. He would be interested to know whether the Government had the option of amending the indexation arrangement before the new three-year period it covered was over, and whether the authorities could adopt different rules for the public sector. He urged the authorities to introduce promptly the necessary legislation to allow greater scope for productivity-based wage bargaining.

In the absence of greater flexibility in wage determination, the only scope in the short term for improving the competitiveness of the nonmining sector was through exchange rate action, Mr. Fox observed. The increased flexibility in that area over the past year was to be commended. Adjustment of the exchange rate in line with the currency basket had achieved some improvement in competitiveness, especially as the Australian dollar had weakened. Moreover, given the much greater importance of Australia as a supplier rather than as an export market, depreciation of the kina vis-à-vis the Australian dollar could improve Papua New Guinea's export competitiveness without the effect on inflation that would be the case if the Australian dollar were not weakening at the same time. Depreciation of the kina, in line with the currency basket, should therefore be continued as a minimum. However, the authorities were reluctant to make a sharp downward adjustment. Indeed, with the current comfortable balance of payments situation, a market-determined rate might well move upward. But costs in Papua New Guinea remained considerably in excess of those in some near neighbors, and it was difficult to see how the authorities could achieve their objective of employment creation and faster growth without a more active exchange rate policy. He would welcome staff comment on that issue.

Action to improve competitiveness through wage and exchange rate policy would have an important bearing on the prospects for the agricultural sector, which was a major source of employment and output, Mr. Fox noted. The staff had reported the great potential for growth in import-competing food production, but the prospects for agricultural production in general assumed in the medium-term projections were rather disappointing. He would therefore welcome comment from the staff on any specific policies--for example, in the area of agricultural pricing--that the authorities might envisage. Eliminating the exemption of basic foodstuffs from the recent increase in the general import levy would be helpful.

The new budget was cautious, and the authorities' decision to use higher than expected revenues to reduce the deficit further and to lower the external borrowing requirement was commendable, Mr. Fox stated. He encouraged the authorities to move ahead quickly with their intention to establish comprehensive debt guidelines. In contrast to the authorities' prudent fiscal stance, however, monetary policy had encountered some problems. Credit growth had been excessive in 1985, and the authorities' recent decision to reduce interest rates in the absence of any apparent tendency for an automatic reduction risked a further overshoot in 1986. He asked the staff for any details it could furnish about recent monetary developments; the staff appraisal had suggested that the need to tighten banks' liquidity might arise soon. He would also be interested in the staff's comments on the slow response of interest rates to the easing of credit conditions earlier in 1986, and whether interest rates in Australia were an effective floor below which rates in Papua New Guinea could not remain for long without adverse implications for credit growth and the balance of payments.

Mrs. Walker noted that developments in Papua New Guinea's economy during 1985 and the first half of 1986 were more encouraging than expected at the time of the 1985 Article IV consultation discussion. Budgetary developments had turned out to be much less troublesome because the authorities had foreseen the weakening fiscal position and had taken necessary additional measures to stop further deterioration of the deficit. In addition, production at the Ok Tedi mining project had accelerated, contributing to real GDP growth of 3 percent in 1985. The external debt situation had improved in 1985 as payments had declined from SDR 1.8 billion to SDR 1.6 billion, and the debt service ratio had fallen by 6 percentage points. Real GDP growth in 1986 was expected to amount to 8 percent, although mainly as a result of contributions from the Ok Tedi mine. The outlook for the budget and the overall balance of payments situation also appeared good.

She concurred with the staff's view that the short-term economic growth prospects were positive, owing in particular to increasing production from the Ok Tedi mining operation, Mrs. Walker continued. However, the rate of economic growth outside the mining sector was relatively slow, and despite steady improvement, the current account deficit--at 8.5 percent of GDP in 1985--remained high. Furthermore, structural weaknesses in the economy must be addressed if the country was to realize the improved economic outlook. The more favorable economic prospects should provide an environment in which the authorities could attack the remaining problems.

The authorities must continue to pursue prudent policies, Mrs. Walker stated. Of particular importance was the continued reduction in the public sector budget deficit. That objective could be accomplished most effectively through reduced government spending. In that regard, the cut in real expenditure on goods and services for 1986, to be achieved mainly through a reduction in public sector employment, was welcome. The public sector's preponderant role in the economy, with 60 percent of all wage and salary earners employed by the central and provincial governments and a large public enterprise sector, indicated that more would have to be done to achieve the desired budgetary effect.

The financial performance of the nonfinancial public sector enterprises, in which the Government had direct equity holdings, had been weak, Mrs. Walker remarked. She welcomed the new initiatives adopted to strengthen the financial operations of those enterprises, and she urged the authorities to extend the coverage of those measures to all such enterprises. A review of the entire sector had been undertaken, and the Government had begun the process of privatizing some of those enterprises; both steps were in the right direction.

The Government's recognition that the private sector would potentially make the greatest contribution to economic growth in the future was welcome, Mrs. Walker said. The authorities intended to redirect government economic activities toward those that encouraged private investment. A continued opening up of the trade and payments system was also desirable. While the liberalization of foreign investment restrictions was a positive step, considerable bureaucratic obstacles remained, and she urged the authorities to continue their efforts to eliminate them.

The use of controls for credit and interest rates could impede efficient credit allocation, Mrs. Walker commented. She asked the staff to comment on the need for such controls in light of the excessive expansion of credit during 1985 and on the possibility of their reduction in the future.

The authorities' implementation of a more flexible exchange rate policy was commendable, Mrs. Walker concluded. However, she remained concerned about the effect of continued partial indexation of wages to inflation, as it hindered employment creation, limited export competitiveness, and reduced the overall competitiveness of the economy. She encouraged the authorities to attack the wage problem and to continue to manage the exchange rate as flexibly as possible.

The staff representative from the Asian Department remarked that the financial performance of the 37 nonfinancial public enterprises in Papua New Guinea had, in general, been unsatisfactory. However, they had not placed a heavy burden on the budget, and, in fact, the largest enterprises had generated profits, although they had not been able to meet the commercial guidelines for their operations set by the Government, with the aid of Fund technical assistance. The authorities had undertaken a comprehensive review of the public enterprise sector, and some 30 enterprises had been identified as suitable for divestiture or foreclosure, or for sale to the private sector. The Government had announced in the 1986 budget that they would take those steps--for example, the Fish Marketing Corporation had been liquidated--and would strengthen supervision of the statutory authorities to improve their efficiency.

The staff had no additional information on monetary developments beyond the March 1986 quarter, the staff representative said. Monetary growth on a 12-month basis had picked up sharply from the increase in the 12-month period to December 1985 and was cause for concern.

Recent developments inspired more confidence in the strength of Papua New Guinea's balance of payments position, the staff representative continued. Gold prices had increased significantly from the levels envisaged in the staff scenarios: while the staff had forecast an average gold price in 1986 of $345 an ounce, it was at present some $100 higher. The additional export receipts that could accrue in 1986 would be about K 40 million. As a result, the staff could see an increase in potential monetary growth in 1986 and, under current interest rate controls, credit growth might exceed the levels envisaged by the authorities. The staff's warnings in the report to the authorities that they should watch monetary developments carefully had become even more valid at present.

Financial and business links between the economies of Papua New Guinea and Australia were very close, the staff representative explained. However, the banking community was subject to controls on the flow of funds between the two countries, and Papua New Guinea had developed a wider network of financial contacts in recent years, thus limiting the extent of its integration with Australia's financial system. Incentives for capital flows existed between the two countries' business and banking communities, as interest rates in Papua New Guinea were generally lower. That situation underlined the staff's concern about credit growth. The interest differential in favor of investment in Australia encouraged lending in Papua New Guinea for offshore investment or foreign borrowing substitution. Observers in the financial and business community considered the authorities' reintroduction of interest rate controls in early 1986 a backward step, the staff representative noted. The authorities had explained, however, that their experience with market-determined interest rates had been less than satisfactory. The Finance Minister especially had been concerned that inefficiencies in the banking community and a lack of competitiveness among the banks had not allowed market forces to set fully competitive rates. The move by the Government to reintroduce controls on lending rates by the banks would encourage the banks to increase competitiveness in order to develop a more sustainable market-determined interest rate structure.

The exchange rate and wages were reverse sides of the same coin in Papua New Guinea, because the close ties between the exchange rate and domestic costs were perpetuated through wage indexation, the staff representative said. Wages were considered high, not in an absolute sense, but through a comparative relationship between the cost of employing labor and the value of the product of that labor on world markets converted in terms of the current exchange rate. The 1985 staff report indicated that wage levels in U.S. dollars were high in comparison with a number of other low- to middle-income developing countries, while there was no evidence that labor productivity was greater. The steady decline in traditional food growing and the substitution of nontraditional food items on a large scale in the national diet illustrated the high cost structure and lack of competitiveness of traded-goods industries outside the plantation and mining sectors. In that connection, agricultural price support schemes did not exist in the largely open economy of Papua New Guinea.

The dimension of the unemployment situation was another factor affecting costs, the staff representative continued. Only 13 percent of the work force was in paid employment, while another 35 percent was self-employed in some form of cash crop farming for export or, to a lesser extent, for domestic marketing, leaving over half the labor force without the opportunity to participate in the cash economy. A large portion of the population lived in villages without an opportunity to advance in the modern world, while others lived in urban areas without support and created severe social problems. Without measures to either reduce real wage levels or adjust the exchange rate, improvement in the employment situation would be difficult. He agreed with Mr. Rye that an abrupt adjustment of the exchange rate would threaten stability. However, any change must be accompanied by government and community acceptance of a cut in real wage levels. Exchange rate adjustment could not be translated into increased wages, as under current indexation arrangements, if competitiveness in traded goods industries was to improve.

A precise measure of Papua New Guinea's competitiveness was difficult to determine. Alternative measures included the import-weighted exchange rate or the export-weighted exchange rate, the staff representative from the Asian Department said. While the country's imports from Australia were significant, it exported mainly to other industrial countries. The recent decline in the value of the Australian dollar had allowed Papua New Guinea to avoid the inflation that could accompany depreciation of the kina against the official basket of currencies, while gaining competitiveness vis-à-vis its major export markets in Japan, Germany, and other industrial countries. However, the weakness of the Australian dollar may well not continue, and were it to recover, this would increase the dilemmas facing the authorities. Their scope for independent action through exchange rate policy to affect competitiveness in the country's major export markets, while containing inflation to acceptable levels, would be constrained.

Mr. Rye observed that the Board discussions were helpful to a country like Papua New Guinea, where economic expertise was sometimes scarce.

The Government saw the recent imposition of interest rate regulations as essentially temporary, Mr. Rye noted. The authorities regarded the fact that interest rates had not fallen after the period of tightness in 1985 as a reflection of an uncompetitive banking sector. The banks were largely foreign owned, and the authorities had difficulty instilling a more innovative and entrepreneurial spirit in the financial sector. Meanwhile, the authorities took the view that the high levels of interest rates had affected investment and the general development of the economy adversely, and they hoped that the new regulations would cause bankers to reconsider their policies.

The central issue of policymaking in Papua New Guinea was the exchange rate and wages, Mr. Rye continued. There was no question that if a foreign exchange market could be created instantly in Papua New Guinea, the value of the kina would almost certainly go up rather than down, particularly given developments in gold prices, which affected the country's prospects significantly. In Papua New Guinea, as in other similarly endowed countries, its resources led to the development of export sectors at the expense of nonexport sectors. The country had inherited a legacy of strong trade unions--notably in key sectors such as transport--and a centralized wage setting system. Undoubtedly, strong industrial unrest in key sectors could be extremely damaging to the economy. Another constraint was the political element. Because the country was fragmented and politicians' loyalties were essentially to their own areas and tribes, any government could quickly lose public support, as seen in the change of government in 1985 brought about by the failure of the Government to pass its budget through Parliament as a result of a sudden shift in alliances.

There was no consensus at present for a major change in the wage-determination system, and it was not clear how that consensus could be reached, Mr. Rye commented. Because of the weakness of the Australian dollar at present, scope existed to push the effective kina rate down in a gradual way without igniting controversy or adding to inflationary pressures domestically. But those favorable conditions would not continue, and if the Australian dollar were to strengthen, the problems faced by the authorities would be magnified.

In the present circumstances, the authorities saw no short-term alternative to the policies they had pursued, including policy measures to enhance productivity, Mr. Rye observed. Greater scope existed to raise productivity levels than to push real wages down, particularly in the public sector. The Government had launched strong and worthwhile efforts to enhance productivity, and it was hoped that those efforts would also flow into private sector activity.

The Acting Chairman made the following summing up:

Executive Directors concurred with the thrust of the appraisal in the staff report for the 1986 Article IV consultation with Papua New Guinea. Directors noted faster overall growth in 1985--but weakness outside the mining sector--a reduced current account deficit, and continuing moderate inflation. Directors commended the authorities for their successful policy adjustment during the course of the year, underpinned by a tightening of budgetary policy and reduced government foreign commercial borrowing, aimed at returning financial policies to a sustainable path.

Directors commented that the outlook for 1986 and beyond had improved, mainly because of better prospects for mineral exports. While this would lessen external constraints to growth, Directors cautioned that the forecasts were subject to uncertainty, and that the outlook for agriculture remained unfavorable. Directors urged the authorities to address deep-seated structural problems, increase the efficiency of investment, and encourage foreign direct investment in order to promote broad-based development and increase employment opportunities.

Directors praised the improved budget outcome in 1985 and commended the authorities for the cautious stance in the 1986 budget. Noting that revenue now appears likely to exceed the budget estimate, Directors strongly supported the authorities' intention to use these additional resources to reduce the deficit and the external borrowing requirement below the budgeted amount, rather than relax expenditure restraint, and to continue efforts to improve the financial position of the public enterprises. Directors were in agreement with the authorities' medium-term strategy to reduce the size of the public service and to shift the resources to economic services and infrastructure to support private sector initiative and growth. In view of the expected decline in foreign aid, efforts to broaden the tax base and to mobilize resources should continue. The authorities were advised to review their recent decision to exempt basic foodstuffs from the general import levy.

The sharp rise in external debt during the past three years was arrested in 1985, Directors observed. The more favorable external prospects for the next few years provided an opportunity to consolidate progress in strengthening debt discipline. Directors welcomed the authorities' recent action to limit external borrowing and their intention to move toward eliminating foreign official commercial borrowing as soon as possible.

A number of Directors noted that monetary policy had been somewhat too relaxed during 1985. Some Directors pointed out that while credit growth was brought back to a sustainable level during the early months of 1986, a potential danger existed that credit growth may again become excessive, especially in light of the reintroduction of interest rate controls. They urged the authorities to create more stable credit conditions and to improve the efficiency of the domestic financial system; real interest rates should be maintained at realistic levels to promote both savings and efficient resource allocation.

Progress in reducing labor costs has been slow, and high wages, largely maintained through indexation, remain a major structural problem that hampers investment and job creation, Directors remarked. Moreover, the system of wage indexation inhibits efforts to improve international competitiveness. Directors expressed disappointment with the decision to maintain the system of wage indexation over the coming three years, which would likely preclude any sizable reduction in real wage levels. They urged the authorities to reinforce their efforts to develop general recognition of the need for convincing action to promote more realistic wage levels and to take steps to introduce greater flexibility into the labor market. Wage policy and exchange rate policy are thus inextricably intertwined, Directors observed. The authorities were commended for the flexibility shown in the conduct of exchange rate policy during 1985. Directors advised the authorities to continue this policy and welcomed the authorities' continued commitment to flexibility in the management of the exchange rate.

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

2. SAO TOME AND PRINCIPE - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with São Tomé and Principe (SM/86/183, 7/28/86). They also had before them a background paper on recent economic developments in São Tomé and Principe (SM/86/222, 8/29/86).

The staff representative from the African Department stated that the authorities of São Tomé and Principe had agreed in principle to undertake, within the framework of a proposed World Bank-financed cocoa sector rehabilitation project, a number of important policy changes, including an adjustment of the exchange rate, a reduction in the overall fiscal deficit, a more selective investment program, and enhanced incentives for agricultural workers. A World Bank mission, in which the Fund staff would participate, was scheduled to visit São Tomé and Principe in November 1986 to discuss the details of those policy changes. The authorities were considering whether to request the use of Fund resources under the structural adjustment facility.

Mr. Mawakani made the following statement:

Despite a pickup in economic activity in 1985 owing to an increase in production in the agricultural and manufacturing sectors, the economy of São Tomé and Principe continues to face serious difficulties. As stated in the staff report, these difficulties are largely a reflection of the prolonged decline in cocoa output, the principal export crop. The production of this commodity, as well as of other cash crops such as copra, has been impeded by various unfavorable influences, including low world market prices--particularly for cocoa--lack of technical and managerial expertise, inadequate worker incentives, the aging of tree crops, and adverse weather conditions. In the fishing sector, the expansion in total fish output, especially in 1983 and 1984, slowed down in 1985 because the two trawlers have become inoperational. Regarding activities in the manufacturing sector, since 1983 performance has continued to be mixed, as the brewery and the ceramics factories are operating below capacity owing to the shortage of imported raw materials and spare parts and the irregular supply of electricity.

To reverse the virtual stagnation of production in the dominant agricultural sector, the Government of São Tomé and Principe has initiated steps that should, in the medium and long term, lead to an improvement in overall domestic output. These steps are being taken in the context of a development plan covering the period 1986 through 1990. Major features of this plan were presented in an official document to donors at a round table conference sponsored by the United Nations Development Programme in December 1985. Like the previous plan, the new one gives paramount importance to measures aimed at increasing and diversifying agricultural production. Particular emphasis has thus been placed on the rehabilitation of the cocoa sector and on the expansion of the production of other export crops such as copra and palm kernels, as well as food crops. As reported by the staff, the cocoa sector rehabilitation program is being undertaken with the assistance of the World Bank. On the basis of the results of the two agricultural enterprises selected for the first stage of the reform program, similar rehabilitation schemes would be extended to cover others. The plan also stresses a more active exploitation of the fish resources of the country, and, in this connection, the artisanal fishing fleet is being expanded under two foreign-financed projects. As part of the rehabilitation efforts in the agricultural sector, and in order to arrest the decline in the agricultural labor force, the authorities are considering the introduction of measures that could enhance the ability of the agricultural enterprises to provide adequate incentives to both managers and workers. To this end, they announced an increase in the cocoa producer price at the beginning of 1986. Expansion of the country's manufacturing capacity as well as upgrading the transportation and communication infrastructure are areas that have also been accorded priority under the plan. The authorities envisage that the completion of projects in these spheres would greatly contribute to minimizing the relative isolation of the island and enhance its touristic attractions.

Fiscal developments in São Tomé and Principe should be viewed against the background of a small economy that lacks a comparatively well-trained corps of administrators and managers. This deficiency has adversely affected the ability of the authorities of São Tomé and Principe to formulate and implement appropriate policies. Available information indicates that during the past few years (1982-85) the overall fiscal deficit has been large because the revenue base has deteriorated while expenditure levels have been high. Owing to the weakness of overall economic activity, tax revenue has not been buoyant. Nontax revenue, on the other hand, has shown an encouraging expansion because of the Government's decision to increase the retail price of petroleum products in line with international prices. The authorities are aware of the need to match government outlays with receipts. To this end, the 1986 budget aimed at a sharp increase in revenue, particularly from the nonagricultural public enterprises and from sales and excise taxes. Together with measures to reduce current expenditure, especially through cutbacks in outlays on official consumption of petroleum products and further reductions in transfers to public enterprises, the authorities envisage that the fiscal deficit in 1986 would be substantially reduced.

In view of the importance of the public sector in the economy of São Tomé and Principe, monetary and credit developments have mainly reflected the financing needs of this sector and, in particular, those of the Government. The authorities are aware of the adverse consequences that continued recourse to domestic bank financing of the budget entails. It is their expectation that this recourse will decline as more revenue flows from the effects of the cocoa rehabilitation program, because the scope for increasing tax revenue through discretionary tax measures is limited.

Developments in the external sector during the past few years closely followed the gradual decline in cocoa production and exports and the high level of imports. These developments led to substantial trade deficits during 1982-85. Reflecting the high cost of freight and insurance and increased amortization payments, the external current account deficit has worsened over the past few years. The overall balance of payments deficit has thus continued to come under pressure. The authorities are aware of the implications of these adverse developments in the external sector, particularly the mounting external debt service burden projected for 1986. They are also aware of the unfavorable medium-term outlook, and they are determined to continue with their rehabilitation efforts in the cocoa sector with the help of the World Bank and friendly countries. In addition, they are examining other policy measures in the context of a medium-term adjustment program that could attract international financial support for alleviating the economic and financial difficulties that have faced the country in the past few years. It is their expectation that donors and the international financial community will provide such support.

Mr. Almeida said that the authorities of São Tomé and Principe should be commended for their efforts in changing the trade and payments system to include more flexible regulations affecting foreign exchange operations and for the adoption of increases in the domestic prices of imported petroleum products. The country's economic problems were basically structural and should be addressed in the context of a medium-term development program to increase and to diversify agricultural areas and production. Emphasis should be placed on the rehabilitation of the cocoa sector, as it was the only area that could induce an increase in exports in the short term. He therefore welcomed the authorities' recent announcement of a significant increase in the cocoa producer price.

The staff had produced a meaningful paper despite the country's incipient economic and financial data base, Mr. Almeida commented. However, it remained unclear how the staff could advocate exchange rate adjustment in the absence of a reliable consumer price index and information about production costs in the context of stable export and import flows. Clearly, the highest priority should be given to technical assistance from the Fund and elsewhere to produce the economic and financial data that could allow both the authorities and the staff to reach firm conclusions about the economic situation and the policies to be adopted.

One of the few areas where statistical data were available was fiscal accounts, Mr. Almeida noted. The country faced a fiscal imbalance that should be addressed at once, as the flow of external financing was declining rapidly. There was little scope for raising additional revenue, and the authorities' only recourse was to reduce expenditures, particularly a reduction in the civil service. As an added benefit, that action would provide qualified labor to the private sector at a time when the authorities were in the initial stages of a privatization program.

Mrs. Walker made the following statement:

The economic and financial situation in São Tomé and Principe is very difficult, evidenced most notably by a projected financing gap of SDR 28 million--including outstanding stock of external arrears at the end of 1985--an amount equivalent to 350 percent of merchandise export earnings for 1986. Strong adjustment measures are seriously needed, along with concessional assistance from foreign donors, to meet the most pressing needs of the country. It is clear that the authorities of São Tomé and Principe recognize the difficult prospects facing the economy and that they intend to address the problems, as evidenced by the staff representative's statement.

Since cocoa accounts for about one fourth of GDP and almost 90 percent of total export earnings, developments in this sector have the most impact on the overall economy. It is interesting to note that since the Government nationalized the private plantations and consolidated them into 15 public agricultural enterprises, output of cocoa has continued to fall. In order to rehabilitate the cocoa sector, the Government is currently preparing several projects to improve productivity, including involvement of the World Bank and private foreign management companies with expertise in the growing of cocoa. I would be interested in how these ongoing projects will fit into the new World Bank loan.

As the staff stated, it appears that the success of the rehabilitation effort will need to include enhancement of incentives for managers and workers. However, the scheme to deposit the cash equivalent of food aid into a special account with the National Bank does not appear to be working. The idea of a two-part salary system based partly on increases in productivity could be helpful, but it has not been implemented yet. Furthermore, the most important incentive would be adequate pricing policies for cocoa. Other agricultural production needs to be increased as well, and in this regard the granting of access by all workers to private plots may help establish new privately operated farms. We would encourage the authorities to continue to decentralize the agricultural system and increase private sector involvement.

The fall in cocoa production and exports has contributed to large operating deficits of the agricultural enterprises, limiting their ability to undertake essential investment and maintenance and resulting in late wage payments and arrears. This has direct repercussions on the Government's fiscal position, which has worsened steadily, evidenced by an accumulation of arrears on external debt service. Clearly, attention needs to be given to improving the Government's fiscal position. In this regard, we agree with the staff that fiscal adjustment should concentrate on a reduction in the investment program by giving priority to investment in highly productive projects, reducing transfers to public sector enterprises, and cutting the size of the civil service. We are glad that the authorities plan to seek advice from the World Bank regarding the investment program.

The weak performance of exports and the continued high level of imports have resulted in a large trade deficit--46 percent of GDP in 1985. Medium-term prospects for the balance of payments call for immediate action by the authorities to design an adjustment program that can address the structural problems in the economy and restore balance of payments viability. The authorities have taken a number of measures that should contribute to some improvement in the external sector, including adoption of a new investment code and modifications in the exchange and trade system. These measures were designed to allow an increased role for the private sector in the economy, which the staff believes should result in more rational decision making and help attract foreign exchange from workers abroad.

However, the staff stated that adjustment in the exchange rate is needed as well to reduce the reliance on imports that has inhibited the development of domestic substitutes, to increase resources to the export sector, and to help promote more rational investment decisions. The expansion of the parallel market at considerably depreciated levels from the official rate and the substantial appreciation of the dobra vis-à-vis its major trading partners during the past several years also signal the need for adjustment. The adoption of a more flexible exchange rate policy against a basket that more closely reflects the country's trading partners is advisable. In this regard, we welcome the authorities' stated intention to consider an exchange rate adjustment. It is clear that São Tomé and Principe can benefit from a comprehensive adjustment program, and we welcome the announcement that efforts will be under way to develop a program with the World Bank.

The staff representative from the African Department agreed with speakers' comments that the statistical base in São Tomé and Principe was weak. Without a consumer price index or other price indices, it was difficult to measure the extent of any overvaluation of the exchange rate. Nevertheless, there was a wide consensus that the dobra was overvalued and that an exchange rate adjustment was required. The authorities had agreed and asked the staff to look into the matter to the extent possible and to provide detailed recommendations, which the staff was currently undertaking.

The very large and seemingly intractable external imbalance, the negative real growth of the economy, and other indicators suggested that an exchange rate adjustment would facilitate an overall adjustment effort, the staff representative continued. The overvaluation of the currency had resulted from the constant peg to the SDR; therefore, the authorities were considering how to rectify that policy with perhaps the adoption of a basket that would more accurately represent the country's trading patterns. The staff would be discussing the matter further with the authorities.

For historical reasons, São Tomé and Principe had been extremely dependent on imports, even for basic footstuffs, and no indigenous group of farmers had developed over the years, the staff representative from the African Department pointed out. The situation was essentially one of plantations or agricultural enterprises where workers received a monthly wage, whether they were involved in farming or in administrative operations. Granting access to plots of land had increased local food production somewhat and had reduced the amount of fresh vegetables and tubers that had had to be imported. Another positive factor was that the workers were thereby allowed to supplement their wages, which had not been increased for a number of years.

The staff representative from the World Bank stated that the cocoa rehabilitation project, which was essentially a rehabilitation operation focused on two of the largest estates, was ready and would be presented for consideration by Bank Executive Directors once the Government had implemented urgent policy changes. In addition, studies were planned to address the future diversification of crops.

Mr. Mawakani made the following concluding remarks:

> My authorities are grateful to the staff for preparing the documents, especially the background paper on recent economic developments, given the shortage of trained personnel in São Tomé and Principe.
>
> There is no doubt that as a small tropical island economy, São Tomé and Principe faces problems peculiar to its relative isolation. Moreover, its economic system is centralized and hence the public sector plays an important role in economic activity, which is dominated by state-owned enterprises engaged in the production of the country's most important export crop, cocoa. The authorities are fully aware of the economic and financial problems that have arisen because of the long-term decline of the cocoa sector.
>
> The reform of this sector is being given priority attention, with the assistance of the World Bank. In addition, the authorities in São Tomé and Principe have taken note of the various policy recommendations, including a new exchange rate regime, that have been discussed with both the Fund and World Bank staffs. They look forward to further discussions with the staff on some of these policy recommendations in order to strengthen their medium- and long-term development strategy. In this context, they have indicated their interest in the possible use of Fund resources, in particular under the structural adjustment facility.

The Acting Chairman made the following summing up:

Executive Directors generally supported the views expressed in the appraisal in the staff report for the 1986 Article IV consultation with São Tomé and Principe. They welcomed the Government's plans to rehabilitate the cocoa sector as well as recent measures to liberalize the exchange and trade system--particularly the greater role for the private sector in external and domestic trade--and to provide additional incentives to farm workers. However, in view of the large fiscal and external imbalances and the difficult medium-term prospects facing the country, the authorities were urged to adopt a stronger, more comprehensive adjustment effort to restore viability to the balance of payments and to attract concessional assistance. Directors noted the importance of a progressive reduction of the fiscal deficit through revenue-raising measures and decreases in government expenditure, including cuts in the civil service and greater selectivity of investment projects.

Directors commended the authorities' intention to undertake important policy changes in many of these areas, including exchange rate action, within the framework of a proposed cocoa rehabilitation project to be financed in part by the World Bank.

Directors commented on the weak statistical base in São Tomé and Principe and emphasized the need for continued action in this area. A substantial improvement in the availability of reliable economic and financial data would be an indispensable ingredient in designing and monitoring a successful medium-term adjustment effort.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to São Tomé and Principe's exchange measures subject to Article VIII, Section 2(a), and in concluding the 1986 Article XIV consultation with São Tomé and Principe, in the light of the 1986 Article IV consultation with São Tomé and Principe conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The restrictive exchange measures of São Tomé and Principe described in SM/86/222 are maintained in accordance with Article XIV, Section 2, with the exception of the restrictive features of a bilateral payments arrangement maintained with a Fund member, and certain external payments arrears, which are subject to approval under Article VIII, Section 2(a). The Fund urges São Tomé and Principe to eliminate these restrictions as soon as possible.

Decision No. 8419-(86/168), adopted
October 10, 1986

3. ALGERIA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Algeria (SM/86/211, 8/21/86). They also had before them a background paper on recent economic developments in Algeria (SM/86/245, 9/24/86; and Cor. 1, 10/8/86).

Mr. M. Benachenhou, Executive Director, World Bank, was also present.

The staff representative from the African Department said that recent information indicated that Algeria had experienced a sharp fall of $843 million in its gross international reserves during the first nine months of 1986 as a result of the decline in hydrocarbon prices. At end-September 1986, Algeria's non-gold reserves had stood at nearly $1.7 billion, compared with $2.5 billion at the end of 1985; the staff had projected the contraction of Algeria's international reserves for 1986 as a whole to about $1.3 billion.

The Algerian authorities had recently informed the staff that the new banking law referred to in the staff report had become effective on October 1, 1986, the staff representative stated. At the same time, interest rates of 3-5 percent had been raised to 7-8 percent. As noted in the staff report, that new legal framework for the banks was being implemented in order to enhance their role in financing the country's economic activities.

Mr. Salehkhou made the following statement:

> The Algerian economy achieved considerable progress over the last decade. Although it continued to depend heavily on hydrocarbon production and exports, this centrally planned economy has achieved high real economic growth, a strong production base, industrial diversification, and significant social progress, largely as the result of the authorities' development policies and the maintenance of a high ratio of investment to GDP.

In the last few years, Algeria has introduced within its centrally planned system an important measure of structural reforms aimed in particular at accelerating economic diversification, reviving agricultural production, restructuring public enterprises, promoting private investment and savings, and achieving a uniform national salary structure.

While parallel to the sharp decline of international energy prices the short- and medium-term prospects of the economy have significantly deteriorated in 1986, the progress achieved in recent years, the accumulation of foreign exchange reserves, the substantial reduction of external debt in terms of GDP, as well as the prompt response of the authorities have limited the impact of such deterioration on Algeria's overall economic performance. Should the oil situation weaken further, however, the authorities would consider additional adjustment measures both to contain the negative impact on performance and to preserve the main thrust of Algeria's economic and financial policies.

Economic developments in 1985

In spite of a higher increase in consumer prices, the 1985 economic and financial performance was to a large extent satisfactory with relatively strong real GDP growth, continued progress in reducing the overall budgetary deficit, and further deceleration in the growth of broad money. Particular progress was achieved with respect to the nonhydrocarbon sector and the external accounts.

Benefiting from favorable weather conditions as well as from the authorities' agricultural policies aimed at expanded acreage and remunerative producer prices, cereal output doubled in 1985, contributing significantly to the higher growth of the nonhydrocarbon sector. In 1985 Algeria also achieved a large increase in the external current account surplus, which permitted the strengthening of gross official reserves from the equivalent of 2 months of imports to 3.5 months while the ratio of external debt to GDP continued to decline, reaching 19.2 percent compared with 35.1 percent in 1981 and 25.4 percent in 1983.

Performance in the fiscal area was also encouraging. The overall budgetary deficit was brought down to 8.1 percent of GDP, compared with 14.5 percent in 1983, reflecting the increase in central government revenue, better financial performance by the public enterprises, and improved tax administration. Furthermore, the deficit continued to be financed from domestic resources, and, for the third consecutive year, nonhydrocarbon receipts exceeded energy-related revenues.

The year 1985 was also marked, however, by lower performance in a number of areas. In addition to the higher rate of inflation, which might partly reflect large salary adjustments under the new national salary structure, broad money continued to grow at a higher rate than nominal GDP, both domestic savings and gross capital formation declined slightly, and a considerable scaling down of the investment target under the current Five-Year Plan (1985-89) was made necessary by the deteriorating external environment. Moreover, in spite of the strengthening of central government finances, the overall fiscal deficit remained relatively high. Finally, the heavy dependence of the external performance on hydrocarbon exports remained very heavy as other exports' share stayed below 2 percent of total exports.

Prospects for 1986

Algeria's terms of trade are projected to fall by 43.2 percent in 1986 in a sharp acceleration of a deteriorating trend that started in 1982. The implications of the drastic decline in international energy prices for the balance of payments, central government finances, growth, employment, as well as structural economic reforms are far reaching. While the measure of adjustment achieved in the last three years and the authorities' cautious debt management should enable Algeria to contain somewhat the negative impact of recent developments, account should also be taken in this regard of the strong measures already enacted, particularly in the areas of public finances and balance of payments.

The authorities have revised downward the government budget and the original import program for 1986 to take into account the decline in hydrocarbon revenues and total export earnings which is expected to reach 36 percent in both cases. Fiscal adjustment included the adoption of additional revenue measures, elimination of the transfer of 20 percent of personal income taxes to local governments, and substantial cutbacks in current and capital outlays. These measures should permit a further reduction in the overall public sector deficit in terms of GDP.

On the external sector, the adopted measures should slash imports by about 20 percent in 1986 and contain the traditionally large deficit on the services account, inter alia, through reduced allocations for foreign travel and reduced outlays on other invisibles. While the external current account should still shift into a deficit and lead to a significant drawdown of reserves, the measures implemented should enable Algeria to preserve the priority of economic growth while containing inflation at about its 1985 level.

Economic and financial policies

As indicated in the staff report, the instability of the oil market and recognition of the eventual depletion of hydrocarbon resources prompted strong adjustment efforts in Algeria long before the recent sharp decline in oil prices. Developments in 1986, however, have clearly indicated the need for the strengthening of such efforts in order to ensure an adequate level of growth and employment, maintain sustainable financial and external positions, and preserve the country's traditionally prudent external debt policy.

In this respect, policies for the diversification of the productive base of exports away from the hydrocarbon sector are considered by the authorities to be particularly crucial. They recognize that progress in this area has so far been rather limited, notwithstanding the increasing share of agriculture and nonhydrocarbon industry in total output. Efforts in this regard include not only the prominence of agricultural development in the current Five-Year Plan but also the adoption of policies aimed at increasing private investment in certain sectors, encouraging import substitution, as well as emphasizing manpower training. Concern with respect to Algeria's low rates of return on investment is being addressed in the current Plan through efforts to promote productive investments, industrial decentralization, fiscal incentives, flexible pricing policies, and foreign exchange allocation.

Regarding public finances, in spite of the considerable shortfall in oil revenues, the authorities continue to aim at an overall improvement through the containment of short-term imbalances and reinforcement of supply-side structural reforms, including incentives for the promotion of housing and export-oriented policies, the streamlining of public enterprises, and the growth of nonhydrocarbon receipts. Employment and wages policy should also contribute to such efforts. As the introduction of the new uniform salary scale is completed, no salary adjustment is planned for 1987, while concerted efforts will aim at reducing the level of public employment. It should be noted in this context that the national salary scale aimed, on the one hand, at eliminating minimum wage differentials in the various sectors of the economy and, on the other hand, at introducing a system of specific bonuses in order to improve productivity and ensure labor mobility.

On monetary policy, the authorities share the concern with respect to the excessive growth of liquidity and the level of central bank financing of the budget. In this regard, a number of measures have been taken in 1986 to achieve a slowdown in credit expansion to public enterprises and to the Central Government. They are also seeking a lower growth of credit to the rest of the economy and are intensifying efforts to mobilize private sector savings. The authorities, however, have difficulty with the staff position on interest rates. They consider that, in the context of Algeria, instruments other than interest rates would be more efficient in mobilizing savings, especially when these instruments are linked to the specific needs of savers. Acquisition of housing is only one example of such needs. Moreover, in an economy such as Algeria's the issue of efficient allocation of resources is not necessarily relevant to the level of interest rates.

Finally, on external policies, while the unfavorable developments of 1986 have necessitated a tightening of foreign exchange allocations and a significant curtailment of imports, the authorities agree that over the medium term the diversification of exports is crucial to their adjustment efforts. Fiscal and financial incentives for the expansion of nontraditional exports should play a major role in this regard. There are, however, a number of constraints facing the diversification of Algeria's exports, including the restrictive trade practices of the industrial countries, the quality of products, and the inadequacy of marketing techniques. Contrary to the staff's view, the authorities believe that addressing these constraints would be more beneficial to the diversification of exports than an active exchange rate policy. While they keep an open mind on this issue, they wish to note that, on the one hand, their method of exchange rate determination has permitted the stabilization of the dinar vis-à-vis the currencies of their trading partners and, on the other, the exchange rate plays only a limited role in the allocation of resources through Algeria's centrally planned economy.

Mr. Alhaimus made the following statement:

The performance of the Algerian economy in 1985 continued to show impressive results in major areas despite the increasingly difficult environment. A fairly high rate of growth of output was maintained, coupled with modest inflation; government finances improved further; and the external current account registered a sizable surplus after remaining in approximate equilibrium since the beginning of the decade. Much of the achievements of the recent period were due to the prudent management of hydrocarbon export proceeds and the pragmatic policy course pursued by the authorities within the framework of a planned economy.

These policy efforts will certainly make it less difficult for Algeria to withstand the impact of the sharp fall in international oil prices that has already affected economic performance in 1986 and clouded the prospects for the years ahead. In this respect, the Algerian authorities have observed, as reported by the staff, that in view of the forward-looking policies that have been pursued, the policy responses in 1986 designed to address the sharp drop in oil prices did not represent a basic shift in policies. Nevertheless, the drastic fall in export revenues and the possibility of further deterioration will, as the authorities fully realize, have to keep policies under active review to meet evolving circumstances. I therefore welcome the focus of the consultation discussions on Algeria's strategy for fostering sustained financial and economic balance compatible with the orderly exploitation of its resources. Many aspects of these policies merit careful attention.

The strategies for the productive sectors will initially continue to emphasize production to meet domestic demand for both agricultural and industrial products. The authorities should indeed find satisfaction with this policy, which contributed to high output growth--reaching 6 percent in 1985--and led to a decline in the import/GDP ratio. Continued gains should be expected in agricultural production in response not only to good weather but also to agricultural policies, including the strengthening of producer price incentives. Industrial production should also improve following the restructuring efforts and the high priority allotted to industry in import authorizations for raw materials and spare parts. However, in light of the more difficult external position, some added attention is needed on the potential contribution of nonhydrocarbon exports, which still account for only a slight share of total exports. The authorities referred to items for which production surpluses were about to emerge and pointed out that steps were being taken to raise their quality to international standards. Any efforts in this direction should be encouraged.

The problem of unemployment is an area where policy responses can usefully be considered. At 16 percent, the rate of unemployment does indeed seem high, although staff comment regarding the authorities' view that a large number of the unemployed may not be actively seeking employment would be welcome. At any rate, the problem can assume a magnitude that may invite policy action as the rate of growth of output decelerates in the immediate future; the real GDP growth rate is expected to be halved in the current year. Although economic plans had not directly targeted employment creation, the authorities will apparently follow the employment situation closely and, if necessary, will give greater weight to employment creation in the choice of investment projects.

The rise in the average wage level by 8 percent in 1985 might have raised some questions in light of the need to further contain the fiscal deficit and to keep inflation at a modest rate. The major factor behind this rise in wage levels was the new nationwide salary scale. This law, however, should also be seen in terms of its positive long-term effects in rationalizing wage structures and providing the authorities with an effective tool for managing the wage bill. Furthermore, one should also bear in mind that average wages, adjusted for the increases in consumer prices, in fact declined by 10 percent over the five years ended in 1985.

Further success was achieved in 1985 in reducing the budgetary deficit in relation to GDP, as it went down from 14.5 percent in 1983 to 8.1 percent in 1985. The original budget for 1985 was revised, and a further reduction to 7.8 percent is now expected despite the large reduction in revenues that is projected to amount, in the case of hydrocarbons, to a 36 percent cut from their 1985 level. The authorities' approach will appropriately seek to contain the short-term budgetary imbalance while enhancing supply-oriented structural measures; notably, further measures will be taken if the situation warrants in light of export prices. Of particular significance is that the authorities are undertaking a review of employment and subsidy policies. The authorities already affirmed that no general increases in wages and salaries are planned in 1987 and that efforts will be made to reduce public employment. Considerable progress was made in addressing subsidies--which amounted to about 2 percent of GDP in 1985--through the general government policy to ensure realistic pricing throughout the industrial and agricultural sectors.

On monetary and credit policies, the staff rightly pointed out the high rate of domestic expansion in past years. The measures taken by the authorities with regard to public enterprises and in the central government budget, however, are expected to slow the rate of credit expansion. Institutional measures have also been taken to bolster savings, which might obviate some of the need for a rise in domestic interest rates. Nevertheless, the authorities have shown flexibility in this regard as evidenced by the recent rise in interest rates just reported by the staff.

The policy response of the authorities to the large external shock has concentrated, inevitably, on a drastic cut in imports in 1986 and on allowing foreign exchange reserves to fall. This stance is consistent with the authorities' objective, still upheld despite the difficulties, to ensure a further decline in foreign debt as a percentage of GDP. Other means of addressing the external imbalance include efforts to increase foreign exchange earnings from nonhydrocarbon exports. One difficulty indicated by the authorities is the protectionism of industrial trading partners, which might render it inevitable for Algeria to resort to countertrade. These barriers will, of course, seriously limit any possible improvement in competitiveness that might be gained through an exchange rate adjustment. Such an adjustment, as the authorities again emphasize, will not be an important instrument in guiding resource mobilization and allocation in the context of the Algerian economy, and nonhydrocarbon exports suffer from various practical problems that the exchange rate cannot address.

Looking ahead, the authorities are aware that 1987 could possibly be a very difficult year. However, the measures that have been taken so far and the readiness to take further measures on a wide scale are a reassuring factor in assessing the capacity of the Algerian economy to cope with the present extreme constraints and safeguard the authorities' objective of maintaining national economic independence.

Mr. Templeman made the following statement:

We continue to have mixed feelings about developments in the Algerian economy. On the one hand, macroeconomic performance continues to be quite favorable in a number of areas. On the other, we continue to have doubts that Algeria's tightly planned and increasingly closed economy will be able to grow and diversify under such a strategy. The sharp drop in energy prices earlier this year underlines the vulnerability of the economy and heightens our concerns.

I would acknowledge that actual performance has been commendable in several areas, and the prompt response of the authorities to the energy price drop has been admirable. Generally good performance can be seen with regard to real growth, employment generation, savings and investment rates, inflation, the balance of payments, and diversification of the hydrocarbons sector and of the manufacturing sector for the domestic market.

Future economic prospects, however, are not so clearly favorable. In fact, in our view, there is an inherent inconsistency between the need for growth and diversification of the Algerian economy and the economic strategy now being followed, which is based on very tight controls over the domestic economy and its increasing isolation from the world economy. For sustainable growth to take place, the factors of production need to be allocated efficiently throughout the economy. In a more open and market-oriented economy, relative price signals and the exposure to competition at home and abroad would play an important role in this process. Yet, in Algeria, relative price movements do not respond automatically to changed economic circumstances, as the prices of goods, labor, capital, and foreign exchange are all subject to substantial direct controls. The growing insulation of the domestic economy from foreign competition also reduces the extent to which domestic investment is tested for efficiency. The increase in restrictions on trade and payments, growing import substitution, the view of nonhydrocarbon exports as a residual when domestic demand does not absorb full capacity, the repayment of foreign debt regardless of external financial developments, job training partly motivated by a desire to reduce dependence on expatriate labor, and a steadily appreciated exchange rate all contribute to a reduction in the Algerian economy's ties with the rest of the world economy.

In the absence of market-determined relative price movements and of exposure to foreign competition, a very heavy burden of responsibility falls on government decision makers, who must have very deep and broad knowledge about how the economy functions and remarkable foresight if economic management is to be successful. In fact, the authorities have adopted a few pragmatic, flexible, and decentralized policies. Examples are the greater flexibility of producer pricing in agriculture, productivity-linked wage bonuses, reorganization and decentralization of public enterprises, banking reform, and the acceptance of a complementary role for the private sector in the development process. An expanded role for the private sector could prove to be very important in shifting savings and investment patterns, both by contributing to maintenance of a high overall savings rate and by facilitating the growth and diversification of investment in industry and nongovernment services. A more flexible interest rate policy would surely be helpful in this regard.

The rapid growth of the labor force suggests the need for wage moderation and job creation. In fact, real wages have declined by about 10 percent over the past five years, with some further fall evidently expected this year and next. This must be contributing to the growth of employment, although an unemployment rate of about 16 percent remains very high. We continue to be rather puzzled by the uniform salary scale that was introduced in 1985-86, in particular, about its effects on labor mobility. The addition to base pay of productivity and other bonuses may preserve a degree of wage differentiation and help to facilitate the movement of labor from one geographic area to another and from one economic sector to another, but we would be interested in comments by the staff or Mr. Salehkhou on how necessary mobility is to be achieved.

Steady progress has been made since 1983 in reducing the treasury deficit. However, the recorded deficit figures in this year's report are much higher than in last year's. Evidently the difference is due to the reclassification of some lending to the Central Government, especially by the public enterprises and local governments, so that such lending is now considered to be a source of deficit financing in the accounts, rather than fiscal revenue. Such an adjustment seems appropriate in terms of transparency and of conformity with standard Fund presentational practices. Of course, the Government has an important intermediation role in Algeria, but this is not unique and could be discussed in the staff report. In any case, the determination of the authorities to continue to reduce the fiscal deficit, despite the sharp decline in energy-based revenues, is commendable, although the size of the Treasury's borrowing requirement remains high in terms of the need to shift savings and investment patterns.

In that connection, the banking reform may be helpful in making the financial system function more efficiently, although we would have more confidence if financial flows were in some way more market related. We also share the staff's view that real positive interest rates could be a helpful means of mobilizing personal savings and of allocating investment more efficiently. Thus, we welcome the staff's statement that some upward adjustment in interest rates has recently been introduced.

On the external accounts, it is disappointing to see that nonhydrocarbon exports have remained essentially stagnant, even in nominal terms, in recent years and that they are not projected to rise perceptibly this year or next. Even with the sharp drop in energy exports projected for this year and next, nonhydrocarbon exports would account for only about 2 1/2 percent of total exports. Such heavy dependence on energy exports leaves the Algerian economy very vulnerable, even if the authorities continue to compress imports. The dramatic drop in Algeria's terms of trade this year by 43 percent followed by anticipated cuts of 30 percent in import authorizations and of 20 percent in import payments testify to the advisability of expanding the country's export base if it is to be able to maintain a degree of balance of payments stability and still be able to draw upon foreign sources of goods, services, and capital to help in the development process.

It is hard to believe that the appreciation of the dinar by 26 percent to 45 percent between 1981 and 1985, depending on which real effective exchange rate index is used, is consistent with the aims of export diversification and of better resource allocation in general. However, it is encouraging to hear that the authorities will be pragmatic in their exchange rate policy approach in the future.

A forecast of Algeria's balance of payments over the medium term would have been helpful in assessing the economic outlook. Admittedly, some sensitivity measures are included in the staff report, and the uncertainty regarding energy prices makes medium-term forecasting difficult. However, such forecasts were also missing from the staff report last year, when energy prices had not shown extreme volatility. While commodity price movements are generally difficult to project, medium-term projections are very helpful to the Board and have become a standard feature of nearly all recent Article IV consultation papers. We see no reason why Algeria should be an exception.

In conclusion, while recent economic performance in Algeria has been rather satisfactory, the outlook is even less clear than it was before the sharp drop in world energy prices earlier this year. It remains our view that, as an economy moves from considerable dependency on the construction of basic infrastructure and on a monoproduct export base, it becomes increasingly difficult for government authorities to allocate resources directly and to ensure their efficient use. Algeria has taken a few steps toward decentralization of decision making and greater policy flexibility. But we would expect that continued relaxation of tight controls and a pragmatic policy response to economic developments will be required if Algeria is to achieve its long-term economic gains.

Mr. de Forges observed that Algeria's economy had performed well during the past few years, both domestically and externally. The GDP growth rate of about 5 percent a year since 1980 was exceptional by all comparative standards. Remarkably, that performance had concurred with a sharp improvement in the current account, which in 1985 had shown a sizable surplus, along with a noticeable decrease in external indebtedness from 39 percent to 19 percent of GDP during the past five years. However, that appraisal must be placed in the perspective of recent developments in energy prices. As the staff had noted, a change in petroleum prices of $1 per barrel could produce shifts of 1 percent of GDP in the balance of payments and of 8 percent of budget revenue. Past improvements in the Algerian economy were thus threatened in 1986. As a consequence of low petroleum prices, the current account could shift to a negative level of at least SDR 1.2 billion as forecast by the staff for 1986. The authorities stated that they were prepared to impose additional revenue and expenditure measures as required to restrain the budgetary imbalances.

The Algerian authorities were to be commended for their prompt reaction, especially as they recognized that 1987 could be a very difficult year, Mr. de Forges continued. Their commitment to safeguard their objectives and to cope with unforeseen developments was welcome. The authorities should pursue two important objectives. First, the resilience of government finances to instability in the petroleum sector should be enhanced; recent improvements in tax administration were commendable and should be pursued vigorously. Second, the diversification of exports was necessary since the policy of reducing authorizations for imported products was necessarily limited if growth prospects were to be maintained. The need for such policies was emphasized by recent developments; however, in a medium-term perspective, the measures implemented in 1986 by the Algerian authorities did not represent a basic shift in policies.

In the productive sector, the objective of bolstering production to meet domestic demand retained its importance particularly in the agricultural sector, Mr. de Forges noted. That objective would be attained by allocating investments favorable to those sectors that could provide the most employment with a view to easing the constraints imposed by a growing labor force. That process would be aided by the comprehensive restructuring of the public enterprise sector that was well under way. That process would also be helped by the reorganization of various mechanisms in the economy, especially by the realistic pricing policy already begun, by cautious management linking wage changes to improvements in productivity, by a softening of foreign exchange regulations, and by an interest rate policy aimed at bolstering financial savings and facilitating adequate resource allocation.

The Algerian authorities had not hesitated to react quickly and to take appropriate measures in the face of unexpected developments, Mr. de Forges stated. Recent changes had lessened the past year's emphasis on the five-year plan, whose objectives nevertheless retained high priority. He commended the authorities for pursuing them under more difficult circumstances, notably the revival of the agricultural sector, the increase in the role of the private productive sector, and the reform of the public sector. By keeping their economic policy within the framework of a medium-term plan, the Algerian authorities had demonstrated their sense of responsibility for the future, as well as proved their ability to react promptly in difficult situations.

Mr. Goos observed that Algeria's economy had performed remarkably well since the beginning of the 1980s. While attributable largely to the favorable external environment, that success also owed a great deal to economic management, which in a centrally planned system had been conducted with a notable degree of flexibility and pragmatism. The authorities deserved commendation for their policy stance and its economic achievements. However, the recent decline in the hydrocarbon sector had brought to light fundamental weaknesses in the economy--notably the continued heavy concentration of exports in oil and gas and apparent poor productivity of domestic investment--that greatly complicated the current adjustment task. Those weaknesses seemed to be directly related to the past failure to pay sufficient attention to export diversification into nontraditional production lines, as well as to rigidities in the central planning process, in particular, its inward-looking posture that had hampered more efficient allocation of resources.

With that legacy of past policy shortcomings, the authorities had apparently, at least in the short run, little choice but to respond to the external deterioration by curtailing domestic demand to the detriment of growth and employment. The policy options available in the years ahead would also remain severely limited in the absence of fundamental policy changes.

While welcoming the recent steps aimed at bolstering productivity, as well as the continued efforts to improve the performance of public enterprises and to strengthen the nontraditional sector, he shared the staff's concern that those endeavors might be insufficient to ensure continued domestic growth and a viable external position, Mr. Goos continued. That concern was underlined by the recent information on the strong decline in foreign exchange reserves. While overall performance of the economy would greatly benefit from greater reliance on private initiative and market forces, to the extent that that avenue was restricted in the context of Algeria's economic and social system there seemed to be a need to rationalize the central planning process. Such rationalization would have to assign more emphasis to the efficiency of resource allocation, including priority allocation of scarce resources to those activities where the country enjoyed a comparative advantage.

The ability to do so, however, was hampered by the pervasiveness of administered price controls and, in particular, the maintenance of an unrealistic exchange rate that obscured those comparative advantages, Mr. Goos commented. Early action on the exchange rate was therefore of paramount importance for achieving the ambitious growth and employment objectives. In that regard, the authorities had emphasized restraint in foreign borrowing. While such restraint as a general policy guide was welcome, it should not be stressed to the extent that it would impair the country's growth potential by curtailing necessary imports for productive investment.

The new nationwide salary scheme gave cause for uneasiness, as did the planned introduction of a national credit plan, Mr. Goos remarked. While it could be premature to draw firm conclusions on the eventual implications of those innovations, he was concerned that they could introduce new rigidities into the economic system. He therefore hoped that the wage system would allow for sufficient wage differentiation in accordance with regional differences in factor endowment and productivity.

Similarly, Mr. Goos added, the task of mobilizing and allocating savings would probably be better served by more active interest rate policies and, in particular, interest rates that were sufficiently positive in real terms. In that respect, he welcomed the fact that interest rates had been increased recently, but he asked the staff to comment on the extent to which the increase had restored rates to levels that were sufficiently positive in real terms.

He agreed with the staff appraisal and supported the proposed decision, Mr. Goos concluded.

Mr. Massé made the following statement:

> I commend the authorities for the considerable progress that has been achieved in the Algerian economy. In general, I

would like to endorse the staff's analysis and express my support for the arguments and recommendations made in the report. A few particular aspects of the staff report, however, deserve special comment.

First, I am concerned, as is the staff, that the reliance on trade and exchange controls, which has been intensified recently, could contribute to a misallocation of resources and might impair growth prospects. The authorities should be encouraged to review their exchange rate policy with a view to achieving more realistic pricing of foreign exchange. This would not only complement the Algerian authorities' efforts in the area of demand management but it would also support the Algerian authorities' objective of improving performance in the tradable goods sector. I am encouraged that the Algerian authorities have agreed to keep an open mind on this issue.

Second, it appears that, notwithstanding the developments mentioned by the staff at the beginning of the meeting, deposit interest rates continue to be negative in real terms. The consequence of this situation must inevitably be to discourage the accumulation of financial assets. The innovative programs devised by the Algerian authorities for mobilizing financial savings by linking instruments to the specific needs of savers should be underlined and are welcome. However, focusing somewhat more on price incentives, like interest rates, should increase allocative efficiency. Increases in deposit rates to positive levels would also support efforts to slow monetary growth and diminish inflationary pressures.

I welcome the authorities' resolve to undertake the steps that would be necessary to cope with unforeseen developments, especially with regard to export prices of petroleum and natural gas. This is of great importance, especially given the weight of the hydrocarbon sector in Algeria's economic performance. It should be stressed also that, if prices indeed fail to recover, the adjustment measures already introduced may need to be intensified. In that event, I join the staff in urging that the authorities try to minimize the associated adjustment costs by placing greater emphasis on improved resource mobilization and allocation through greater reliance on market-related price mechanisms.

In conclusion, I support the proposed decision.

Mr. Suraisry made the following statement:

In 1985, the Algerian authorities continued to pursue strong adjustment policies. As a result, the fiscal deficit was reduced substantially from its 1983 level and the balance of payments current account moved into surplus. It is encouraging that the reduction in domestic and external imbalances was achieved while maintaining a robust rate of growth. In addition, the authorities have wisely limited their external borrowing.

I was particularly impressed by the fact that the fiscal retrenchment was accompanied by a shift in the pattern of deficit financing away from external sources and toward domestic nonbank sources. This is consistent with the authorities' objective of limiting their recourse to external borrowing; at the same time, it is less inflationary.

Unfortunately, the large deterioration in the terms of trade expected for 1986 has complicated the authorities' adjustment efforts. The sharp fall in Algeria's foreign exchange reserves in the first nine months of 1986 will make the task ahead even more difficult. It is encouraging, however, that the authorities have responded quickly to the deterioration in their external economic prospects.

The authorities have revised their 1986 budget with a view to continuing to build on the substantial improvement in government finances achieved in 1984-85. However, the financing of the deficit envisaged for 1986 relies extensively on central bank credit. As the authorities are aware, this might increase excess liquidity in the economy and aggravate the relatively high level of domestic inflation. To prevent this, a continuation of firm fiscal policy is essential.

In the external sector, the sharp deterioration of external prospects experienced in 1986 unveiled a serious weakness in the structure of the balance of payments, which relies excessively on exports of petroleum and petroleum products. As the authorities recognize, there is a clear need for diversifying exports. I am satisfied with the progress made in the diversification within the hydrocarbon sector. Such diversification was appropriate and has met with a great deal of success. It is important, however, to expand the authorities' export diversification efforts to the nonhydrocarbon sector. I am gratified that the new Five-Year Plan aims at enhancing nonhydrocarbon exports. The success of such a strategy will clearly depend on the adoption of appropriate pricing policies, including a realistic and flexible exchange rate policy. I agree with the authorities, however, that other factors--such as improving the quality of products, ensuring the availability of credit, strengthening marketing techniques, and, above all, securing access to industrial countries' markets--are as important in enhancing nonhydrocarbon export performance.

I welcome the continued emphasis on expanding the role of the private sector and the authorities' good progress since 1982 in strengthening that role. They have liberalized private investment laws, ensured both private sector access to bank credit and fairness in competing for government contracts, and administered import licenses more flexibly. Moreover, the authorities have recently increased producer price incentives, and they have lowered real estate taxes and profit taxes. These measures, together with the improvement of the infrastructure and the easing of administrative controls and procedures, should help enhance the participation of the private sector in economic activity. I encourage the authorities to continue these efforts, in particular because the private sector could prove to be an important source of growth, exports, and employment.

In conclusion, the authorities have made commendable efforts to adapt their policies to adverse external developments. Good progress has been made, and I am impressed by their flexibility and timely response to changing circumstances. I wish the authorities every success in the task ahead, and I support the proposed decision.

Mr. Foot observed that the Algerian authorities had made commendable decisions within the framework of the priorities that they had set out in recent years. However, the outlook for oil prices was uncertain, and he therefore urged the authorities to have both fiscal and monetary adjustment contingency measures ready to be introduced as needed.

He remained unconvinced that the policy of negative real interest rates--compounded in the case of expatriate Algerians by the overvalued exchange rate--was in the country's longer-term interests, Mr. Foot continued. The latest increase in interest rates was welcome and, although not sufficient to ensure positive real rates, it might help to establish more clearly that further increases would be helpful. One clear example of the questionability of the current policy was that, even with a 40 percent premium over the official rate for returning remittances, many expatriates brought goods rather than financial assets when returning home, thus preventing the authorities from acquiring needed foreign exchange. Export revenues were concentrated significantly on hydrocarbons. It was difficult to see how current policies could produce diversification of exports, even within a decade. The exchange rate question must be addressed as the current concentration on hydrocarbons was not sustainable in the long run. Finally, he could support the proposed decision.

Mr. Kyriazidis made the following statement:

I can agree in general with the staff appraisal. The management of the economy during the oil boom years was wise, and overall performance has been very creditable. The authorities have also reacted promptly to the shock of the collapse of oil prices so that the overall impact has been contained within manageable proportions. The balance of payments registered a substantial overall surplus in 1985, and the authorities must also be commended on their success in reducing the budget deficit despite the unfavorable environment.

Although the situation has unavoidably deteriorated in 1986, the prospects of an overall deficit of $1.2 billion can be met without any change in the Government's debt management policy. I wonder, however, whether the substantial decline in foreign exchange reserves that this policy implies may not create liquidity problems in 1987 and therefore whether it might not be advisable for the Algerian authorities to be somewhat more flexible in their otherwise correct external debt policy, and perhaps seek Fund support in this connection.

Under the present adverse external situation, the main structural problems of the economy are more evident. Two characteristics are of particular interest: the lack of any significant progress toward export diversification and a clear tendency of the economy toward isolation from external markets. The relatively weak results obtained in agriculture and export-oriented nonhydrocarbon activities would seem to indicate the major areas in which reorientation of government policy should receive high priority.

Although various reforms were attempted in the agricultural sector and output growth has not been insignificant, performance continues to be weak. The planned increase in agricultural investment is a welcome development, but there clearly is a need for more effective incentives for private producers through appropriate pricing policies and technological improvement.

The authorities should pay particular attention to the dangers arising from excessive import compression; imports as a percentage of GDP are steadily declining from 22 percent in 1982 to about 9 percent forecast for 1987. These figures reflect the perhaps excessive emphasis given by the authorities within their diversification effort on import substitution rather than production for export and their strong reliance on import controls both as a protective measure and as a means of balancing their external accounts.

They have already taken measures that are expected to reduce imports in 1986 by 20 percent and, as the staff estimates, a further reduction of imports of the same magnitude should be envisaged if the authorities' targets are to be met and non-oil prices do not recover.

Such a further contraction of imports might have various adverse consequences on the growth prospects of the economy. The authorities, although not unaware of these dangers, may well be underestimating them. The policy of import substitution that the authorities are pursuing does not always represent the best way to achieve efficient allocation of resources and sustainable growth. I therefore strongly support the staff recommendation on the need for a comprehensive strategy aimed at increasing foreign exchange earnings from nonhydrocarbon products and tourism. I also agree with the staff that such a strategy would have to be more forthcoming on the role of the private sector and the exchange rate.

I do not wish to minimize other constraints on the expansion of exports, which, according to the authorities, need priority attention, but an appropriate exchange rate policy is an essential element of any export drive, quite apart from the beneficial effects it is likely to have on the domestic allocation of scarce resources.

With regard to monetary policy, there are two main concerns. First, the money creation process accelerated sharply since the early 1980s. Although the rate of domestic credit creation declined in 1985--the annual change was 14 percent--the liquidity of the system remains very high, which is an ominous sign given the current re-emergence of inflationary pressures.

Second, real interest rates are negative. This could constitute a problem in the medium to longer run when the current strong connection between savings and real capital accumulation--mostly housing--would become less effective as an incentive to save. Moreover, a more market-oriented determination of the interest rate should guarantee a faster achievement of the equilibrium between supply and demand of funds that seems to be one of the main aims of the financial reform currently supported by the Government.

The Algerian authorities have given ample evidence of their wisdom and foresight. They have also responded with promptitude and courage to the deterioration of the external environment. I wish them every success in their efforts.

Mr. Wijnholds observed that the period 1980-85 had been a good one for the Algerian economy, which had performed well in 1985. The authorities deserved to be commended for that performance and for their ability to modify objectives and plans according to changing circumstances. Particularly impressive had been the reduction of external debt as a percentage of GDP from 39 percent to 19 percent during those five years. The economic situation, however, had clearly deteriorated in 1986.

The authorities' response to the changed economic environment had been mixed, Mr. Wijnholds continued. On the one hand, they had acted to offset the loss of government revenue, with the result that the budget deficit would not rise. They were also rightly using their external reserves as a buffer to draw on, apparently to a considerable extent. On the other hand, domestic credit expansion had not been sufficiently compressed. Also, because insufficient attention had been paid to export diversification, the authorities had no choice but to slash imports substantially, despite the use of reserves, with possible negative future consequences for investment and growth. While exchange rate changes did not play the same role in centrally planned economies as in market-oriented ones, the sharp appreciation of the real exchange rate seemed to pose a problem. He welcomed the authorities' willingness to consider exchange rate adjustments in a pragmatic manner. He also agreed with the staff that for an effective strategy to bolster foreign exchange earnings--inter alia, from tourism for which the scope should be substantial--a more forthcoming attitude toward the private sector would be desirable.

With regard to the fiscal situation, the authorities' considerable reliance on central bank financing was a weak spot, Mr. Wijnholds commented. A greater share of monetary financing of the budget deficit would be desirable, and consequently more efforts should be made to increase private sector savings. The authorities remained unpersuaded that negative real interest rates were an important disincentive to higher savings in the Algerian context. They considered that other incentives, especially linking savings to the acquisition of housing, were more suited to their system. While recognizing that the role of interest rates in a centrally planned economy was somewhat different from the role usually discussed by the Board, and that special incentives were a legitimate means of promoting savings, the authorities should not overlook the fact that a more market-oriented pricing of deposits and credits would be compatible with, and complementary to, other structural reforms undertaken in recent years. Countries, such as Algeria, that had opened up their economies to some extent and introduced some supply-side measures but were reluctant to introduce objective allocative elements in other areas, risked ending up with new distortions created by the uneven application of reforms throughout the economy.

The authorities faced a sharp deterioration of the balance of payments, while endeavoring to continue their policy of reducing external debt, Mr. Wijnholds noted. With the debt service ratio rising to over 40 percent, that task would be daunting. The staff paper did not contain any medium-term scenarios, which was understandable in view of the central role of energy prices in the Algerian economy and the hazardous nature of making any projections for such prices for a number of years ahead. But perhaps the staff could indicate in broad terms the outcome with reference to the balance of payments and debt service ratio that would be likely with oil prices remaining approximately at present levels.

After a number of successful years, the Algerian economy was likely to encounter difficulties in 1987, Mr. Wijnholds remarked. In meeting the challenge of the deterioration in the external environment, the authorities would be well advised not to turn to administrative controls and restrictions but to respond with prudent fiscal and monetary policies, combined with efforts to further encourage investment, particularly in the private sector, and policies geared toward export diversification and promotion of tourism.

Mr. Parmena made the following statement:

> The staff papers and Mr. Salehkhou's statement have clearly confirmed the commendable success of the Algerian authorities in the management of their planned economy over the last few years; at the same time, they have left us with no doubt that the severe deterioration in the external terms of trade has posed a formidable challenge to the authorities. Economic performance in 1985 was particularly impressive with a GDP growth rate of 6 percent while the authorities' perseverance with moderation in financial policies reduced the budgetary deficit further to about 8 percent from 14.5 percent in 1983. With regard to the external sector, the current account recorded a substantial surplus equivalent to 1.7 percent of GDP, and the country was in a position to register a substantial overall surplus, thus building up its foreign exchange reserves to the relatively high level of three and one-half months of import coverage compared with two months one year earlier.
>
> Beginning in 1986, however, there has been a dramatic turnaround induced by the deterioration in the external sector, in particular the collapse of the oil market. The terms of trade are expected to fall by 43 percent, and the severe reduction in export earnings has compelled the authorities to scale down imports, notwithstanding a policy of a sharp drawdown on reserves, and to reduce planned expenditures with the implication that the rate of growth is now expected to be no more than half that of last year. In addition, Mr. Salehkhou stated that although the authorities have undertaken strong adjustment measures during the year, they stand ready to take whatever additional measures are required to preserve economic growth and to contain inflationary pressures. Indeed, this is going to be a difficult task, and I urge the authorities to ensure that their policies give maximum inducement to the diversification of exports. This is already being done in the framework of the Five-Year Plan, but a more widespread system of fiscal and monetary incentives that also embraces the private sector is required. A comprehensive strategy should include promoting food-import substitution, reducing dependence on imports, and increasing manufactured goods for import substitution and for export.

With regard to exports, the authorities' focus on the need to develop external markets can only succeed if Algeria's trading partners eliminate protectionism. We therefore strongly urge Algeria's trading partners to collaborate fully in this respect. We would also agree with the staff that the Algerian authorities should keep an open mind on the exchange rate since it appears to have appreciated in real effective terms by nearly 23 percent in the last three years.

We commend the restrictive policy in 1986 aiming at a further reduction in the fiscal deficit to 7.8 percent of GDP. In this connection, we welcome the assurance from the staff and from Mr. Salehkhou that there will not be any salary increases in 1987 and that concerted efforts will be made to reduce the size of public employment. While this achievement on the fiscal front has facilitated moderation in monetary policy, the rates of growth of domestic credit and money supply--at 15.8 percent and 13.0 percent, respectively--in 1986 are still considerably higher than growth in nominal GDP, which is estimated at 9 percent. There is, therefore, need for further restraint, especially in view of the high rate of inflation of about 10 percent and the deteriorating balance of payments.

I welcome the interest rate hikes announced by the staff representative, although rates remain negative in real terms. While I agree with the authorities that special savings schemes linked to savers' needs, such as housing, may play a larger role in mobilizing savings and that in a centrally planned economy interest rates play less of a role in the allocation of resources, I nevertheless tend to concur with the staff view that, on the whole, positive real rates of interest would serve the interests of Algeria much better. The persistence of negative real rates of interest would have adverse effects on financial savings and on allocative efficiency even in a centrally planned economy. This would be particularly costly for the present strategy of diversifying the economy, which is a crucial consideration in the evolution of the Algerian economy. Finally, I support the proposed decision.

The staff representative from the African Department commented that the level of unemployment was high in Algeria, although the staff could agree with the authorities that it included a large number of students and young people. Nevertheless, the unemployment ratio gave cause for concern and would likely rise in the future. The impetus for the uniform nationwide salary scale had arisen from the sizable differences in wages between different sectors in the past. In particular, wages in a number of public enterprises had been considerably higher than for comparable jobs in the Central Government. The first objective of the national salary structure was to achieve wage uniformity, at least within the public sector. Moreover, regional and efficiency bonuses were awarded;

the authorities were attempting to measure productivity in various sectors, as was done in the manufacturing industries. Because implementation of the salary structure had been gradual, with the final step taken only in 1986, it remained difficult for the staff to judge whether it would be harmful in terms of labor mobility and the efficiency of the economy.

The authorities were not averse to giving adequate interest rates to savers, but they considered that sharply higher lending rates in a planned economy would create problems on the real side of the economy, the staff representative noted. Nevertheless, they had indicated their willingness to move pragmatically and gradually to increase interest rates, although measures taken to date had not led to positive real interest rates.

Because of the extreme uncertainty about petroleum prices prevailing at the time of the consultation discussions, the authorities had noted that it would not serve a useful purpose at present to give a full-fledged medium-term balance of payments scenario in the staff report, the staff representative said. However, the staff had included certain qualitative considerations, including a sensitivity analysis. The staff considered that as Algeria was almost exclusively dependent on oil prices, it was not difficult to forecast developments on the assumption that oil prices would stay approximately in line with recent data in the World Economic Outlook. Furthermore, the authorities aimed at no further decline in international reserves beyond the end of 1986 and at maintaining the debt service ratio at the present level. Consequently, a severe further compression of imports was to be expected in 1987 and subsequent years. Although some of the assumptions about international reserves and the debt service ratio could be relaxed, that would probably be unwise, particularly given the vulnerability of the economy. The past decline in reserves had been in line with the authorities' target, and no further decline was envisaged; equally, the high debt service ratio, reflecting particularly the sharp decline in exports, gave little room to expand external borrowing beyond that needed to meet amortization payments due in the next few years.

Mr. Salehkhou commented that his Algerian authorities greatly valued their cooperation with the Fund, not only through the useful annual discussions and consultations under Article IV but also through other Fund activities. The staff's extensive discussions with the authorities had been fruitful.

The authorities wished to make one clarification with respect to the staff presentation of public finances, Mr. Salehkhou continued. The format adopted for treasury operations in the staff report differed from the format used in previous years. Under the new format, the figures for overall treasury deficits for the entire period under review (1980-86) were worse than those given in the 1985 staff report (SM/85/185, 6/27/85), both in absolute terms and in terms of percentage of GDP. That deterioration was attributable to the fact that institutional savings--a revenue item at the capital operations' level--had been reclassified under financing. The deficit, which reflected the overall operations of the Treasury, also included public enterprises' planned investments financed by temporary treasury advances that must be repaid by the enterprises. Those investments were financed by the budget surplus and other sources.

The central government budget, under which expenditure was broken down into current and capital, had shown a surplus every year during the 1980-85 period, with the exception of 1983 when there had been a slight deficit, Mr. Salehkhou added. The authorities therefore urged the staff to retain the old format, which was more compatible with the organization and economic management of the Algerian system, and they requested that their comments be reflected in the relevant chapter of the report.

The drop in reserves during the first nine months reported by the staff representative, amounting to a fall of $843 million, was in line with the projection for international reserves of $1.3 billion for 1986 as a whole and therefore gave no cause for concern, Mr. Salehkhou concluded.

The Acting Chairman made the following summing up:

Executive Directors generally concurred with the views expressed in the staff report for the 1986 Article IV consultation with Algeria. They commended the authorities for their prudent economic policies in recent years which have resulted in high rates of savings, investment, and economic growth; modest inflation; and the maintenance of a satisfactory external position in the recent past. They noted the diversification and expansion that have been achieved in the hydrocarbon and industrial sectors; however, performance in agriculture and export-oriented nonhydrocarbon activities had not measured up to expectations.

Directors observed that the structural policies initiated under the last Five-Year Development Plan--including the restructuring of the public enterprises, the adoption of more flexible pricing policies, and the pursuit of cautious incomes policies--have resulted in improved productivity and enhanced financial performance in the productive sectors. The authorities' determination to redouble efforts on these fronts was welcomed, especially in the present context of diminished and uncertain prospects in the energy sector and the consequent large overall balance of payments deficit and loss of external reserves that have emerged in 1986. While Directors noted that thus far hydrocarbons had been predominant in exports and that the exchange rate had played a limited role in Algeria's centrally planned economy, they saw a need in present circumstances for according employment creation greater weight in the allocation of investment and for extending flexibility in pricing policies to the exchange rate so as to strengthen the development of nonhydrocarbon exports and the inflow of workers' remittances.

Directors welcomed the timely remedial budgetary measures adopted in 1986 in the face of the dramatic fall in hydrocarbon receipts, which has put considerable pressure on the balance of payments and public finances. Nevertheless, they pointed out that the overall treasury deficit is likely to remain high in 1986, contributing to the overhang of excess liquidity in the economy and to domestic inflationary pressures. In this context, they took note of the authorities' intention to further increase reliance on nonpetroleum receipts and to continue to restrain current and capital expenditure through containment of foreign borrowing, public sector employment, and the wage bill. They stressed the importance of reducing the fiscal deficit still further and of supporting measures in the area of monetary and credit policy, including upward adjustment in interest rates and other steps directed at bolstering financial savings and promoting balanced credit expansion to the various sectors. Directors commended the recent introduction of the new banking law, with a view to enhancing the role of banks in the financing of development and the increases in interest rates.

With respect to the external sector, Directors welcomed the importance that the authorities attach to maintaining a satisfactory balance of payments and reserve position, and they commended the substantial decline, since the late 1970s, of outstanding external debt in relation to GDP. Nevertheless, they noted with concern the slow expansion thus far of nonhydrocarbon exports, the sharp curtailment of imports through administrative means, the substantial appreciation of the exchange rate in real effective terms, the maintenance of a restrictive trade and exchange system, and the recent emergence of a large overall balance of payments deficit. In these circumstances, most speakers called for a reassessment of the development strategy for the external sector along the lines outlined by the staff. In particular, they saw a need for a strategy that is more forthcoming with regard to the role of the private sector, market-related price and wage mechanisms, the exchange rate, and interest rates, which in turn would offer greater scope for easing and simplifying administrative controls and procedures.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Algeria's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1986 Article XIV consultation with Algeria, in the light of the 1986 Article IV consultation with Algeria conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Algeria maintains the restrictive measures described in SM/86/245 in accordance with Article XIV, Section 2, except that the multiple currency practice resulting from the premium on workers' remittances from abroad is subject to approval by the Fund under Article VIII, Section 3. The Fund urges Algeria to ease the restrictions on payments and transfers in respect to current international transactions which continue to be in effect, and to adopt policies which would enable it to eliminate the multiple currency practice.

Decision No. 8420-(86/168), adopted
October 10, 1986

4. MEXICO - REPORT BY DEPUTY MANAGING DIRECTOR

The Deputy Managing Director stated that intensive negotiations had been under way between the Mexican authorities and the commercial banks' advisory committee, the Fund, and the World Bank on the details of the financing agreement that had been agreed in principle at the time of the Annual Meetings. While some issues remained to be settled between the commercial banks and the Mexican authorities, he would outline the agreements that had been reached to date that would have an effect on the arrangement negotiated between the Fund and the Mexican authorities. The staff would be distributing a paper to Executive Directors within the next few days, describing in detail the agreements that had been reached and indicating the implications of those agreements for the adjustment program for Mexico approved by the Executive Board. Some modifications in the memorandum of understanding and the letter of intent would be required. It was the judgment of management that those changes were minor and were appropriate in the context of the entire package. Management was therefore prepared to recommend the modifications to the Executive Board.

He wished to bring three aspects of the negotiations to the attention of the Executive Board, the Deputy Managing Director commented. First, the commercial banks would be linking their disbursements explicitly not only to Mexico's ongoing performance within the framework of the Fund-supported adjustment program but also to Mexico's performance under various programs supported by the World Bank. The commercial banks had considered that in the light of the new efforts to deal with the debt problem and the importance that was attached to an expanded role for the World Bank, they should also link their disbursements closely to progress under programs supported by the World Bank.

Second, the commercial banks would make one disbursement in the first quarter of 1988, the size of which was yet to be determined, the Deputy Managing Director indicated. The consequences of that disbursement, which was beyond the end of the 1986/87 financing period, for the Fund arrangement and for the understandings reached between the Fund and the authorities would have to be determined. From the Fund's perspective, the banks would have to understand that that last disbursement would be part of the 1986/87 financing package, although it would not take place until early 1988.

Significant changes had been made with respect to the oil contingency, which had been agreed between the authorities and the Fund without prior consultations with the commercial banks, the Deputy Managing Director stated. The banks had been reluctant to accept the linkage of their financing to developments with respect to a particular commodity price. They had also felt that given the magnitude of the financing package, it would be difficult to receive the support of all the 500 commercial banks involved if both a growth contingency and an oil contingency were included. It had been noted that in some countries a contingency liability would have to be carried on the books as a liability until its contingency nature was ended. The commercial banks were also concerned about the nature of the relationship between the commercial banks' Contingent Investment Support Facility and the Fund's Oil Contingency Mechanism. While the banks saw the advantages of a close association between those contingent facilities, they favored an independent facility that was not directly related to the Fund's Oil Contingency Mechanism. It had finally been agreed that the triggering of the Contingent Investment Support Facility would be linked to the triggering of the Fund's Oil Contingency Mechanism. However, as the commercial banks were unwilling to link their financing to the price of oil, the Contingent Investment Support Facility would be based not only on deviations around the expected path in the price of oil but also on deviations around the projected volume of oil production and export-related budget receipts, including noncrude oil export receipts. In other words, the banks' support facility was not tied tightly to the Fund's oil contingency. It had also been agreed that at least $200 million would be drawn under the Fund's Oil Contingency Mechanism before the banks' support facility would be triggered. Beyond that point, the commercial banks would contribute $3 for every $1 provided by the Fund. That concession had been the most significant from management's viewpoint. The commercial banks' Contingent Investment Support Facility would initially be triggered by certification by Fund management that a shortfall in Mexico's public sector export receipts from both oil and non-oil sources had occurred, reducing Mexico's capacity to maintain its 1986-87 public sector investment program. Those resources would help to protect the ongoing implementation of Mexico's planned public sector investment program. The language of the agreement with the commercial banks emphasized that the basic logic of the contingency plan was to ensure that adequate resources would be provided to ensure the maintenance of Mexico's investment program.

Within the context of the total package, the modifications just outlined were relatively minor and, management believed, had been necessary in order to gain the acceptance of the commercial banks' advisory committee, the Deputy Managing Director indicated. The staff would be discussing with the Mexican authorities any changes in the memorandum of understanding that had been necessitated by the agreement with the commercial banks. It would then distribute a staff paper on the details of the modifications to Executive Directors for discussion in the near future.

The Deputy Director of the Exchange and Trade Relations Department explained that Mexico was not the first case in which the disbursements of a commercial bank package had been linked to both the Fund and the World Bank. Several different types of such linkages had been described in the staff studies on international capital markets. With respect to the World Bank, some linkages were fairly broad and called only for some measure of progress in discussions with the World Bank, whereas others were linked specifically to disbursements under the Bank's structural adjustment loans.

Of course, as conditions attached to particular disbursements were increased, so would the uncertainties surrounding the timing of those disbursements, the Deputy Director continued. The linkages could therefore add rigidity to the financing package, particularly since in most cases not only the amount but also the timing of disbursements were important. The general question of linkages therefore merited study by the staff. However, it would not be possible to include such a study in the staff paper on Mexico requested by Executive Directors for the following week; that paper would describe the features of the agreement between Mexico and the banks and how those features affected and modified the stand-by arrangement for Mexico that had been approved in principle on September 8, 1986. In reviewing the adjustment program and policy implementation, the staff would endeavor to assess how policies in those areas covered by the World Bank interlinked with the policy measures on the Fund side. It would, however, be difficult to establish precise relationships between numerous and complex policies that had different time horizons; the World Bank, in its own assessment, would also be following the implementation and progress of policies under its programs.

Mr. Suraisry said that he wondered what the implications were for cross-conditionality of linking the commercial banks' disbursements to Fund and World Bank disbursements. Moreover, if the commercial banks insisted in future programs on the same type of linkage, they could reduce the flexibility of Fund programs and impede the Fund's independent evaluation of an economy. Implications could also arise for other areas, such as enhanced surveillance. Those aspects warranted timely discussion.

Mr. Goos observed that the financing relationship between the Fund and the commercial banks, previously set at 1:2, had been changed to 1:3. However, the Deputy Managing Director had said that the banks' support facility was not tied tightly to the Fund's oil contingency; he asked for an explanation of that relationship. He also asked whether the certification provided by management to the banks on the impact of fiscal revenue from exports and on the public investment program would consist of a factual statement or include projections and assessments.

The Deputy Managing Director explained that the overall relationship between the Fund's oil facility contingency and the commercial banks' support facility remained at 1:2; under the former, up to SDR 600 million could be drawn while the commercial banks would account for $1.2 billion. The 1:3 gearing ratio resulted from the Fund's agreement that before the commercial bank's Contingent Investment Support Facility would be activated, at least $200 million would be drawn under the Fund's Oil Contingency Mechanism. Thereafter, any further drawings on both facilities would be at a ratio of one from the Fund to three from the commercial banks.

Under certain circumstances, the commercial banks could, in any one quarter under their facility, participate to a larger or smaller extent than the 1:3 ratio, depending on the behavior of noncrude oil export receipts and on oil production volume during that quarter, the Deputy Managing Director continued. A complicated linkage existed between the two, with a quarterly cap built in for maximum disbursements by the Fund and another for disbursements by the commercial banks if the price of oil declined. Other caps also existed on the basis of possible swings in other non-oil exports that comprised Mexico's budget receipts. The staff paper would describe the facilities fully.

Management would make a general certification, following consultation with the World Bank and the Mexican authorities, that in its judgment, a drawing under the investment facility would help to protect Mexico's capacity to maintain its investment program, the Deputy Managing Director stated. Moveover, the commercial bank facility was also linked to Mexico's performance under the Fund-supported adjustment program, and the criteria under the Fund arrangement would have to be satisfied for disbursements to take place under either the Fund's Oil Contingency Mechanism or the commercial bank facility.

Mr. Zecchini remarked that the analysis to be incorporated in the staff paper requested by Directors was essential to reach a judgment on the present issues. He asked for reassurance that the paper would be prepared before the next Board discussion of the matter.

The Deputy Director of the Exchange and Trade Relations Department remarked that as the modifications to the arrangement described in the staff paper considered on September 8, 1986 would not affect a priori the policies and the analysis presented at that time, an extensive elaboration would not seem to be required. The modifications pertained to technical features of the agreement between Mexico and the banks and affected only certain elements of the arrangement. Most of the modifications would not change the structure of the program; one change would, for example, affect the maximum amount that the Fund would contribute to the Oil Contingency Mechanism--a reduction from SDR 800 million to SDR 600 million. Other changes related to the gearing ratio between the disbursements by the Fund under the Oil Contingency Mechanism and those by the banks under their Contingency Investment Support Facility. As he had already noted, although the gearing ratio of 1:2 had been kept in principle, a modification in the pace of disbursements had resulted from some front-loading on the Fund's part that would require a 1:3 ratio for subsequent disbursements in order to return to the original 1:2 relationship. Other possible revisions might be required on account of the conditions that the banks and the Mexican authorities had agreed regarding the disbursements, but those would not necessarily affect policies.

On the more general question of the various linkages to actions by different agents, they could reduce the leverage of the Fund to ensure that disbursements took place, the Deputy Managing Director commented. However, as the linkages had provided the basis on which the banks had entered into the financing package, a balance had to be struck between the need to reach agreement on the package and the acceptance of consequent conditions on which the disbursements were made contingent. The general aspects of that question would be a fruitful area for study in order to determine how a financing package could be designed that would avoid undue rigidity and reduce the uncertainty of timing of disbursements which could serve as a disincentive for keeping policies on track.

Mr. Ortiz commented that negotiations for the financing package had been complex, as his Mexican authorities had considered it preferable to avoid inasmuch as feasible the establishment of interlinkages that could impede drawings even when the program with the Fund was on track. The commercial banks' original proposals had contained many more linkages than the more simple package being agreed upon.

At a meeting to be held that day at the Bank Association for Foreign Trade, the Mexican package would be quasi-formally launched by the Steering Committee, the Mexican authorities, participants from the World Bank and the IMF, and U.S. officials, Mr. Ortiz said. Apparently the commercial banks had questioned why their role was rather subservient to that of the World Bank. They considered that they should be playing a more active role in the promotion of structural change and other policies, which thus far, had been monitored and pursued exclusively by multilateral institutions. That view had interesting implications for future agreements.

Mr. Zecchini explained that his concerns lay not only with the general aspects of the package but with the question of the financing gap. Apparently if Mexico complied with the conditions set forth in the Fund program but encountered difficulties pertaining to the World Bank program, the commercial banks would not disburse their portion. That situation would give rise to the emergence of a financing gap that could lead to the derailment of the Fund program in spite of the fact that Fund objectives had been met. He wondered to what extent that situation could take place and how the Fund could cope with it.

The Deputy Managing Director remarked that a slippage in the World Bank program that would prevent a planned disbursement from the Bank would also create a financing problem that would affect the performance of the economy under the Fund program. If a breakdown occurred in any one element, subsequent breakdowns could occur in other sectors; in that sense, linkages existed.

With regard to the commercial bank agreement, a great deal of effort had been made during the negotiations by the Mexican authorities, the World Bank, and the Fund to limit the extent of the linkages so that interrelationships would not become overly rigid, the Deputy Managing Director stated. The banks' procedures would include waivers, through qualified majorities, that would permit flexibility in responding to circumstances--such as a program going slightly off track or delayed in the World Bank--and allow a drawing.

The Deputy Director of the Exchange and Trade Relations Department recalled that in the past, the Fund had played a role of passive catalyst; it had supported programs wherein future balance of payments flows--including capital movements--were estimated. No formal linkages had been established with regard to the materialization of those flows and, therefore, the danger had clearly existed that some capital inflows would not occur as anticipated. The Fund's resources had been protected by the fact that the member, in order to meet the performance criteria, would need to take the measures required to keep the program on track even when the expected inflows had not taken place. That protection continued to exist, and was present in the case of Mexico. However, given the shrinkage in international capital markets and the ensuing reduced flows relative to financing requirements, a member would have difficulty in introducing measures sufficiently to offset the reduction in external resources.

In the present case, if one of the disbursements from the commercial banks did not take place, it was possible that the policies would not keep performance in the economy on track, the Deputy Director of the Exchange and Trade Relations Department said. It was therefore important to establish sufficient flexibility in such multiparty agreements. Such flexibility could be achieved by means of, for example, waiver provisions, a technique that had developed over time in the Executive Board to prevent certain events from needlessly interrupting an arrangement and thereby allowed disbursements to take place as scheduled.

Mr. Foot noted that seven to ten days had elapsed since the Managing Director had reported that a broad agreement on the Mexican package had been reached. He understood that October 31 was the end-date and, in that connection, he wondered whether the telexes to participating banks that would activate the process of establishing a critical mass would be dispatched before a Board discussion and whether Executive Directors would have two to three days to study the paper prepared by the staff before the Board meeting.

The Deputy Managing Director said that it was hoped that the telexes would go out as soon as final agreement was reached, and that it would not be possible to have a Board meeting beforehand. The text of the message from the Managing Director that would accompany the telexes had not been finalized. The Managing Director would, of course, be prepared to submit the package to the Executive Board.

Mr. Rye said that he was puzzled by the staff's comment that the arithmetical relationship between the Fund and the banks' contributions under the oil contingency mechanism would remain at 1:2. He wondered whether that relationship was preserved only if the Fund were called upon to make its full contribution of SDR 600 million. If the Fund contributed a lesser amount, would the banks, in effect, be contributing less?

The Deputy Director of the Exchange and Trade Relations Department explained that the maintenance of the 1:2 relationship together with the understanding that the Fund would disburse SDR 200 million up front had led to the new gearing ratio of 1:3. After the disbursement by the Fund of the first SDR 200 million, the 1:3 gearing ratio was derived from the relationship of the remaining SDR 400 million from the Fund to the total contribution that would be required from the banks.

The staff representative from the Western Hemisphere Department pointed out that two reviews affecting the possible triggering of contingency funds were contemplated. A specific review at the Executive Board level would take place before December 31, 1986 to consider the details of the program for 1987. The second review would take place before June 30, 1987 to consider, in general, the performance of the program and, in particular, the economy's evolution with respect to growth and the policies being implemented to achieve the program's goals.

With regard to the Fund's Oil Contingency Mechanism, a formula existed in the program whereby the staff's calculations could establish that the conditions had been met for a drawing to occur automatically, and a Board meeting would not be required, the staff representative said. Similarly, to the extent that the staff could certify that the shortfall had occurred under conditions established in the banks' Contingent Investment Support Facility, then drawings would occur automatically under that facility without the need for subsequent reviews.

Mr. Templeman wondered whether, at the time of the second review, the Board would be given the opportunity to consider two quarters during which there might not have been a triggering of the mechanisms and therefore of disbursements.

The staff representative from the Western Hemisphere Department noted that in the case of the so-called growth contingency, a determination would be made as to whether the economy had been growing at the expected rate during the first quarter of 1987. Because of the usual delays in receiving such data, that information would be available only by the time of the Board meeting. Therefore, before the end of June, the Board would have an opportunity to consider whether the Government's policies were appropriate in the circumstances.

Mr. Templeman inquired whether the Board would therefore be considering the country's economic growth in the fourth quarter of 1986 and the first quarter of 1987, with regard to the oil and investment contingency mechanisms.

The staff representative from the Western Hemisphere Department said that the Fund's Oil Contingency Mechanism had been originally conceived as operating during the period June-September 1986, which comprised the first quarter for calculations to trigger the mechanism. Because that quarter had elapsed, it had been agreed by all involved in the negotiations to drop the corresponding amount. That agreement had facilitated approval of the financing arrangement. Such technical details would have to be modified in the text of the memorandum of understanding agreed with the Mexican authorities.

Mr. Fujino asked for more information on the status of discussions in the World Bank, for example, with regard to guarantees.

The staff representative from the Western Hemisphere Department remarked that while agreement had been reached on some specifics of the term sheet, some aspects were still in the process of being finalized. Therefore, the staff had considered it appropriate to present complete information in the paper to be prepared for the Board. He understood that a number of agreements had been reached regarding the actions that would trigger specific disbursements under the commercial bank support facility.

Certain loan agreements with the World Bank included the provision that when a structural measure had reached a specific stage, the Bank was prepared to authorize funding, the staff representative explained. For that reason, the commercial banks would be reassured that the structural adjustment program was proceeding as scheduled.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/167 (10/10/86) and EBM/86/168 (10/10/86).

5. IRELAND - TECHNICAL ASSISTANCE

In response to a request from the Irish authorities for a review of aspects of income tax administration, the Executive Board approves the proposal set forth in EBD/86/267 (10/7/86).

Adopted October 10, 1986

APPROVED: June 15, 1987

LEO VAN HOUTVEN
Secretary