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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/39

10:00 a.m., March 11, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	A. K. Diaby, Temporary
C. H. Dallara	M. K. Bush
	D. C. Templeman, Temporary
J. de Groote	
B. de Maulde	
M. Finaish	T. Alhaimus
H. Fujino	
	B. Goos
J. E. Ismael	
R. K. Joyce	L. Leonard
A. Kafka	C. Robalino, Temporary
	E. Olsen, Temporary
	A. Abdallah
	B. Jensen
	J. E. Suraisry
	E. M. Taha, Temporary
	J. de la Herrân, Temporary
	J. de Beaufort Wijnholds
	A. V. Romuâldez
G. Salehkhou	O. Kabbaj
	R. Msadek, Temporary
	A. S. Jayawardena
N. Wicks	
	N. Coumbis
	Wang E.

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

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Also Present

P. Eigen, Latin America and the Caribbean Regional Office, IBRD. Administration Department: R. Tenconi, Director. Exchange and Trade Relations Department: C. D. Finch, Director; M. Guitián, Deputy Director; J. T. Boorman, G. G. Johnson, S. Kanesa-Thasan, G. Oliveros. External Relations Department: H. P. Puentes. Fiscal Affairs Department: A. L. Antonaya. IMF Institute: M. Hosny. Legal Department: G. P. Nicoletopoulos, Director; P. L. Francotte, Ph. Lachman, J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; F. Drees, H. E. Jakubiak, B. A. Karamali, G. Tomasson. Research Department: W. C. Hood, Economic Counsellor and Director; J. S. Lizondo. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat. Treasurer's Department: D. Williams, Deputy Treasurer; G. Wittich. Western Hemisphere Department: E. Wiesner, Director; M. E. Bonangelino, M. Caiola, O. Gronlie. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: D. Hammann, G. E. L. Nguyen, M. A. Weitz. Assistants to Executive Directors: I. Angeloni, M. B. Chatah, G. Ercel, R. Fox, V. Govindarajan, G. D. Hodgson, J. M. Jones, A. K. Juusela, H. Kobayashi, A. Mustafa, J. E. Rodríguez, A. A. Scholten, A. J. Tregilgas.

1. GROUP OF TEN - DEPUTIES' MEETING - REPORT BY STAFF

The Director of the Research Department said that the Group of Ten Deputies had met in Paris on March 6-7, 1985 to discuss two chapters--on surveillance and the role of the Fund--of the draft report to the Ministers on the evolution of the international monetary system. They planned to meet again on April 10-11 and May 15-16, 1985 to discuss further drafts of those chapters and draft texts of the remaining chapters, on exchange rates and liquidity. The Group of Ten Deputies planned to present their report to the Ministers in June 1985.

2. ECUADOR - STAND-BY ARRANGEMENT AND EXCHANGE SYSTEM

The Executive Directors considered the staff paper on Ecuador's request for a one-year stand-by arrangement in an amount equivalent to SDR 105.5 million, together with a proposed decision on Ecuador's exchange system (EBS/85/25, 1/29/85; Cor. 1, 2/28/85; and Sup. 1, 3/8/85).

The staff representative from the Western Hemisphere Department said that the staff had just been informed by the Chairman of the Steering Committee of Ecuador's commercial bank creditors that, as of March 8, 1985, written commitments had been received from the international banking community representing $180 million in new financing out of the total proposed package of $200 million. The Chairman of the Steering Committee had indicated that he expected another $6.6 million to be committed on March 8, 1985, thereby bringing the total commitments to the equivalent of 93.8 percent of the proposed package. Approximately 280 banks had confirmed their participation in the rescheduling of Ecuador's debt; that number represented roughly 94 percent of the banks that had agreed to participate in the rescheduling.

Mr. Robalino made the following statement:

> My authorities are in broad agreement with the staff's analysis in EBS/85/25. Since 1981, Ecuador has faced serious economic imbalances originating from external factors as well as domestic policies. An increase of 100 percent in the basic minimum nominal wage in 1980 and a cut of almost 10 percent in the weekly hours worked by the labor force in Ecuador, followed by an expansionary fiscal and monetary policy in 1980-82, led to an important increase in the fiscal gap as well as in the current account of the balance of payments. The overall deficit of the nonfinancial public sector increased from 4.6 percent of GDP in 1980 to 6.8 percent in 1982. The deficit in the current account of the balance of payments reached a level as high as 11.6 percent of GDP in 1982. External factors, such as high interest rates in world financial markets, the world economic recession, the deterioration of the terms of trade, and the drop

in international oil prices led to a fall in exports between 1981 and 1983 and to a sharp decline in Ecuador's access to foreign financing from commercial banks.

The country's loss of competitiveness and the unsustainability of the disequilibrium in the balance of payments imposed the need to implement an economic adjustment program; this took place in 1983 under a stand-by arrangement supported by the Fund.

Under the stand-by arrangement, from July 25, 1983 to July 24, 1984, the Government adopted a tight demand policy in order to restore confidence and the competitiveness of the economy. Under this arrangement, Ecuador fulfilled all the quantitative performance criteria and drew 100 percent of the amount agreed under the arrangement.

On August 10, 1984, a newly elected Government took office. The new President has a clear economic philosophy, which is aimed at reducing government intervention in the economy, limiting the growth of the public sector, and expanding and fostering growth of the private sector. Since that date, the adjustment effort has been consolidated; on September 4, the new Government introduced some measures. On that date, a large number of the import restrictions introduced in the previous two years were eliminated. The Government also decided to take a further step in the process of unification of the exchange rate system, transferring from the official market to the intervention market, administered by the Central Bank of Ecuador, some important current account transactions of the balance of payments. The free exchange rate in that market, which is applicable to most import and export transactions, was adjusted to S/. 95 per dollar. By the end of 1984, only petroleum exports and a reduced list of imports, such as medicines, food staples, inputs for medicine and agriculture, and imports by the state, as well as the public external debt service, remained in the official exchange market of S/. 66.50 per dollar.

At the end of 1984, lending and deposit rates of commercial banks were allowed to increase by 2 percentage points, to 23 percent and 20 percent, respectively. Financial institutions were permitted to issue certificates of deposit at market-determined rates to enhance the growth of financial savings. Financial resources obtained from these instruments can also be lent out at floating rates. On December 28, 1984, the prices of oil products were increased by 75 percent on a weighted average basis.

The new Government, headed by a political leader who is market oriented, has designed a financial program to consolidate all the previous achievements and to allow market forces to play a major role in the allocation of resoures in the economy.

These objectives cannot be pursued without the financial assistance of the Fund. This is why the Government has requested a stand-by arrangement for 12 months for an amount equal to 70 percent of quota (SDR 105.5 million).

The authorities are satisifed with the overall result of the financial position of the nonfinancial public sector of Ecuador, since at end-1984 the overall deficit has been almost eliminated. But, because the Government is convinced of the need to continue the policy begun last August 10, it is planning to take additional measures to reach a fiscal surplus of 3.4 percent of GDP under the assumption set forth in the financial program agreed with the Fund staff. I must call the Board's attention to the fact that a financial surplus of the nonfinancial public sector, such as the one in Ecuador, is not often found at the moment in other parts of the world. That fiscal surplus will be possible because of the implementation of a tight demand policy.

On the revenue side, the measures taken since August 10 will be fully executed during 1985. The increase in the rates charged by public utility companies (electricity, telephone, water, and sewage) will be sustained in the medium term as a matter of policy.

The unification of the exchange rate will enhance the financial position of the Central Government, since the proceeds of oil exports will be quoted at a higher rate of exchange. In addition, import taxes will be calculated and paid, after the unification, at a higher official rate of exchange. The Government is also strengthening the Internal Revenue Tax Department in order to increase the productivity of the tax system. Particular emphasis will be placed on improving income and sales tax collections as well as receipts from customs duties. In October 1984, a Swiss company, the Société Générale de Surveillance, was contracted to assist in the fight against smuggling, overinvoicing of imports, and underinvoicing of exports. Public sector revenues are projected to increase from 29.2 percent of GDP in 1984 to 33.4 percent of GDP in 1985.

On the expenditure side, the Government will continue its tight policy. Current expenditures of the Government, including the nominal wages of public employees, will not be increased as much as the average inflation rate estimated for 1985. My authorities want to call the Board's attention to the fact that, up to now, they have not increased the nominal remuneration of public employees at all; there has been no increase in salary since August 10. As to investment expenditures, the authorities will maintain a restrictive policy that will contribute to the creation of a surplus in the government accounts. Total expenditures will increase slightly, from 29.2 percent of GDP in 1984 to 30 percent of GDP in 1985.

One of the main objectives of the financial program in 1985 will be the strengthening of the external sector of Ecuador, and this objective will be pursued through a competitive exchange rate. My authorities are convinced that an active, flexible, and realistic exchange rate policy is needed to create the conditions for maintaining the competitiveness of the country's external position as well as to promote and diversify the productive base of the Ecuadoran economy. My authorities recently introduced additional measures to eliminate all import prohibitions.

In the second semester of 1984, the rate of inflation in Ecuador declined because of three factors: first, a tight demand policy, particularly the wage and fiscal restrictive stance pursued by the Government; second, the normalization of weather conditions; and third, the new pricing policy for goods produced by the private sector that has allowed, since last August, better profits in the private sector, particularly for Ecuadoran farmers.

The evolution of the inflation rate is shown in the following table:

Rate of Inflation
(Percentage change; annual rate)

	Month	Total	Footstuffs
1984	July	25.2	26.9
	August	22.6	21.5
	October	19.1	14.7
	December	25.1	27.1
1985	January	29.9	33.2
	February	29.1	31.4

The recent revival of inflation had its origin in the corrective price adjustments by my authorities in 1984, especially the increse in domestic prices of oil in December 1984 in order to strengthen the financial position of the Government and as part of the policy of preserving the oil as an exhaustible natural resource. The monthly rate of inflation in February 1985 was 1.2 percent, compared with 6.4 percent in January 1985. Owing to a restrictive aggregate demand policy, the inflation rate in Ecuador is projected to decrease by the end of the year to 20 percent.

The Government's income policy will continue to be conservative and prudent. Wage increases will not be higher than the inflation rate. Moreover, in the future, any increase in remuneration of public employees will be financed through the creation of new taxes or by an increase in tax rates.

In the past, wage policy has relied mainly on the practice of increasing the general basic minimum wages. The last time that wages were increased by decree was in July 1983. Since that date, nominal basic minimum wages have remained unchanged. Real basic minimum wages have fallen almost 50 percent from July 1983 to the end of February 1985. Future increases in minimum wages will be consistent with the financial program that the Board will be discussing today.

With a view to increasing the volume of financial savings and in order to improve the allocation of resources in the economy, the Government has decided to allow the forces of supply and demand to play a major role in the financial sector of the economy. Traditionally, interest rates were, from time to time, fixed by the monetary authorities. None of the participants on the financial market could pay or charge their customers an interest rate different from the ones set by the authorities. That was the practice.

Following that practice, the authorities increased the lending and deposit rates by 2 percentage points. For my authorities, the financial innovation--in a country full of economic taboos--is that commercial banks and financial companies have now been permitted to issue certificates of deposit at floating rates. These resources will then be lent by the commercial banks at a free-market rate. It is expected that the second market will absorb financial savings from the first market. This process will not work fully in the very short run, but it is expected that this technique of giving more flexibility to interest rate policy will mobilize more savings, and will also increase the whole structure of interest rates in an effort to gain positive real interest rates in the medium term. According to the latest information, commercial banks in Ecuador have begun, very recently, to issue certificates of deposit, paying 29 percent to savers, and to charge 33 percent on the loans made with the financial resources captured in the second market. These rates correspond to financial transactions with maturity of 180 days. The interest rate structure is as follows:

	(percent) June 1984	March 1985
1. Fixed-rate market		
Annual interest rate for loans	21	23
Annual interest rate for savings accounts	18	20
Annual interest rate for time deposits (180 days)	19	22
2. Floating-rate market		
Annual interest rate for certificates of deposit (180 days)	None	29
Annual interest rate for loans (180 days)	None	33
Rate of inflation during the past 12 months	30.3	29.1 (February)
Expected rate of inflation by the end of 1985		20

As a matter of policy, my authorities will continue viewing the interest rate issue in a flexible manner.

As in the past, my authorities will continue cooperating with the Fund, and I hope that my colleagues can support Ecuador's request.

His authorities appreciated the role that the Fund had played in helping them to arrange a multiyear rescheduling of the commercial bank debt that was initially to have fallen due in 1985-89, Mr. Robalino added.

Mr. Jensen remarked that the authorities had successfully implemented an adjustment program under an earlier arrangement with the Fund. The proposed stabilization program included a comprehensive set of adjustment measures that deserved the Fund's full support.

When the economy had begun to deteriorate in late 1980, the authorities had not hesitated to implement the adjustment measures needed to reverse the emerging domestic and external imbalances, Mr. Jensen commented. The staff had clearly described the main causes of the large external imbalance, the accumulation of arrears, the acceleration in the rate of inflation, and the weakening of public finances. Most of those problems had been tackled appropriately under the stand-by arrangement in 1983, and, with the exception of a minor slippage in the area of external arrears, all the quantitative performance criteria under that arrangement had been observed. As a result, the public finances had strengthened and the balance of payments position had improved, as the current account deficit had fallen sharply. The prudent fiscal management--including a deceleration in the growth of expenditures and an increase in public tariffs--the acceleration in the rate of depreciation of the sucre in the official market, and the slowing of the rate of growth of central bank credit had played a crucial role in curbing the deterioration in the economy.

To some extent, Mr. Jensen went on, those remarkable achievements had been endangered in the final months of 1984, when inflationary pressures had re-emerged, owing mainly to the exchange rate adjustments, the increase in administered prices, and the acceleration in the rate of growth of central bank credit. The uncertainty about the likely exchange rate management under the new Government had helped to increase the differential between the official and parallel market exchange rates and had intensified the pressure on both domestic prices and the external position. The authorities had reacted promptly and courageously to avoid jeopardizing the continuation of the stabilization effort: they had formulated a financial program for 1985 designed to strengthen the external position and reduce the rate of inflation, thereby creating the conditions required for sustainable economic growth. In addition, they had negotiated a debt rescheduling arrangement.

Under the proposed program, the authorities were to strengthen the public finances by carrying out additional revenue measures and by keeping the increase in expenditures in line with GDP growth, Mr. Jensen noted. They hoped that those efforts would result in an overall public sector surplus in 1985 of almost 3.5 percent of GDP. That objective was particularly commendable because it was based upon a realistic pricing policy for public enterprises, appropriate investment decisions affecting priority areas, and a further restriction on the growth of current expenditure. The expected overall public sector surplus should permit a sizable buildup of deposits in the Central Bank, so that the desired increase in bank credit and in nominal GDP could be realized. The authorities' determination to maintain a flexible interest rate policy should cause real rates to become positive, thereby helping to mobilize domestic savings and alleviating the pressure on the balance of payments. Given the fiscal objectives and the need to control inflationary pressures, the authorities' intention to limit salary and minimum wage adjustments was welcome.

He agreed with the staff that simplifying the exchange system and maintaining a flexible exchange rate policy were the key elements of the proposed program, Mr. Jensen commented. The authorities' intention to unify the official and intervention exchange markets and eventually to transfer all current transactions in the parallel market to the new unified market was welcome. According to the staff estimates, those steps would imply a depreciation of the sucre in real effective terms of as much as 18 percent. The effect of that adjustment on domestic prices would depend on the pace at which it was made and on the accompanying management of monetary policy. He wondered whether monetary restraint and prudent wage management alone could ensure the achievement of the proposed reduction in the inflation rate to only 20 percent in the coming year.

He was pleased that the authorities had already taken steps to liberalize the trade system, Mr. Jensen remarked. That effort was consistent with the exchange rate policy that they intended to maintain and with their aim of creating a sound foundation for efficient resource allocation. Given the measures that the authorities intended to adopt under the proposed program and the assumptions concerning the behavior of key variables in the coming period, the authorities should be able to achieve a viable external position and sustainable economic growth in the medium term. He strongly supported the proposed decision.

Mr. Taha said that the program objectives and the measures to achieve them were appropriate. The request for a stand-by arrangement should be accepted.

The program reflected the authorities' determination to maintain the momentum of adjustment and establish a sound basis for achieving sustainable growth, Mr. Taha continued. Those objectives were appropriate, particularly in the light of the current economic and financial imbalances, which were attributable partly to factors beyond the authorities' control.

He strongly supported the authorities' intention to continue their successful efforts to strengthen public finances by increasing revenues and controlling expenditures, Mr. Taha commented. The expected increase in investment was encouraging, and he hoped that the authorities would soon be able to introduce the measures needed to strengthen tax administration.

The prudent fiscal policy should be supported by a firm wage policy to help bring inflation under control, Mr. Taha said. The proposed wage policy for 1985 seemed consistent with the inflation objective, but a further comment on the matter by the staff would be helpful.

The proposed monetary program was broadly consistent with the goals of reaching balance of payments equilibrium in 1985 and reducing the rate of inflation, Mr. Taha commented. In the external sector, the simplification of the exchange system and the adoption of a flexible exchange rate policy were welcome. Those steps, together with the proposed demand management policies, should help to strengthen exports and improve the balance of payments outlook. A viable current account position was essential if the authorities were to meet their debt obligations in an orderly manner. In that connection, he was pleased that all the external payments arrears to private creditors had been settled, and that the proposed program would not permit new external arrears to develop during 1985. Following the Fund's approval of the proposed stand-by arrangement, the authorities intended to settle the arrears to official bilateral creditors within the framework of the Paris Club.

Mr. de la Herrân considered that the proposed adjustment program was reasonable and that Ecuador's request for a stand-by arrangement should be approved. The authorities had met all the quantitative targets and made a number of important structural adjustments under previous arrangements with the Fund; the proposed arrangement would consolidate the improvements in the fiscal, monetary, and external areas, thereby strengthening the foundation for adjustment in the medium term.

The authorities were to be commended for having maintained a flexible exchange rate policy in the recent past, Mr. de la Herrân commented. He agreed with the staff that exchange rate policy would play a critical role in the effort to achieve external equilibrium. Given the overall public sector surplus expected in 1985, the projected improvement in the external current account seemed feasible.

The authorities' decision to increase interest rates on savings and lending and to permit market forces to play a greater role in determining the interest rate for certificates of deposit was welcome, Mr. de la Herrân said. The expectation was that eventually all interest rates would be set on the basis of market forces. The authorities' interest rate policy should help to generate financial savings.

One of the main objectives of the new program was an overall public sector surplus equivalent to nearly 3.5 percent of GDP, something that few other countries could hope to achieve, Mr. de la Herrân commented. However, he wondered whether that target was consistent with the need to improve health, education, and housing in Ecuador. A further comment on the economic significance and consequences of the fiscal surplus objective would be helpful.

The heavy debt burden seemed to make the economy vulnerable to adverse external developments and swings in confidence, Mr. de la Herrân remarked. Meeting the program objective of moving toward a sustainable external balance should enable the authorities to reduce the external debt, including short-term debt. Moreover, the agreement in principle with the steering committee of foreign commercial banks on rescheduling Ecuador's external debt would help to restore confidence and would place the authorities in a better position to manage the debt problem. Finally, the authorities should be encouraged to liberalize the trading system further.

Mr. Joyce commented that, with the assistance of the Fund, the authorities had successfully begun to address many of the structural imbalances in the economy during the previous two years. The recovery in economic growth, the reduction in the rate of inflation, the increase in reserves, and the considerable progress in strengthening both public sector finances and the external accounts were welcome. He was pleased that the critical mass of the previously agreed commercial bank support had been reached; the Canadian banks concerned were prepared to participate fully in the refinancing package. In the light of those developments, the framework of the new program was fully appropriate, and the proposed stand-by arrangement should be approved.

The staff papers clearly showed that, despite the progress made, demand restraint must continue to play a major role in the adjustment effort, particularly in reducing inflation to an even more manageable rate, Mr. Joyce continued. At the same time, increased attention would have to be paid to supply-side factors, including the need both to reduce further some of the structural rigidities in the economy and to find more effective ways of mobilizing domestic financial resources. Hence, he was pleased that a change in the exchange rate system was to be a major element of the proposed stand-by arrangement. The need for a devaluation, which would inevitably increase the pressure on domestic prices, underscored the importance of maintaining a solid hold on domestic demand.

The increased role of the World Bank in providing financing and technical assistance in Ecuador's sectoral reform process was welcome, Mr. Joyce went on. The cooperation between the Fund and the World Bank should continue to be close in Ecuador as well as other countries. Indeed, such cooperation was essential if Ecuador were to obtain adequate assistance in the medium term.

The further improvement in the fiscal balance planned for 1985 was welcome, Mr. Joyce commented. The projected budget surplus equivalent to 3.4 percent of GDP would play a key role in helping to contain overall growth in the money supply while permitting the needed expansion of credit to the private sector. The growth in outlays would have to be closely monitored if the overall fiscal target were to be achieved. In that connection, recent press reports of a 28 percent increase in minimum wages were worrying. An increase of that magnitude in both public and private sector wages would be inconsistent with the authorities' intention to limit public sector wage increases to no more than the projected inflation rate of 20 percent. The authorities' intention to match any additional expenditures that might be approved by the Congress with additional revenue measures or offsetting budget cuts was welcome. That Ecuador was once again in a position to increase the share of investment expenditures in total expenditures was encouraging.

On the revenue side, the practice of earmarking a significant portion of petroleum revenues to finance specific expenditures was a cause for concern, as it might well be somewhat inefficient, Mr. Joyce said. For example, a significant portion of the revenues was earmarked for road construction, even though the World Bank had concluded that further construction of primary roads at the present stage might be inappropriate. Therefore, he was pleased that the authorities intended to seek legislation modifying the existing earmarking procedures, although fully eliminating such procedures was still the ideal solution. He agreed with the staff that tax administration should be strengthened with a view to improving the collection of traditional taxes, thereby significantly improving the viability of the Central Government's financial position in the medium term.

The recent increase in lending and deposit interest rates, and the authorities' commitment to adjusting the rates in the future with a view to maintaining positive real rates, were welcome, Mr. Joyce remarked. Those adjustments were essential to providing adequate incentives for financial savings and discouraging capital outflows. The introduction of certificates of deposit with market-determined interest rates was a significant initial step toward a more flexible interest rate policy, but he hoped that the authorities would lower the minimum amount of the certificates as soon as possible. The decline in the rate of domestic savings over the previous several years was a cause for serious concern, and additional measures would be needed to mobilize domestic savings more effectively.

The simplification of the exchange system and unification of the exchange rate were key elements in the proposed program, as they would affect both the supply capacity of the economy and the level of demand, Mr. Joyce said. The estimated depreciation of the sucre of up to 18 percent in real terms following the exchange rate unification should more than compensate for the loss in overall competitiveness since 1981 and should help to encourage non-oil exports in particular. The authorities' commitment to maintaining a flexible exchange rate policy was welcome, and the steps already taken to eliminate import restrictions and the advance deposit insurance scheme were encouraging. Their efforts to encourage more foreign direct investment through changes in the relevant legal provisions were appropriate, although such changes alone might not produce all the desired results, particularly if potential investors felt that the domestic policy stance was not fully appropriate.

The debt rescheduling agreement that had been reached in principle with the commercial banks should help to stabilize the external accounts over the medium term, and he was confident that a rescheduling on appropriate terms could also be reached with Paris Club creditors, Mr. Joyce commented. The medium-term balance of payments scenario showed that a viable external position could be achieved, but there were clearly a number of risks involved, particularly because of the uncertainties about the evolution of world oil markets and international interest rates. If Ecuador were to achieve a genuinely sustainable external position--one that would not require recourse to further rescheduling--by 1990, a determined adjustment effort would have to be made. The authorities must be prepared to adopt additional measures, if necessary, especially if the assumptions about the volume and value of oil exports and about the level of interest rates were not realized.

The proposed program was a strong, good one and deserved the Fund's support, Mr. Joyce concluded. The authorities were to be congratulated for the efforts made thus far, and they should be urged to remain on the present course.

Mr. Salehkhou remarked that Ecuador's request for a stand-by arrangement for 1985-86 was based on the rather encouraging performance under the earlier stand-by arrangement after several years of deterioration in the economy owing partly to adverse external developments and partly to the expansionary demand policies of the previous Government. Oil products accounted for 70 percent of exports, so that fluctuations in world petroleum prices caused substantial variations in government earnings and affected the authorities' investment decisions and the country's balance of payments. Hence, because of the weakening of oil prices in 1982, Ecuador had suffered a sharp drop in exports and a decline in net private capital inflows. Moreover, GDP growth had slowed from 5 percent in 1980 to 1.4 percent in 1982, while the rate of inflation had accelerated from about 13.5 percent to almost 25 percent and the balance of payments had weakened. Trade-related arrears of $211 million had appeared in 1982.

The authorities had responded to the difficult situation by attempting to spur economic activity through deficit spending financed largely by external commercial borrowing, Mr. Salehkhou noted. At the same time, they had devalued the sucre and increased taxes and consumer prices.

The Fund-supported stabilization effort had been started in time--July 1983--to reverse the deterioration in the financial position of the public sector and to limit the loss of net international reserves through an increase in revenues, better control of expenditure, and postponement of investment projects, Mr. Salehkhou went on. As a result, the balance of payments had improved; the current account deficit had been reduced, mainly through import restrictions. Moreover, during the program year, the domestic economy had continued to improve, mainly because of the broad revenue measures that had restored equilibrium to the public sector finances. Those measures, together with the generally prudent monetary policy and improved agricultural production, had helped to reduce the rate of inflation to 25 percent in 1984, compared with 53 percent in 1983. However, the depreciation of the exchange rate in the parallel market had spurred the growth in credit to the private sector, and the external current account deficit had risen from $104 million in 1983 to $200 million in 1984 as a result of an increase in both interest payments and imports.

While developments in 1984 suggested that the performance of the economy had generally improved, the authorities had recognized the need to support the adjustment momentum under the proposed stand-by arrangement, Mr. Salehkhou commented. Two of the most sensitive remaining issues were the need to strengthen the external position and the need to reduce the high rate of inflation to pave the way for economic growth. The staff projections for 1985-86, including balance of payments equilibrium and GDP growth of 2.5 percent, were based partly on the assumption that export receipts would grow by 6 percent in dollar terms and that a number of fiscal and monetary policy performance criteria would be met. However, meeting the criteria probably would be difficult, given Ecuador's external debt, high rate of inflation, and dependence on petroleum exports, the price of which had been declining for a number of years. Still, current estimates and the new concessions given to the state petroleum companies operating in the Guayaquil region suggested that there was room in Ecuador to increase petroleum production. In addition, agriculture was expected to recover from the flood damage sustained in 1983.

Agricultural products had traditionally accounted for a significant share of Ecuador's exports, Mr. Salehkhou continued. The projected decline in the external current account deficit in 1985 was based partly on the assumption that petroleum and agricultural production would increase, productivity would rise, and a close watch would be kept on cost and price relationships, thereby enabling Ecuador to take full advantage of its competitiveness. While the proposed stand-by arrangement provided for less commercial borrowing and tighter control of government expenditure, it would pave the way for a better credit standing and an increase in concessional lending. However, the staff's scenario for 1986-89 seemed unrealistic, particularly in the light of the assumptions on which it was based, including an improvement in exports, the provision of debt relief from official creditors, and an improvement in competitiveness through the exchange rate; in the light of the considerable uncertainty about the prospects for the world economy, the assumptions might well prove to be incorrect.

Ecuador had made good progress in 1983-84 in reducing its large internal and external imbalances, Mr. Salehkhou remarked, but the adjustment efforts must be continued to restore satisfactory economic growth and gain a viable balance of payments position. In the circumstances, Fund support was needed, particularly as it, together with World Bank assistance, could help Ecuador to reschedule its commercial bank debt in an equitable fashion, thereby alleviating the pressure on the external position, something that was a precondition for improving the medium-term outlook for the economy. In the light of the good progress the authorities had made thus far, the proposed decision was acceptable.

Mr. Goos said that he, too, believed that Ecuador had made good progress under the previous stand-by arrangement, and that the proposed stand-by arrangement constituted an important step toward achieving a more balanced and viable overall economic position. The draft decision was acceptable.

The increase in Ecuador's outstanding Fund credit to 231 percent of quota under the proposed stand-by arrangement seemed justified, given the strength of the country's adjustment record, its balance of payments need, and the authorities' continued commitment to adjustment, Mr. Goos continued. At the same time, acceptance of the proposed stand-by arrangement would greatly reduce the scope for further Fund assistance in later years. That fact underscored the need to maintain and, wherever possible, strengthen the stabilization effort. Moreover, the staff had noted that the rescheduling arrangement tentatively agreed between Ecuador and the commercial banks was based on the assumption that another stand-by arrangement would be adopted for 1986. In the circumstances, he wondered whether it would not have been more advisable to consider a multiyear arrangement for Ecuador, under which the Fund could have economized on the resources made available to Ecuador by spreading them over a longer period, and the emphasis on structural adjustment measures could have been increased. He also wondered whether the tentative arrangement with commercial banks implied that management had already pledged Fund resources in support of the 1986 rescheduling operation, and whether there were any understandings between management, the commercial banks concerned, and the authorities about enhanced surveillance of Ecuador's economy after 1986.

The commitment to continue implementing prudent demand management policies under the proposed stand-by arrangement was impressive, Mr. Goos commented. Such policies had also been stressed under the previous adjustment program, and the authorities had achieved an exceptional turnaround in the fiscal position. However, it was somewhat disappointing that the turnaround had not led to a similar improvement in the external accounts and was unlikely to do so in the coming period. Indeed, the external current account gap had approximately doubled since 1983, the trade account surplus had stagnated, and external arrears had re-emerged in the second half of 1984.

The external sector's disappointing response to the demand management policies might be an indication that the degree of supporting structural adjustment under the previous program had been insufficient; accordingly, the greater emphasis on structural adjustment under the new program was welcome, Mr. Goos commented. He was particularly pleased that the import restrictions were to be eliminated and the exchange markets unified. Those steps should go a long way toward improving the efficiency of the domestic economy. Nevertheless, much more would have to be done, particularly in the light of the sluggish export performance. The staff report revealed a number of areas with persistent structural problems that had not been explicitly addressed under the proposed stand-by arrangement. He hoped that those problems would be dealt with soon; to that end, there must be close cooperation between the World Bank and the Fund. Given Ecuador's continued difficult external position, every effort should be made to encourage structural adjustment with a view to strengthening overall efficiency and nontraditional exports as well as to increasing domestic savings.

It seemed inappropriate to link public sector pricing policy to the overall fiscal performance, as suggested on pages 11 and 12 of EBS/85/25, Mr. Goos continued. He strongly agreed with the staff that positive real interest rates should be introduced as soon as possible. The authorities might be tempted to leave interest rates at present levels while waiting for the projected decline in the rate of inflation, but he doubted whether that projection was realistic, particularly in the light of the 18 percent devaluation that was likely after unification of the exchange rate. In the circumstances, a more active interest rate policy seemed warranted; indeed, the authorities had already authorized banks to issue certificates of deposit and freely determine the interest rate on loans financed by the proceeds from those certificates. While that step would certainly help to increase the flexibility of the interest rate structure, the authorities should move cautiously in linking lending rates to short-term interest rates: such action could easily pave the way for indexation of the credit system, with all its well-known adverse effects on the stability of both the financial system and prices.

The proposed stand-by arrangement seemed to represent a further step in the right direction, Mr. Goos concluded. However, the authorities would be well advised to reinforce their structural adjustment efforts, as positive results in that area would be in the immediate best interest of Ecuador and would strengthen the case for a follow-up arrangement.

Mr. Wicks considered that the authorities were to be commended on the successful completion of the previous stand-by arrangement. The prospects for economic growth and lasting improvement in the balance of payments were promising, if the authorities were resolute in implementing the adjustment measures in the new program. However, as the staff appraisal had clearly shown, external viability would remain crucially dependent on debt relief for at least the rest of the 1980s. Accordingly, developments in Ecuador would have to be carefully monitored by the authorities and by private and official creditors.

He welcomed the authorities' actions eliminating all external payments arrears to private creditors and some import restrictions, Mr. Wicks continued. Those steps had placed Ecuador roughly in the position that had been intended at the end of the previous stand-by arrangement.

He looked forward to the rapid unification of the exchange markets at a realistic exchange rate, Mr. Wicks remarked. That step, perhaps the most crucial element of the proposed program, should improve competitiveness--perhaps by as much as 18 percent--and hence the external position, but only if it were maintained over time. In that connection, the change in the intervention rate in September 1984, bringing it more into line with the rate in the parallel market, had been the first step in the right direction; thereafter, however, the intervention rate had been held unchanged, despite the decline in the parallel-market rate. The authorities should be urged to maintain much greater flexibility in the new unified rate to avoid eroding the benefits of the exchange reform.

The authorities were to be commended for having eliminated the public sector deficit in 1983 and 1984 and for planning to achieve a surplus in 1985, Mr. Wicks commented. However, part of the projected increase in government revenues was traceable to the effects of the expected depreciation of the exchange rate on oil export revenues, which were denominated in dollars. That fact underscored the crucial role of the exchange rate in the adjustment effort. The staff should comment on its confidence in the projected increase in oil prices and production, which were also expected to contribute to the rise in government revenues in 1985. The staff's medium-term projections underscored the sensitivity of the external position to assumptions about the oil market; presumably, the fiscal position was equally sensitive. Under the proposed program, the increase in expenditure was to be moderate, but he agreed with the staff that the pressures to increase expenditure were likely to be strong, and that the authorities would have to show great determination in resisting them.

The staff should comment further on the reasons for the projected strong growth in services and the decline in 1984 and 1985 in other private sector capital outflows shown in Table 6 of EBS/85/25, Mr. Wicks suggested. The authorities were to be commended for--and should be urged to continue--their efforts to substitute direct investment for commercial borrowing, and a further comment on their success in attracting investment in the nonpetroleum sector would be helpful.

He strongly endorsed the staff's recommendation to increase real interest rates to positive levels, Mr. Wicks remarked. The decision allowing banks to determine the interest rate on loans financed by the proceeds from certificates of deposit with market-oriented interest rates was a welcome first step in that direction. The authorities' decision to set the minimum amounts for those certificates at a high level in order to reduce their attractiveness suggested that interest rates elsewhere in the financial system were excessively low.

The rescheduling agreement with the commercial banks was an essential prerequisite to the new program, Mr. Wicks said. Furthermore, that agreement required a Fund-supported adjustment program to be in place in Ecuador in 1986 as well as 1985; thereafter, procedures for so-called enhanced Article IV consultations were to be applied. In principle, Fund involvement in the period after the end of a formal Fund-supported program was welcome, but the Executive Board should have the opportunity to discuss the precise format and content of the procedures for so-called enhanced Article IV consultations before management agreed on the details for such procedures with the Steering Committee of Ecuador's commercial bank creditors. His authorities would not object to the creditor commercial banks' receiving Article IV consultation reports if the Ecuadoran authorities so wished and provided that the banks clearly understood that the reports conveyed merely the views of the staff. The Executive Board's conclusions on Ecuador should not be reported to the banks. However, if the Paris Club approved a multiyear rescheduling agreement for Ecuador, his authorities would expect the Executive Board to play a more constructive role in establishing and evaluating the necessary conditions. The commercial banks were attempting to make their rescheduling agreement with Ecuador conditional on a Paris Club rescheduling, and his authorities regretted that effort in effect to force the terms of the Paris Club arrangements for Ecuador. Finally, the proposed decisions were acceptable.

Mr. Wijnholds considered that the proposed stabilization program was satisfactory. The performance criteria and required prior actions were significant and would require a considerable effort by the authorities. The size of the proposed arrangement was appropriate, and the draft decisions should be accepted.

He agreed with the authorities that the unification of the exchange rate should be the central element of the proposed program, Mr. Wijnholds continued. The good fiscal performance in 1983 and 1984 had been accompanied by a hesitant policy on relative prices, as the exchange rate adjustment had been insufficient, interest rates had not been sufficiently high to encourage efficient resource allocation, and the rate of increase in domestic gasoline prices had lagged behind the rate of inflation. Still, some important changes in those areas had been made, and further changes were envisaged. The unification of the exchange rate would entail a depreciation of the exchange rate by perhaps as much as 18 percent in real terms. The likely considerable effect of that adjustment on domestic prices underscored the importance of maintaining prudent fiscal and monetary policies in the coming year. In that connection, it was important to remember that the acceleration in the inflation rate to more than 50 percent in 1983 had been due partly to the depreciation of the sucre and partly to changes in administered prices; a recurrence of such a sharp increase in the rate of inflation should be avoided.

While arrears had been a problem in past years, Mr. Wijnholds noted, they had recently been eliminated, and the multiyear commercial bank rescheduling, new credits from the commercial banks, and the Paris Club rescheduling should enable Ecuador to avoid arrears in coming years. However, the staff projections included a balance of payments financing gap in 1990, after the multiyear consolidation period. The staff had mentioned that such a gap might require further debt relief, but that conclusion was inconsistent with the objectives of a multiyear rescheduling agreement; the expectation should be that, at the end of such an agreement, any financing gap would be covered by new, "spontaneous" borrowing. Ideally, a gap should not be allowed to develop.

Under the complex financial arrangements that had been worked out for Ecuador, a further stand-by arrangement was expected in 1986, Mr. Wijnholds observed. Moreover, the rescheduling operations were based on the assumption that procedures would be in place for enhanced Article IV consultations with Ecuador. The implications of those conclusions were not fully clear to him, particularly as the rescheduling operations were also based on the condition that Paris Club rescheduling would be available. In recent years, every country negotiating with the Paris Club had been required to conclude an upper credit tranche arrangement with the Fund; apparently, it was assumed that a series of such arrangements with Ecuador would be approved by the Fund.

The assumptions underlying the balance of payments and debt projections up to 1990 seemed reasonable, but he wondered whether the staff was correct in describing the assumed 3 percent annual increase in oil export volume as "conservative," Mr. Wijnholds commented. After all, although Ecuador was attempting to increase oil production, it was a member of OPEC, and that organization was maintaining a policy of production restraint. Indeed, OPEC had recently asked a Dutch accounting firm to audit the production and price data of its member countries. In addition, while foreign direct investment was projected to increase from $50 million in 1984 to $180 million by 1990, and the authorities were to be commended for actively promoting such investment, he wondered whether the projection was not somewhat overoptimistic. Finally, the staff should comment on the likely repatriation of capital by Ecuadoran residents in coming years.

Mr. Dallara said that he was pleased that the critical mass of the proposed financing package had been reached. During the discussion on Ecuador's previous stand-by arrangement, he had noted that Ecuador had made good progress in some areas of adjustment and he had expressed the hope that the authorities would reinforce the adjustment effort. They had generally done so, and economic performance had basically been reassuring, as there had been progress in restoring real economic growth, decelerating the rate of inflation, and containing the external current account deficit. The authorities' ability to maintain balance in the public sector accounts for the second consecutive year--due mainly to continued revenue growth--and the real effective depreciation of the exchange rate had played the key roles in that performance. However, the rate of inflation was still excessively high, monetary policy did not seem fully adequate, and the foreign debt burden was still large.

The external current account deficit had been the equivalent of 1-2 percent of GDP in 1983-84, and a similar deficit was expected in 1984-85, compared with ratios of 10-12 percent in 1980-82, Mr. Dallara noted. During the previous discussion on Ecuador, he had been worried that the import compression reflected in the significant cut in the volume of imports in 1983 had accounted for an excessively large share of the improvement in the balance of payments. The increase in the volume of imports by more than 5 percent in 1984 and the 4 percent increase expected in 1985 were encouraging. Indeed, the positive import growth in place of import compression in a number of countries was welcome. In Ecuador, the expected increase in imports together with the projected 10 percent rise in export volume in 1985 suggested that the improvement in the balance of payments might be sustainable. The import recovery was needed to sustain growth. At the same time, however, there had been a dramatic decline in private capital outflows, which had amounted to at least $300 million each year in 1981-83. The recovery of economic activity, the exchange rate depreciation, and the move toward less negative real interest rates had undoubtedly helped to improve the capital account and were evidence of Ecuador's enhanced creditworthiness.

The plans to unify the official and intervention exchange markets and to transfer all current transactions from the parallel market to the new unified market were welcome, Mr. Dallara commented. The authorities' commitment to a flexible exchange rate policy was encouraging; he hoped that the new policy would be consistent with the balance of payments targets and that in implementing it the authorities would not have to rely on exchange restrictions.

The medium-term outlook for the balance of payments, including foreign debt, suggested that, if adequate policies were maintained, the situation would be difficult but manageable, Mr. Dallara said. The balance of payments could be expected to remain vulnerable to unanticipated oil price developments. Success in encouraging the growth of foreign direct investment would cause a corresponding decline in the debt burden. In that connection, a reduction in the restrictions on foreign investment might be needed to improve the investment climate. In any event, foreign debt at the end of the 1980s would likely still remain high. The balance of payments projections were based on the assumption that generous debt relief from both foreign private and official creditors would be provided; to that end, continued strong economic adjustment efforts, with the Fund's cooperation, would be needed.

The staff had mentioned that at least 85 percent of the eligible debt service obligations falling due to Paris Club creditors must be rescheduled and that an agreement in principle had been reached in December 1984 between the authorities and the Steering Committee of the foreign commercial banks on rescheduling, Mr. Dallara remarked. Apparently, the agreement contained conditions concerning future debt relief from official creditors and the role of the Fund. He agreed with Mr. Wicks that such conditions were potentially counterproductive to Ecuador's adjustment efforts. No matter what the commercial banks might say about the need for additional debt relief from official creditors and Fund involvement in Ecuador's adjustment efforts, only the official creditors and the Fund could make the actual decisions. In formulating balance of payments financing programs, the staff should be careful about the assumptions that it made concerning debt relief. His authorities wished to see Ecuador's adjustment efforts and cooperation with the Fund continue. The staff should comment further on any understandings about the future role of the Fund in Ecuador.

The recent steps to eliminate the arrears with private creditors and terminate the remaining import prohibitions, and the authorities' commitment to unifying the exchange market and abolishing the prior import deposit requirement were welcome, Mr. Dallara said. However, he was disappointed that the minimum import financing and barter restrictions as well as the two bilateral payments agreements had not been fully eliminated. The staff had not recommended approval of the bilateral agreements, and he wondered why it had recommended approval of the minimum import financing and barter restrictions.

The staff could usefully comment further on the reasons for the sharp drop in the investment ratio between 1980-82, when it had averaged 25 percent of GDP, and 1983-85, when the average would be less than 16 percent, Mr. Dallara commented. He wondered whether the staff felt that an investment ratio of 16 percent was sufficient to sustain long-term economic growth, and, if not, which policies might be implemented to encourage domestic savings and investment. As to inflation, the planned decline in the average rate in 1985 to 20 percent seemed modest.

He wondered whether the insufficiently tight monetary policy--including the persistent negative real interest rates, despite the commitment to achieving positive rates at some point, and the credit expansion to the private sector of nearly 28 percent--might also have contributed to the rather slow deceleration in the rate of inflation, Mr. Dallara went on. The staff had mentioned that in 1984 special credit for the local currency counterpart of foreign debt payments taken over by the Central Bank from the private sector had been a factor in the growth of credit to the private sector, and he wondered whether that factor would be evident again in 1985. In assessing price performance, it would also be useful to know more about wage rate pressures, particularly in the light of the proposed 50 percent increase in the minimum wage. Progress had been made in containing wages, but additional progress would be helpful.

The turnaround in the financial position of the public sector had been impressive, Mr. Dallara remarked: the public sector deficit had been nearly 7 percent of GDP in 1982, but the sector was expected to achieve a surplus of almost 3.5 percent of GDP in 1985. However, as previous speakers had stressed, more than 80 percent of that shift was due to revenue increases. To some extent, the revenue gain was traceable to the more realistic exchange rate and domestic pricing policies. However, the authorities were apparently worried that the significance of traditional revenue sources had decreased in recent years, and he wondered whether the authorities had any specific plans to change the structure of the tax system in the longer run.

The authorities were to be commended for continuing the adjustment process following the completion of the previous stand-by arrangement in July 1984, Mr. Dallara concluded. Their record thus far had been impressive, particularly in restoring real economic growth, considerably reducing the rate of inflation from its peak in 1983, sharply cutting the ratio of the current account deficit to GDP, and maintaining approximate balance in the public sector accounts for two consecutive years. The authorities' commitments under the proposed stand-by arrangement led him to feel optimistic about developments in the coming year, and the proposed stand-by arrangement and the draft decision temporarily approving Ecuador's exchange and trade restrictions were acceptable. The authorities should be encouraged to continue their adjustment effort to maintain the process of restoring the confidence of private and official creditors.

Mr. Alhaimus commented that the authorities had made an active policy response to the difficulties that Ecuador had faced over the previous several years. A series of measures had been adopted in 1982 and 1983 in the exchange rate and fiscal areas. The Fund-supported program approved in mid-1983 had been adhered to, and commendable results had been achieved in 1983 and 1984 in the financial position of the public sector and the external current account. The monetary policy implemented in 1984 had contributed to the reduction in inflation to less than half the 1983 rate. Despite the emergence of arrears and the relaxation of credit policy in

1984, the overall adjustment policy record had been satisfactory, and the proposed program to address the emerging difficulties warranted the Fund's support.

The 1985 program objectives of balance of payments equilibrium, real GDP growth of 2.5 percent, and a somewhat lower rate of inflation were appropriately designed to achieve adjustment, growth, and stability, Mr. Alhaimus remarked. Fiscal policy would contribute to adjustment through the maintenance of strict control over public sector expenditure, a significant improvement in revenues, and the achievement of an overall surplus of 3.4 percent of GDP in 1985. The expected rise in overall outlays of the Central Government was understandable, as investment expenditure was needed to rebuild the infrastructure damaged by the severe floods and to maintain the present investment programs. The monetary program was appropriately aimed at achieving overall balance of payments equilibrium and at further reducing the rate of inflation. The main element of external sector policies was the set of exchange rate measures, and export performance was expected to improve owing to a rise in both oil and non-oil exports. He wondered whether the projected increase in the volume of oil exports in 1985 was expected to result from an increase in the productive capacity of the oil fields, which had been constrained in recent years.

Apparently, the external debt would be manageable in the medium term, assuming that, inter alia, the multiyear rescheduling arrangement agreed in principle with foreign banks were actually finalized, Mr. Alhaimus said. As the agreement for rescheduling the 1985 and 1986 debt required that a Fund-supported program would be in place in 1986 as well as 1985, he invited the staff to elaborate on the expectation of a further Fund-supported program for 1986. Finally, the proposed decisions were acceptable.

Mr. Romuáldez recalled that during the 1984 Article IV consultation discussions, in July 1984, many Executive Directors had been perplexed by, and concerned about, the authorities' reluctance to come to grips with structural problems, particularly through more flexible and realistic pricing policies. He was pleased that they had apparently overcome their reluctance and had begun to take some bold steps, for which they were to be commended. He was also pleased that the critical mass of commercial bank commitments had been reached, although the considerable debt management problems could be eliminated only through restraint in the public sector's use of foreign commercial borrowing and through strong and sustained export growth, which, in turn, would depend significantly on the demand and exchange rate policies.

The proposed decisions were acceptable, for two reasons, Mr. Romuáldez said. First, the new authorities had moved quickly to deal with the slippages that had occurred following the successful completion of the previous Fund-supported program. Second, the proposed program gave the authorities the opportunity to make many of the structural adjustments that Executive

Directors had called for during the 1984 Article IV consultation. The key features of the proposed program appropriately included a marked simplification of the exchange system, the maintenance of a flexible exchange rate policy, continued strict control over the operations of the public sector, and adjustments of the domestic prices of petroleum derivatives. Moreover, the new program contained a number of improvements over previous programs, such as an explicit timetable for the relaxation of various import and exchange restrictions. The authorities intended to eliminate all external arrears to private creditors by March 4, 1985 and all the remaining import prohibitions introduced in 1984 by February 28, 1985. He welcomed the authorities' commitments to unifying the official and intervention exchange markets, to eliminating the requirement introduced in October 1984 of advance payment for purchase of foreign exchange for imports, and to transferring all service transactions from the parallel market to the unified exchange market before the completion of the midterm review under the new stand-by arrangement. The performance criteria had been set well in advance, and the quantitative targets were to be adjusted in the light of developments. Accordingly, the only performance criterion that would have to be established at the time of the midterm review was the one for outstanding external debt in 1986.

He was particularly pleased that the authorities were no longer reluctant to adjust relative prices, Mr. Romuáldez continued. Under previous arrangements, an unduly large portion of the adjustment burden had fallen on fiscal policy. The authorities must actively maintain a flexible and realistic exchange rate policy. Given the large reductions in imports in recent years, export growth should be the main source of any substantial improvement in the trade balance in the coming period. One of the key assumptions of the medium-term scenario was that the authorities' commitment to managing the exchange rate in a flexible manner and to maintaining an appropriate level of external competitiveness would result in a 7.5 percent increase in the value of nontraditional exports.

While the 1985 program objectives of balance of payments equilibrium and a real GDP increase of about 2.5 percent were fully appropriate, the planned reduction in inflation of 5 percentage points, to 20 percent, seemed excessively moderate, Mr. Romuáldez considered. He wondered whether changes in administered prices and the adjustment of the exchange rate were expected to keep the rate of inflation from decelerating significantly. Did the staff believe that a significant reduction in the rate of inflation could be achieved only in the longer run? The staff had appropriately stressed that a prudent wage policy would have to be maintained if the authorities were to slow the rate of inflation, and a further comment on the likely wage policy in the coming period would be helpful. He wondered whether the policy was to be restricted to limiting the increase in public sector wages in 1985 to the projected rate of inflation in order to have a positive demonstration effect on the private sector.

According to the medium-term scenario, the adjustment policies were expected to result in a viable external position, Mr. Romuáldez noted. However, many of the assumptions behind the scenario concerned developments that were likely to be beyond the authorities' control, and, for that reason, the staff's sensitivity analysis was useful. The combined effect of lower oil prices and higher interest rates could create a financing gap equivalent to nearly 2 percent of GDP in 1986-89 and a gap exceeding 4 percent in 1990. The staff should comment on the authorities' room for maneuver in the event of any adverse developments, and on the likelihood of an agreement on contingency measures at an early stage. He wondered whether it would have been possible or desirable to specify at the time that the program had been formulated certain contingency actions that could be taken if economic developments were to diverge from the basic assumptions underlying the program.

Some aspects of monetary policy were fully appropriate, Mr. Romuáldez remarked. However, the authorities were still not prepared to permit real domestic interest rates to rise to positive levels comparable with rates abroad. However, the decision permitting the banking system to issue term deposits at market-determined rates had been a major achievement. He hoped that it had represented the first step toward a more flexible interest rate policy. The authorities should be encouraged to reduce their emphasis on protecting the profitability of savings institutions and to increase the effort to strengthen domestic savings and the external capital account.

Little progress had been made in dealing with the weaknesses in tax administration that had been identified during the 1984 Article IV consultation, Mr. Romuáldez commented. The staff should comment on the reasons for the delay in handling that problem. He wondered whether technical assistance would not be helpful.

The authorities should be encouraged to eliminate the remaining exchange restrictions, Mr. Romuáldez considered. The proposed approval of those restrictions and the multiple currency practices was acceptable, but the new program should have included steps that the authorities could take to eliminate the restrictions in the near future.

The staff's attempt to explain the proposed access of 70 percent of quota under the new stand-by arrangement was welcome, Mr. Romuáldez said. However, the explanation was too brief to meet the criteria established in the Chairman's summing up of the discussion on access at EBM/83/167 (12/2/83), and particularly the statement that "in bringing forward requests by members for use of the Fund's resources under the enlarged access policy, the staff will try to explain more fully how it had come to the access limits proposed in each case in the light of the framework that has emerged from the views expressed by the Executive Board." In that connection, the general points made by the staff on page 26 were helpful but did not fully explain why the staff favored access of 70 percent. For example, it was not clear to him whether 70 percent of quota was the amount that Ecuador had requested, or whether that amount was all that Ecuador could afford to add to its debt servicing, or whether the proposed amount was the maximum justified by the proposed degree of adjustment. Presumably, the proposed access could reflect a scaling down of Fund involvement in Ecuador following the higher level of access under the previous stand-by arrangement.

The authorities were to be commended for the steps that they had taken and were committed to take, Mr. Romuáldez concluded. While some of those steps appeared moderate to outsiders, they were clearly bold in Ecuador's circumstances and augured well for the future. The authorities should be able to move ahead more forcefully in the coming period.

Mr. Wang said that he accepted the proposed decisions. The staff should comment further on the likely cooperation between the Fund and Ecuador in coming years.

Mr. Fujino said that he shared the concern expressed by Mr. Wicks and Mr. Dallara about the conditions attached to the debt rescheduling negotiations between commercial banks and Ecuador.

The staff representative from the Western Hemisphere Department commented that the size of the fiscal surplus under the proposed program and the policies to achieve it were consistent with the objective of maintaining an appropriate level of investment. At the time of the negotiations on the adjustment program, the World Bank had concluded that both the level and the composition of the investment program were adequate. The new investment program reflected the World Bank staff's earlier recommendation to increase the emphasis on export-oriented investment. Under the proposed program, the ratio of public investment to GDP was expected to increase.

The staff assumed that, in 1985, minimum wages would not be increased by more than the expected rate of inflation, which would constitute a deceleration in wages compared with 1984, the staff representative said. Salaries had been declining in real terms during the previous three years, and the authorities had concluded that a more ambitious wage policy was not possible at the present stage. The Congress had not yet decided on salary increases for 1985. An increase of 50 percent had been proposed by the Congress, but the President had reaffirmed his intention to veto such a proposal if it were approved by the Congress. The authorities had proposed a 28 percent increase, which the staff felt was somewhat on the high side, given the expected average rate of inflation of 20 percent. The authorities believed that a 28 percent increase in minimum wages would not necessarily have significant adverse implications, partly because the increased rate would take effect only when the decision on it had been approved and would therefore not be applied over a full year; in addition, salaries above a certain threshold would not be raised. As a result, the average wage increase in the public sector was likely to be less than the 28 percent proposed. Private sector salaries were determined largely by collective bargaining, and the demonstration effect of public sector wages on the private sector underscored the need to keep civil service wages under control. The staff hoped that the increase in public sector wages would not exceed 20-24 percent.

The staff also hoped that the rate of inflation would decelerate in 1985, the staff representative noted. However, it was important to remember that the rate had already decelerated considerably in 1984, and that the rate in 1983 had been high mainly because of the damage to crops from heavy rains. The recovery of agriculture in 1984 had helped to slow inflation to 24 percent in that year. The rate of inflation was projected to fall to 20 percent in 1985, which seemed an appropriate objective, given the adjustments that were to be made in the exchange rate and in certain administered prices; for instance, gasoline prices had been increased by 66 percent in December 1984. A major policy effort in the monetary, fiscal, and wage areas would be required to achieve the desired deceleration of inflation and the other program objectives.

The ratio of public investment to GDP had declined in recent years, as the recession had caused financial difficulties that had led the Government to postpone selected investments, the staff representative explained. Private investment had also declined. The projection for aggregate investment of 16.5 percent of GDP in 1985 might well prove conservative. The authorities attached great importance to providing incentives to private investment. In that connection, much would depend on the appropriateness of the authorities' macroeconomic policies and on certain possible legal changes, for example, in the provisions of the Andean Pact governing remittances of profits by foreign investors. In the past, those provisions had had a negative effect on foreign investment in Ecuador, and the authorities were seeking to change them. The authorities were also promoting major investments in the oil sector. A number of foreign companies were exploring for oil; in earlier years, foreign companies had not been permitted to explore for oil in Ecuador. Given the present productive capacity in the oil sector, the authorities should be able to increase output even within the limits recommended by OPEC. While the domestic price of gasoline had been increased, the staff expected a decline in the prices of crude oil and refined petroleum exports in 1985. The authorities had recently stated that they felt that the oil price projections were still realistic. The price of crude oil might well be slightly lower than projected, and the volume of oil exports might be slightly larger. The authorities felt that the projected volume of oil exports in 1985 seemed realistic even in the wake of recent price developments. The average projected increase in oil prices in the medium term contained in the staff paper on Ecuador was much lower than the projection in the latest World Economic Outlook exercise.

The staff did not believe that the projected increase in private investment and other services was excessively optimistic, the staff representative said. The staff expected a relatively moderate increase in terms of GDP--from approximately 0.7 percent to 1.2 percent--by 1990. In that connection, much would depend on interest rate policy and the various policies designed specifically to attract foreign investment. Given the efforts that had been made to encourage investment, particularly in the oil sector, an increase in private investment in coming years was likely.

The staff agreed with Executive Directors who had stressed the need for structural adjustments in the coming period, the staff representative commented. However, it was important to remember that the authorities had taken office only fairly recently. They had concluded that they needed more time to formulate structural adjustment measures, and that they would be in a better position to introduce a structural reform package after the proposed one-year stand-by arrangement. The Fund and World Bank staffs had been working closely together to review the investment program in general, and its structural elements in particular, and they would continue to do so in the coming period.

The authorities had not made substantial progress in improving tax administration, the staff representative observed. The new Government was reviewing the situation and was determined to improve collection procedures. In that connection, there might well be room for technical assistance. It was too soon to say with any certainty whether or not reforms of the tax system were likely or necessary in coming years. However, a number of measures affecting traditional taxes had been introduced under the previous Fund-supported adjustment program. In the coming period, efforts in that area of taxes should stress the need to improve the collection mechanism.

The staff had not been involved in the negotiations between the authorities and the commercial banks on the multiyear rescheduling agreement that had resulted in a requirement that there be rescheduling under the Paris Club in every year of the period covered under the arrangement with banks, the staff representative explained. The staff's medium-term projections did not include any debt relief from the Paris Club. Any such relief would of course improve the balance of payments outlook through 1990. The balance of payments estimates for 1985 also did not include Paris Club debt relief; accordingly, the estimates included a balance of payments gap of $136 million. Ecuador was on the Paris Club agenda for late April 1985.

The authorities clearly believed that, once the exchange rate had been unified, exchange rate policy must be flexible to ensure that adequate competitiveness would be maintained, the staff representative remarked. The 18 percent depreciation mentioned in the staff paper was based on price assumptions made earlier, including the relationship between the U.S. dollar and other currencies. Those factors had changed somewhat since the original staff calculations, and the rate of depreciation following the unification of the exchange rate might well be somewhat less than 18 percent. Exchange rate policy would be carefully examined during the midterm review, when the staff and the authorities might well reach further agreement on appropriate exchange rate policy steps.

The introduction of certificates of deposit with market-determined interest rates was an important step forward, the staff representative considered. The staff hoped that the authorities would reduce the minimum denomination of those certificates and step up their effort to introduce a more flexible interest rate policy. The authorities clearly intended eventually to introduce a fully flexible interest rate system.

The outflow of private capital had declined in 1984 compared with the previous several years, the staff representative remarked. Moreover, the staff and the authorities expected that the implementation of the proposed program would increase confidence in the private sector, thereby helping the private capital account to improve further. They hoped that the overrecording and underrecording of transactions in the past, when the difference between the exchange rates had been substantial, would be reduced in the coming period. The unification of the exchange rate and the maintenance of a more realistic exchange rate for the bulk of import and export transactions should have a positive effect on the capital account. The improvement in the services account in the recent past was due mainly to tourism and the effects of the improvement in the trade account, as the increase in exports had helped to bolster direct services, particularly shipping.

The Deputy Director of the Exchange and Trade Relations Department said that the staff believed that the explanation of the proposed access for Ecuador in the staff appraisal was consistent with the four main points that the Chairman had made in his summing up of the discussion on access at EBM/84/35 (9/5/84). The assessment of access in individual cases was not a mechanical process. Rather, the staff gauged the record and magnitude of a member country's outstanding use of Fund resources, the authorities' ability to implement the required policies, the size of the balance of payments need, the strength of the adjustment effort, and the likely speed of adjustment. Ecuador was making a substantial adjustment effort and would probably be able to restore external balance in a reasonably short period, but it was not likely to be able to do so by the end of the proposed stand-by arrangement. The access proposed for Ecuador was not as limited as the access given to countries that were expected to take a fairly long time to restore viability to the external accounts and for which Fund approval of a stand-by arrangement was required mainly to catalyze financing from other sources. Nor was the proposed access as large as might be suggested for countries expected to complete their adjustment by the end of their arrangement with the Fund.

Negotiations on stabilization programs were inherently difficult, and seeking to formulate, in addition, contingency plans to deal with unforeseen events tended to compound the difficulty, the Deputy Director observed. In many instances, the authorities viewed contingencies as giving rise to additional resource needs, while the staff tended to think that the requirement was instead for adjustment measures beyond those included in the program. As a norm, the staff felt that a package of adjustment measures under a stand-by arrangement together with the agreed reviews under the arrangement were sufficient to enable the authorities to handle most contingencies. Indeed, that seemed the best approach because it gave the authorities and the staff the opportunity to formulate additional measures in the light of a current problem, the precise dimensions of which could be examined in detail; the alternative was to try to foresee a problem that might or might not arise and the dimensions of which could only be guessed at.

Ecuador's bilateral payments arrangements contained discriminatory features, and the staff was not recommending approval of them, in line with Board policy, the Deputy Director remarked. Approval of the exchange restrictions and remaining multiple currency practices had been recommended, also in line with Board policies, on the ground that they were temporary; in particular, implementation of the proposed program should eliminate the need for those restrictions. The draft decision proposed that the restrictions be approved for a specific period, at the end of which the Executive Board would have the opportunity to review the implementation of the program and, if the restrictions had not been eliminated, to consider whether or not they should be approved for a further limited period.

There had been no commitment made to provide additional Fund resources in the period after the proposed stand-by arrangement, the Deputy Director of the Exchange and Trade Relations Department concluded. The staff's long-established practice was to avoid discussing use of Fund resources beyond the period of a member country's arrangement with the Fund. Nor was the Fund committed at present to conducting enhanced consultation discussions with Ecuador. The Executive Board was scheduled to consider the general subject of enhanced surveillance on March 22, 1985. If specific procedures for enhanced surveillance were approved at that time, they could of course be applied to Ecuador in the period after the proposed stand-by arrangement, if that were deemed appropriate. Like a number of Executive Directors, the staff was somewhat concerned about the specific nature of the reference made by the commercial banks to the terms of the debt rescheduling under the Paris Club. However, the Paris Club was expected to take up Ecuador's debt in the near future, and the terms and outcome of the negotiations would depend entirely upon the participants in the exercise, namely, the official creditors and the representatives for Ecuador.

Mr. Robalino commented that the authorities were under pressure to increase wages. However, they were determined to ensure that the increase in the minimum wage was consistent with their efforts to solve the financial problems in the public sector.

The authorities were encouraging foreign investment, Mr. Robalino continued. The Government had recently signed contracts with various companies to undertake exploration for oil in Ecuador. The authorities were also seeking foreign investment in other sectors.

The authorities had asked the Paris Club to consider a multiyear rescheduling agreement, Mr. Robalino said. They hoped that the proposal would be accepted in the coming period.

The Executive Board approved the following decisions:

Stand-By Arrangement

1. The Government of Ecuador has requested a stand-by arrangement for a period of one year from March 11, 1985 in an amount equivalent to SDR 105.5 million.

2. The Fund approves the stand-by arrangement set forth in EBS/85/25, Supplement 2.

3. The Fund waives the limitation in Article V, Section 3(b)(iii) of the Articles of Agreement.

Decision No. 7926-(85/39), adopted
March 11, 1985

Exchange System

1. The Fund approves the multiple currency practices arising from the multiple rate system and from the advance import deposit requirement, the exchange restrictions involved in the minimum financing or barter requirement for imports, and the exchange restriction giving rise to external payments arrears until the completion of the midterm review contemplated under paragraph 4(f) of the stand-by arrangement or July 31, 1985, whichever is earlier.

Decision No. 7927-(85/39), adopted
March 11, 1985

3. OMAN - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Oman (SM/85/47, 2/11/85). They also had before them a report on recent economic developments in Oman (SM/85/64, 2/25/85).

Mr. Finaish made the following statement:

The principal objective of the economic strategy that has been followed in Oman is to promote diversified growth while maintaining financial stability. The rapid increase in revenues from the main resource--oil--prior to 1982 permitted the authorities to undertake substantial investment in infrastructure, manufacturing, mining, and oil exploration. As a result, economic growth accelerated, and notable progress was achieved in diversifying the non-oil economy. Despite the rapid increase in expenditures, large financial surpluses were recorded, most of which were assigned to a reserve fund for future use.

The weakening of the international oil market in recent years has slowed down the pace of growth from the high levels of earlier years. However, the economy has continued to grow at a fairly brisk pace. During the two years 1983-84, while oil export prices fell, oil production increased at an average rate of about 10 percent. In the non-oil sector, the average growth rate of nominal GDP during this period is estimated at 14 percent, while domestic prices are estimated to have declined at a rate of 3-5 percent. This pace of growth is expected to be broadly maintained in 1985.

Progress has continued to be made in strengthening and broadening the production base, particularly in the industrial field. Efforts to find new oil resources and enhance recovery methods raised Oman's proven oil reserves by at least one third during the two years 1983-84. Oil production capacity also increased, as a result of pipeline expansion. The oil refinery that began operations in late 1982 is currently able to satisfy domestic demand for virtually all refined products, and some surplus is being exported. Oman's industrial base was also strengthened by the establishment of a copper smelter, two cement plants, and the mining of chromite ore. The implementation of the second Five-Year Plan (1981-85) has proceeded with considerable success. Development spending over the first four years exceeded the Plan target by about 6 percent. At the same time, the private sector has been encouraged to increase its role in productive investment, especially in manufacturing. The development of needed infrastructure and the maintenance of financial stability and liberal trade and exchange policies have established a favorable environment for that purpose. The emphasis on greater private sector participation is to be further increased under the Third Plan (1986-90).

Fiscal policy assumes particular significance in Oman in view of the large influence that government net domestic spending exerts upon growth in the non-oil economy. The drop in oil prices since 1982 has led to a sharp slowdown in oil revenue growth and to the emergence of a fiscal deficit. The authorities have responded with several measures with the objective of cushioning the impact of the fall in oil prices on the fiscal position while maintaining an adequate rate of growth of development-related expenditures. On the revenue side, oil production was raised. In order to increase non-oil revenues, upward adjustments were made in certain taxes and fees. As a result, these revenues grew by 25 percent in 1983 and 30 percent in 1984. On the expenditure side, the rate of increase was reduced by subjecting expenditure decisions to closer scrutiny and by identifying areas where economies could be made. A further significant reduction in expenditure growth is planned in the current year. The budgetary position has also benefited from a general avoidance of subsidies. The authorities intend to continue to seek ways of expanding non-oil revenues and to exercise an appropriate degree of restraint on expenditure growth. They plan to keep foreign commercial borrowing to a minimum and to try to avoid it altogether during the Third Plan period.

Monetary expansion has been on a declining trend over the period 1982-84, owing mainly to the slowdown in the growth of government expenditures. The growth of credit to the private sector, however, has so far not been affected by the lower rates of growth of nominal non-oil GDP. While interest rates continue to be subject to ceilings, the authorities are considering allowing greater flexibility in the movement of the rates. For the present, the existing level of ceilings could be regarded as appropriate, considering both the current international rates and the domestic price situation. With respect to the authorities' policy of promoting sound banking practices, several new measures were taken over the past two years.

The slowdown in oil revenue growth is also reflected in the external position. Both the current account and overall surpluses fell in 1983 and 1984. Another factor contributing to this outcome was the continued rapid increase in foreign workers' remittances. The adoption of a restrained public expenditure policy and the coming on stream of the oil refinery have served to moderate import growth, though, Oman being an open and growing economy, the expansion in non-oil imports remains sizable. In 1985, as a result of a further tightening of the fiscal stance, and assuming no further drop in oil prices, the overall balance of payments is projected to remain in surplus, although the current account could show a deficit. Oman's debt service ratio is relatively low, and its reserve position remains comfortable.

Because of its peg to the dollar, the rial Omani has appreciated in nominal effective terms in the recent period. However, since the domestic price level fell significantly over the same period, the authorities estimate that no significant appreciation may have taken place in real effective terms, although data limitations render precise estimation difficult. The authorities recognize the role that the exchange rate can play in the promotion of existing and potential export and import-substitution activities.

Mr. Suraisry said that the authorities were to be commended for their good management of the economy. They had maintained an active policy of diversification, had responded quickly to changes in the world economy, and had implemented their development program in a cautious manner. As a result, Oman had enjoyed both growth and financial stability.

During the previous several years, the economy had grown at impressive rates owing to the sustained growth in crude oil exports and the authorities' efforts to increase the share of the non-oil sector in GDP. The various manufacturing projects that had recently been completed had contributed to the diversification of production and to the efforts to increase the standard of living of the Omani people.

However, Mr. Suraisry went on, investment in agriculture and fisheries under the Second Development Plan had been below the projected amount. There might well have been compelling reasons for the shortfall, but those sectors were important; they were likely to make a significant contribution to the diversification effort. Oman's potential in agriculture and fisheries--particularly the latter--was considerable, and the time was ripe to pay more attention to exploiting it, particularly in view of the completion of the large manufacturing projects and the new emphasis on small-scale projects. The authorities were aware of the importance of agriculture and fisheries, and he hoped that they would emphasize them under the new development plan.

In the fiscal policy area, the authorities had clearly demonstrated their ability to react quickly to unforeseen developments, Mr. Suraisry remarked. For example, when actual revenues deviated from the original assumptions under the 1983 budget, the authorities had introduced several measures to increase revenues and reduce spending. At the same time, however, as the authorities recognized, spending had grown steadily and had exceeded budgetary receipts. As a result, the reliance on foreign commercial borrowing had increased, and the debt service ratio had grown. The present level of reserves was comfortable, and Oman would have no difficulty in meeting its financial obligations, but, if present trends continued, they might well complicate the management of the economy. Given the uncertainty about oil receipts in the coming period, it was essential for the authorities to reduce the growth in government expenditure.

The prudent economic and financial policies that the authorities had been maintaining should dispel all doubt about their ability to correct the weakness in the fiscal accounts, Mr. Suraisry continued. Indeed, the authorities had already indicated that the increase in government expenditure under the 1985 budget should be kept to 5 percent, and that they did not intend to rely on additional external commercial borrowing in the period of the Third Development Plan. Those steps were clearly welcome.

The balance of payments had been weakened by the reduction in oil prices and by the growth in payments for imports and remittances, Mr. Suraisry observed. After being in surplus for several years, the external current account was estimated to have been roughly in balance in 1984 and was projected to record a deficit in 1985. However, the tighter fiscal policy that the authorities intended to implement in 1985 should help to strengthen the external sector.

The members of the Gulf Cooperation Council (GCC) were making vigorous efforts to coordinate their economic and financial policies, particularly exchange rate, trade, and fiscal policies, Mr. Suraisry remarked. A major objective of the GCC countries was to encourage and expand the role of the private sector in the development process. He was confident that Oman, like other GCC members, would continue to maintain appropriate economic and financial policies within the framework of the effort to improve coordination among the GCC countries.

Mr. Abdallah noted that Oman was located in a strategic region where violent conflict had been raging for four years, casting a shadow over the whole area and affecting the current requirements and future prospects of the GCC countries. Expenditure on defense and security had sharply increased in all those countries, where efforts were nevertheless being made to reduce the role of government in their economies.

Oman had enjoyed the beneficial effects of the oil boom and had established a strong and growing economy, Mr. Abdallah continued. Since 1982, the authorities had made commendable progress in adjusting to the changing prospects for the economy. However, a great deal remained to be done, and room for maneuver still existed.

The fiscal position had been steadily eroded as a result of the increase in spending and the stagnation or relatively small increases in revenues, Mr. Abdallah commented. The 1983 budget deficit had been equivalent to 0.3 percent of GDP, despite the doubling of the import duty to 4 percent and the sale of some government assets. Although the rate of growth in expenditure had been reduced and some resources of the State General Reserve Fund had been used, the authorities had had to resort to borrowing in the Euromarket to finance the deficit. The fiscal position had significantly weakened in 1984; the budget deficit had been estimated at about 3 percent of GDP, and the authorities had again resorted to external commercial borrowing to finance it, even though they had also used additional resources of the State General Reserve Fund and had sold additional government assets. A similar budget deficit was expected in 1985.

It was clear that the authorities had not yet gained a firm grip on expenditure, Mr. Abdallah went on. They had sought to reduce the rate of growth of expenditure instead of making real reductions in expenditure. That approach had not worked, and tougher measures should be taken forthwith. The devices that had enabled the authorities to avoid expenditure cuts were becoming less useful. In that connection, the number of government assets that could be sold had been reduced, further recourse to Eurodollar borrowing for general budgetary purposes could have serious adverse effects on the balance of payments, and the use of the State General Reserve Fund to finance the deficit was inconsistent with the purpose of that fund.

The authorities were to be commended for evincing their strong commitment to development and for maintaining a capital budget that had consistently been equivalent to 25 percent of total expenditure, Mr. Abdallah said. In many other countries, expenditure reductions had been concentrated in the capital budget, a practice that the Omani authorities had carefully avoided. Recurrent outlays in Oman should be reduced, and additional efforts should be made to raise revenue from domestic sources. The corporate tax on enterprises owned by Omani citizens was relatively low--15 percent--and could be raised, and expenditure taxes on nonessential items could be introduced. He wondered why the Central Bank had not transferred profits to the Treasury in 1982. Such transfers would certainly have improved the budgetary position, perhaps reducing or eliminating the small deficit that had been registered in 1983.

The continued rigidity in domestic interest rates was regrettable, Mr. Abdallah remarked. The authorities set the maximum rates that could be paid to depositors and charged to borrowers. They maintained that that practice was needed to encourage business investment and other activities. However, because the interest rates paid to depositors were not seen to be sufficiently remunerative, holders of surplus funds tended to transfer them outside the country; at the same time, they tended also to borrow at low rates from domestic banks. The Central Bank used administrative controls on commercial bank operations to prevent that undesirable transfer of savings, but their efforts had not been effective, and he agreed with the staff that the best solution was to permit interest rates to be determined by the market.

The rial had appreciated by 14 percent in nominal effective terms in 1982-84, Mr. Abdallah noted. That trend was unwarranted and should be corrected.

The external current account and overall external balance had deteriorated rapidly in 1980-84, Mr. Abdallah observed. The occasional external surpluses had been due mainly to official capital inflows in the form of grants and external borrowing, most of which had been loans raised on commercial terms. The persistent recourse to deficit financing from external sources had doubled Oman's external debt in 1982-84. At the same time, debt service payments had risen to the equivalent of 6 percent of export proceeds and were expected to increase to 8 percent in 1985. Debt service payments would increase further when the amortization grace period under the first Euroloan expired in 1987.

The staff reports did not contain medium-term balance of payments projections, Mr. Abdallah commented. However, there were indications that in coming years the current account would record only small surpluses or would move into deficit, and that the authorities might have to continue to resort to external borrowing to service the debt or might have to draw down the reserves. In that connection, it was important to note that, as the staff had consistently stressed, the errors and omissions item of the capital account clearly showed that the private sector had been exporting capital for many years. That trend might well be due partly to the unattractive domestic interest rates and partly to the discomfort caused by the conflict in the region and the overvaluation of the rial, which encouraged Omani citizens to export their savings and to borrow from local banks at low interest rates. The authorities must face that problem and take appropriate steps to encourage the private sector to strengthen the balance of payments instead of continuing to weaken it. The authorities had adopted a number of appropriate policies, and he was confident that they would heed the Executive Board's policy advice.

Mr. Msadek remarked that, in comparison with the other smaller member countries in the Persian Gulf, Oman had maintained cautious and stable economic policies. While all those countries had depended significantly on oil export revenues, Oman had had more success in diversifying the economy in response to the falling international petroleum prices and in recognition of the depletable nature of the oil resources.

In 1979-80, the increase in oil prices had supported an economic boom in Oman, as the fiscal surplus had reached the equivalent of 11 percent of GDP and government outlays on the development of the non-oil sector had grown by 30 percent, Mr. Msadek continued. Recognizing the vulnerability of the oil sector, the authorities had made an early commitment to diversifying the economy. That commitment was reflected in the Second Five-Year Plan, which stressed expansion of infrastructure and public services, the development of manufacturing and mining, and improvements in education to pave the way for an increase in the role of the private sector, which was being encouraged to undertake the major productive functions in the economy. Events in 1982 had shown the wisdom of the authorities' commitment, as oil prices and export earnings had continued to fall. The subsequent development of new oil fields had restored production to its regular level of 300,000 barrels per day. Nevertheless, the authorities had approached the 1984 budget in a cautious manner, limiting spending growth to 13 percent, half the rate of previous years. With the decline in government expenditure and in import prices, owing to the rising value of the dollar and the peg of the rial to the dollar, the rate of inflation had fallen to an estimated 5 percent in 1983 and 1984. At the same time, the reduction in imports had caused reserves to increase to the equivalent of 17 months of 1983 imports and one year of projected 1985 imports.

The persistent decline in world oil prices had led the authorities to focus their attention on formulating additional appropriate policies for the oil sector, the budget, and the external accounts, Mr. Msadek observed. Bearing in mind the Executive Board's recommendations during the 1983 Article IV consultation to approach cautiously any expansionary policies in the medium term, and pending the growth and full development of the non-oil sector, the authorities had stressed the importance of identifying new petroleum sources, developing methods for recovering oil from old fields, introducing a program of gas exploration, and levying duties on nonessential goods. Their efforts had succeeded, as oil reserves had increased to the equivalent of a 25-year supply at current production rates; and refining capacity, which had covered domestic needs, was to be expanded. In addition, copper smelting had begun to make a contribution to exports, and the two cement factories had met half the country's construction needs. Considerable attention had been paid to the development of agriculture and fisheries, but the growth of that sector had been relatively slow owing to difficulties in implementing projects. Still, the authorities had implemented a number of new projects, and development expenditures had exceeded the original target by 6 percent. Accordingly, despite efforts to limit spending and improve revenue performance, the fiscal deficit was estimated to have reached 5 percent of GDP in 1984, compared with 0.3 percent in 1983.

The authorities had undertaken a Eurodollar bridging loan of $300 million to cover the budget deficit, Mr. Msadek continued. The debt service burden had been the equivalent of 3 percent of exports in 1982 and was expected to rise to 8 percent in 1985, when a new Eurodollar loan of $400 million was to be negotiated. As a result of the growing debt service burden, the declining oil export receipts, and the trend in public finances, the balance of payments surplus in 1983 had been the smallest since 1979; in 1984 the external current account and the overall balance of payments had weakened further. The balance of payments outcome in 1985 would depend upon the degree of moderation in fiscal policy and on the level of international oil prices. Given the continued weakening of oil export prices, a current account deficit seemed likely, unless imports were restrained.

The external debt had doubled in 1982-84, reaching $1.7 billion, but reserves had risen to $3.7 billion, the equivalent of one year's imports in 1985, Mr. Msadek remarked. Given the authorities' cautious policy stance, developments in 1985 and beyond were likely to include reasonable control of expenditure growth, development of new oil revenue services, and a reduction in subsidies and duties on certain goods following the significant rise in disposable income in recent years. The authorities should be able to maintain reasonable economic growth while halting the growth in external debt. The authorities hoped that, in the longer run, private sector development would encompass export industries, thereby alleviating the country's dependence on the oil sector.

Mr. Templeman commented that, like a number of other countries, Oman had had to adjust to the less buoyant conditions in the oil market. The comfortable level of proven reserves together with the accumulation of foreign currency holdings provided a degree of insurance against future unexpected developments, but that should not cause the authorities either to reduce their adjustment and development efforts, or to fail to pay sufficient attention to the medium-term outlook. Indeed, the budget and balance of payments had been deteriorating over the previous several years. The fiscal imbalance was equivalent to about 5 percent of GDP, and the external current account was likely to record a substantial deficit in 1985. As the staff had noted, there was a close link between an expansionary fiscal policy and the balance of payments in an open economy like Oman's.

Revenue growth had been steadily declining--even becoming negative in 1982--largely because of the fall in world oil prices, Mr. Templeman noted. Given the uncertainties about the oil market, the tax structure should be reassessed. At the same time, current and capital spending had grown at double-digit rates during the previous four years, and current spending as a proportion of GDP had been steadily rising. The authorities' wish to avoid serious cuts in development expenditure and the high priority given to current expenditure in education and health were understandable. However, in the light of both the slowing of the growth of revenues and the size of the budget deficit, the authorities must decelerate the growth of current spending. Development expenditure had been increased after the adoption of the Second Development Plan, and he wondered whether other unplanned expenditures were expected.

The use of commercial foreign borrowing to finance the budget deficit in recent years might have been reasonable, given Oman's previously low foreign debt, Mr. Templeman went on. However, the uncertainties about export growth, and the required amortization payments on earlier borrowing beginning in 1987, suggested the need for a cautious approach to additional borrowing. The Government's intention to avoid further commercial foreign borrowing to finance the budget deficit under the Third Development Plan should provide room for private sector borrowing, if necessary, to finance productive investment.

Money and credit to the private sector had grown by 10-25 percent in 1981-84, Mr. Templeman noted. While that rapid growth had not created strong inflationary pressures, it had reflected the weakening of the fiscal position and had probably contributed to capital outflows. In addition, the decision to eliminate direct capital subsidies from the budget seemed inconsistent with the practice of providing concessional lending to the private sector through the specialized banks. In addition, the limits on deposit and lending rates of 9.5 percent and 11.5 percent, respectively, seemed inconsistent with the domestic savings and investment objectives and with the openness of the economy to international capital flows. He agreed with the staff that the control of interest rates should be reduced.

The weakening of the balance of payments since 1981 had been striking, Mr. Templeman remarked: the current account had moved from a surplus of $1.3 billion to a likely deficit in 1985 of $350-400 million. The increase in oil export volume had stabilized the value of oil exports. At the same time, non-oil imports and remittances by workers in Oman had grown rapidly, while net investment income had declined. The negative errors and omissions item of $100-600 million per annum in the previous four years raised questions about the adequacy of domestic financial management policies.

He was pleased that the authorities were aware that excessively expansionary financial policies could jeopardize the achievement of their main objective of growth with financial stability, Mr. Templeman said. The authorities' proposed sharp reduction in the growth of fiscal spending in 1985, their willingness to re-examine interest rate policy, and their recognition of the need to keep exchange rate policy under review because of its effects on the competitive position and resource allocation, were positive signs. Still, it was not yet clear to him whether or not policy adjustments were being made quickly and forcefully enough to reverse the recent fiscal and balance of payments trends.

The authorities were to be commended on the limited number of trade and payments restrictions, Mr. Templeman considered. However, in 1982, they had introduced a prohibition on petroleum product imports that competed with the output of the domestic refinery, and in 1984, following the completion of a new cement plant, the authorities had imposed a 20 percent duty on cement imports.

He strongly agreed with the staff that the authorities should fill the statistical gaps, particularly the absence of national income accounts in constant prices and of a comprehensive price index, Mr. Templeman said. Better price and cost data were particularly important for assessing the prospects for exports and import substitution.

The staff representative from the Middle Eastern Department explained that the staff had no additional information on the transfer of Central Bank profits to the budget.

Mr. Finaish remarked that oil was clearly the dominant factor in GDP growth, the balance of payments, and the budget. As a result, the changes since 1982 in the oil market, particularly the decline in oil export prices, had been reflected in Oman's budget and balance of payments.

While he agreed with Executive Directors that the authorities should maintain a cautious policy approach, the overall economic situation in Oman clearly was not alarming, Mr. Finaish went on. Although oil export prices had fallen, oil production had increased, and non-oil revenues had grown by 25 percent in 1983 and 30 percent in 1984. Moreover, the authorities intended to maintain their efforts to encourage non-oil revenue. On the expenditure side, the authorities had limited the growth of certain expenditure categories and tightened expenditure control. The growth of current spending had slowed significantly, while capital outlays had been maintained at what the authorities felt was an adequate level. Moreover, the budgetary position had benefited from a general avoidance of subsidies. Nevertheless, the budget had recorded a deficit, most of which had been financed through external commercial borrowing. The authorities had not wished to reduce significantly the level of international reserves and had wanted to establish and maintain a good credit rating in the financial market. Still, they were aware of the implications of commercial borrowing to finance the budget, and they intended to avoid any new such borrowing for that purpose during the 1986-90 planning period. At the same time, while estimated debt service ratio for 1985 had increased to about 8 percent, it was still relatively low, and the level of reserves, which was equivalent to more than one year's imports, remained comfortable. Approximately 15 percent of oil revenues were channeled to the reserve fund established in 1980, and the commercial borrowing planned for 1985 would strengthen that fund.

The interest rate ceilings were 9.5 percent on deposits and 11.5 percent on loans, Mr. Finaish noted. Given the decline in domestic prices, those ceilings translated into high real rates relative to international interest rates. Moreover, the authorities were considering adopting a system of flexible ceilings under which interest rates could move with, but would remain somewhat below, international rates. The main objective of interest rate policy was to maintain fairly stable rates while providing the private sector with credit at a reasonable cost in order to stimulate private sector development and activities. Over the medium term, the authorities intended to encourage private sector involvement in agriculture, fishing, and small-scale manufacturing. In that connection, the authorities felt that the Government should encourage the private sector by providing an adequate infrastructure, financial stability, and a free exchange and trade system, and there were indications that those efforts would be continued in coming years.

As to the exchange rate, Mr. Finaish remarked, despite the rial's appreciation in nominal effective terms, there was no evidence of a significant appreciation in real terms. In any event, the authorities recognized the need to take into consideration the competitive and allocative effects of the exchange rate in the areas of export promotion and import substitution.

The Chairman made the following summing up:

> Directors commended the Omani authorities on the progress achieved by the economy in recent years. The economy had been characterized by rapid growth, the completion of major diversification projects--although agriculture and fisheries clearly required attention--large increases in real incomes, and the maintenance of financial stability.
>
> Directors noted that, with a strong commitment to development, the authorities had sought to sustain economic expansion through significant increases in government expenditures, particularly for investment. With the weakening of the world oil market, however, there had been an erosion in the fiscal position. Directors, therefore, welcomed the authorities' intention to reduce expenditure growth substantially, particularly of current outlays, in 1985. They also considered that it would be timely for the authorities to consider measures to generate additional domestic revenue. Directors noted that the fiscal weakening had led to large commercial borrowings abroad. In view of the rising levels of debt service payments in the fiscal and external accounts, Directors welcomed the authorities' intention to avoid commercial borrowing for the budget after the current year.
>
> Directors observed that the current account and overall positions of the balance of payments have weakened in recent years. A current account deficit was forecast for 1985, and private capital outflows have been large in recent years. While

Oman's reserve position was comfortable, Directors commented, firm implementation of the cautious fiscal policy stance planned for 1985 should help to contain the erosion. The competitive effects of the exchange rate, which had appreciated in nominal effective terms in the recent period, must also be kept under review. According to Mr. Finaish's opening statement, while there was no clear evidence of an appreciation in real effective terms, the Omani authorities recognized the role that the exchange rate could play in the promotion of exports and import substitution.

Directors noted that the authorities intended to assign greater responsibility to the private sector for investment and growth of the economy. They observed that the country's liberal economic policies, financial stability, open trade regime, and membership in the GCC would be conducive to such an approach. In addition, it was considered that a freeing of interest rates would help resource allocation, permit the banking sector to play a larger development role, and reduce private capital outflows.

It is expected that the next Article IV consultation with Oman will be held by June 1986.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/38 (3/8/85) and EBM/85/39 (3/11/85).

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and an Advisor to an Executive Director as set forth in EBAP/85/57 (3/7/85) is approved.

APPROVED: December 19, 1985

JOSEPH W. LANG, JR.
Acting Secretary