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Minutes of Executive Board Meeting 85/97

10:00 a.m., June 17, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	K. Yao, Temporary
C. H. Dallara	D. C. Templeman, Temporary
J. de Groote	
	X. Blandin
	C. Flamant, Temporary
	T. Alhaimus
	M. Sugita
G. Grosche	B. Goos
J. E. Ismael	
R. K. Joyce	
	J. Hospedales, Temporary
	K. A. Hansen, Temporary
E. I. M. Mtei	A. Abdallah
	B. Jensen
	J. E. Suraisry
	G. Ortiz
	J. de la Herrân, Temporary
J. J. Polak	A. A. Scholten, Temporary
C. R. Rye	
G. Salehkhou	O. Kabbaj
	V. Govindarajan, Temporary
N. Wicks	
S. Zecchini	N. Coumbis
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. M. Oppenheim, Assistant

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Also Present

IBRD: W. Humphrey, Western Africa Regional Office. African Department: A. D. Ouattara, Director; P. A. Acquah, J. W. Kratz, E. van der Mensbrugghe. European Department: P. B. de Fontenay, Deputy Director; P. Dhonte, A. Leipold, K.-W. Riechel. Exchange and Trade Relations Department: C. F. J. Boonekamp, J. T. Boorman, S. Kanesa-Thasan, M. Xafa. External Relations Department: L. Peters. Legal Department: J. K. Oh, J. V. Surr. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. M. Ainley, E. A. Ajayi, H.-S. Lee, P. Péterfalvy, T. Sirivedhin, E. M. Taha. Assistants to Executive Directors: H. Alaoui-Abdallaoui, W.-R. Bengs, G. Biron, Bo T., A. K. Diaby, J. J. Dreizzen, G. Ercel, R. Fox, G. D. Hodgson, A. R. Ismael, S. Kolb, M. Lundsager, K. Murakami, A. Mustafa, W. K. Parmena, D. J. Robinson, J. E. Rodríguez, B. D. White.

1. LUXEMBOURG - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Luxembourg (SM/85/152, 5/24/85). They also had before them a report on recent economic developments in Luxembourg (SM/85/157, 6/3/85).

Mr. de Groote made the following statement:

My Luxembourg authorities are in agreement with the staff's thorough analysis of their country's economy. They attach great importance to the consultations with the Fund. In a tiny country like Luxembourg with a very open economy and a culture closely interwoven with that of its neighbors, the assessments of outside experts are received with much respect and interest and are carefully studied and discussed in political circles. Where found applicable, they are then translated into guidelines for policy formulation. And at some point during this whole process, the assessments are also shared with the public.

The year 1984 was a propitious one for the economy of Luxembourg; real GDP grew by 2.2 percent, although a drop of 1 percent had been expected. Helped by strong foreign demand, the steel industry, which accounts for 9 percent of GDP and more than 40 percent of exports, increased its output by 21 percent. The banking sector, one of the strongest pillars of the economy, contributing about 13 percent to GDP, also fared well; it grew only 2.6 percent in volume, but its profits appear to have increased substantially. These favorable developments compensated for the weakness of domestic demand, especially for services and construction. Moderation of import prices and the exchange rate stability of the Luxembourg franc permitted reduction of the inflation rate to 5.6 percent. The official unemployment rate of 1.7 percent did not change much, but total unemployment, which includes the idled steel workers aided by the "Division Anti-Crise" scheme, fell from 2.6 percent to 2.0 percent. Estimates of the current account position for 1984 indicate an increase of the surplus to 10 percent of GDP.

Because of its small size and openness, the economy of Luxembourg is obliged to adapt swiftly and thoroughly to changes in the world economic environment. Restructuring is an ongoing process; the most striking evidence is provided by the steel industry. In a little more than ten years, this industry's capacity and employment have been reduced by about half, while the technology of production has been modernized to become in many respects the most advanced in the world. At the same time, the product line has changed toward the most competitive products and exportable techniques. Such a massive adjustment would clearly have been impossible without a mutual understanding among all the social partners. The Government has played a crucial role in supporting this smooth but comprehensive adjustment process. The first phase, that of industrial adjustment, is now largely complete. That phase mainly involved aid to investment and the establishment of schemes to take care of shed labor. The second phase, now under way, is focused on financial adjustment. The Government's aim is to reduce the debt burden of the steel industry through interest subsidies, equity holdings, and progressive refinancing of the remaining debt through the state-owned Société Nationale de Crédit et d'Investissement using money raised on the markets with government guarantees. Commercial banks have also agreed to convert a large part of the steel industry's short-term debt into subordinated convertible bonds.

The Luxembourg authorities have traditionally preferred to finance budgetary expenditures out of ordinary receipts rather than resort to excessive borrowing. The aids to the steel industry were accordingly financed predominantly by raising the indirect value-added tax and introducing a direct "solidarity tax" surcharge on the income tax. The latest figures for the 1984 budget show a relatively large surplus of Lux F 1.8 billion in place of the expected deficit of Lux F 3.3 billion owing to revenues that were higher than projected. For the same reason it is now expected that 1985 will produce an even larger surplus. It might accordingly be thought that the time is now ripe to relieve tax pressures, especially on incomes, but the Government cautiously believes it wiser not to overestimate these recent favorable developments, and therefore prefers to seize this opportunity to replenish and increase its budgetary reserves in readiness for any additional major adjustments which may be needed. Tax pressures will therefore be progressively reduced only later on, in 1986/87.

Incomes policy in 1984 was affected by the very high 15 percent increase in steel sector productivity. This gain permitted hourly wages to be raised by a monimal 9.3 percent without loss of competitiveness. It was deemed proper, given these favorable developments, to at least partially make up for the sacrifices borne earlier by this sector's employees in the form of real income losses up to 25 percent. Also, general indexation of wages and salaries has been reintroduced since the beginning of this year, but in a more restrictive form that can be modified or suspended promptly if events dictate such a course. Indexation was resumed at the same level as when it was suspended in 1982, and there will be no attempt to make up the losses due to the suspension. One aim of the reintroduction of indexation was to bolster domestic demand, which has been quite sluggish, as shown inter alia by the stagnation of commerce and the further sharp decline in housing construction.

The banking industry, which, like the steel industry, is almost entirely exposed to external factors, has also undergone a thorough restructuring. After a slack period and the difficulties encountered in the area of international loan syndication, it was urgent that most of the 117 banks doing business in Luxembourg should diversify both their asset-and-liability and their off-balance-sheet product lines. They thereby succeeded in attracting new customers interested in their new services and have shifted the emphasis, which was mainly on wholesale banking, to a better mix of wholesale and retail banking. An important contributing factor to this success is the confidence enjoyed by the financial center, largely because of the authorities' approach to bank supervision which is carried out by the Institut Monêtaire Luxembourgeois. Bank supervision must meet special challenges in an offshore center. There must exist a sound combination of rules and regulations capable of coping with the great variety of special risks inherent in the conduct of international banking, while preserving the advantages offered by the center. In Appendix II of the report on recent economic developments, the staff has correctly assessed these factors, and has accurately reflected the authorities' view that since the number of banks based in Luxembourg will probably not increase, the present framework of banking activities and supervision will be adequate to preserve the sector's healthy functioning.

Luxembourg's level of official development assistance (ODA) is low compared with that of the other OECD countries, a fact of which the authorities are well aware and for which there are a number of reasons. One of these is Luxembourg's lack of an infrastructure sufficiently coherent for channeling development assistance; another is the grant element of Luxembourg's assistance. The composition of Luxembourg's ODA is about two-thirds multilateral and about one-third bilateral. The bilateral component is entirely made up of grants, and in addition the grant portion of the multilateral aid is very high because the configuration of Luxembourg's industrial production limits opportunities for procurement. Nonetheless, the authorities intend to increase their efforts, and legislation has recently been introduced to enlarge and streamline Luxembourg's development assistance infrastructure. A first step will be to bring under regulation governmental subsidies to nongovernment organizations dealing with development assistance; such subsidies could amount to as much as 200 percent of these organizations' own contributions to development projects. A second step will be the creation of two special funds. The first will gather together all yearly budgetary contributions and the contributions of local communes for development assistance. It will also receive, in due course, the contents of the second fund, which will accumulate the tax-deductible voluntary contributions from private donors, expected to include many banks.

Mr. Blandin observed that the most serious problem that appeared to have faced Luxembourg's economy a number of years previously--the restructuring of the steel industry--had been successfully confronted and the targeted reduction in productive capacity in that sector had been achieved. Moreover, diversification within the banking sector had limited the risk implicit in a reduction in importance of the steel sector that Luxembourg's economy might become overly dependent on a narrow set of extremely specialized skills. In addition, the creation of some 1,600 new jobs in the industrial sector during the previous two years had been extremely encouraging. Fiscal incentives or administrative simplification that promoted further diversification of the economy toward the industrial and services sectors would be helpful.

If the structural adjustments already initiated were to proceed smoothly, Mr. Blandin continued, two areas of concern had to be dealt with. First, on incomes policy, it was debatable whether it had been prudent to reintroduce structural rigidity in the economy through the full indexation of wages and salaries to the consumer price index. There also appeared to be some contradiction between the large real wage increases registered in the steel sector in 1984 and the further injection of public funds to relieve the financial burden on that sector. The authorities ought to steer a prudent course of action in that policy area, not only to preserve the competitiveness of the present industrial activities but also to attract much-needed new investment. Second, while prudence in the realm of fiscal policy was understandable during 1983 and 1984, it was not clear why such a restrictive fiscal policy should continue.

Since 1979, there had been a continuous upward trend in revenues as a proportion of GDP while the ratio of expenditures had slowly decreased, Mr. Blandin added. At 22.5 percent of GDP, Luxembourg had the highest rate of direct taxation in the European Community. Although the financial credibility of Luxembourg required that fiscal accounts be balanced in the medium term, there was certainly some room for maneuver and for a shift in the tax burden away from direct taxation. The level of ODA at 0.2 percent of GDP, though higher than the 0.12 percent registered in 1982, should probably be raised to a rate more in line with the average for industrial countries. Finally, given the outstanding performance of the economy, it was perhaps time to place Article IV consultations with Luxembourg on a two-year cycle.

Mr. Grosche said that he agreed with the staff's appraisal and in particular with its views on the incomes and fiscal policies of Luxembourg. The high share of foreign trade in the economy made Luxembourg's maintenance of international competitiveness crucially important. Given that monetary policy was severely circumscribed by the monetary association with Belgium, the burden of maintaining that competitiveness fell on incomes and fiscal policies.

The authorities should be commended for maintaining a prudent fiscal policy stance, Mr. Grosche stated. However, recent wage developments were a major source of concern. Since the productivity gains in 1984 were in part cyclical and since the outlook for the world steel industry did not provide a signal for a further jump in domestic output, it was regrettable that a general indexation of wages and salaries had been reintroduced. Although the system could be suspended if events so dictated, there were perhaps insufficient safeguards to prevent a substantial cost-push effect. A conflict could arise between the aim of maintaining stable exchange rates within the European Monetary System (EMS) and competitiveness if hourly wages continued to increase by the nominal 9.3 percent of 1984. In the steel sector, large increases in wages had been granted at the same time as the introduction of a new package of public aid. Those developments would raise the pressure for real wage increases in other sectors of the economy and it would not be surprising if the population became tired of paying further solidarity tax surcharges to support the steel industry.

He welcomed the intention of the authorities to pursue a policy of cautious fiscal management, Mr. Grosche said; he wondered whether there ought to be certain shifts in the structure of public expenditures and income. In particular, the large expenditures planned to reduce the debt burden of the steel industry juxtaposed to the continuation of solidarity taxes appeared to place a heavy burden on the shoulders of the tax-paying public. That could be reduced somewhat if the rise in wages in the steel industry were contained. To the extent that revenues from the temporary solidarity tax surpassed the resources needed for the steel industry, an early reduction in the tax should be envisaged.

The strengthening of bank supervision would help to ensure that the country's banking business maintained a stable share in Europe's financial markets, Mr. Grosche concluded.

Mr. Rye remarked that the Luxembourg authorities' economic policies and the performance of the economy were notable, especially considering the low level of unemployment and the rigorous efforts made to restructure the key industries of steel and banking. The one area of potential significant concern was incomes policy. While it was true that the return to indexation might contribute to the maintenance of social harmony and that there was a system of safeguards, which allowed for a partial suspension or modification of wage indexation should the need arise, it was nevertheless doubtful whether the return to indexation had been an appropriate development. It seemed particularly questionable in the light of the recent rising pressures for real wage gains, particularly in the steel sector, which dimmed the prospects both for further necessary adjustment and for attracting new business ventures.

He questioned the need for a regional policy in a country as small as Luxembourg, Mr. Rye commented. He asked whether the measures envisaged to promote the establishment of new industries and services, particularly in regions identified as structurally weak, implied that there would be centrally directed policies that favored economic policies in one part of the country over another. Moreover, while the authorities' maintenance of Luxembourg's tradition of fiscal prudence was welcome, it was surprising that there had been a rise in central government debt--both as a proportion of GDP as well as in absolute terms in 1984--notwithstanding the fiscal surplus achieved in that year. The increase in government debt appeared to reflect a sharp rise in central government reserves. It would be helpful to know the rationale behind a policy of running up long-term debt by nearly 50 percent in 1983-84 for the purpose of maintaining or increasing reserves. A policy of tax reduction might have been preferable. The proposal to maintain an 18-month Article IV consultation cycle was appropriate, although a 24-month cycle might well suffice in Luxembourg's current circumstances.

Mr. Templeman expressed admiration for Luxembourg's macroeconomic performance in 1984, which had been as good as, or better than, the 1983 performance for real growth, inflation, employment growth, the current account, and fiscal balance. Only the unemployment rate had shown a marginal worsening, although it remained below 2 percent. There had been continued success in implementing structural adjustment within the steel industry and in diversifying the economy, difficult problems that confronted many industrial countries. The steel industry's high productivity augured well for its survival and prosperity, and the reduction in excess capacity was also evidence of success. Especially impressive had been the ability of the authorities to finance assistance to that industry without creating a burden on the budget, by raising the value-added tax rate and by means of the solidarity tax surcharge. The adaptation of the growing international banking sector had also been a positive development, as was the gradual diversification of the industrial sector. A number of incentives to foreign investment were already in place and might be expanded, including interest and investment subsidies, tax credits, and credit guarantees. It remained an open question whether those incentives might be creating artificial props or unfair practices in terms of long-run competitiveness.

Luxembourg's experience with partial wage indexation was noteworthy, Mr. Templeman pointed out, and adjusted real wages in manufacturing had fallen slightly in each of the past three years. Unit labor costs in industry had fallen substantially in 1983 and 1984; as a consequence, profitability had been improving. However, the exceptionally rapid growth of productivity in 1983 and 1984 could not be expected to be repeated. In 1984, real wages in industry had risen by about 3 percent, while wages in the steel sector had increased by about 6 percent. As a consequence of the restoration of full wage indexation, an opportunity might have been missed for permanently reducing or eliminating automatic wage-price linkages. The impediment that the indexation mechanism created for wage differentiation could hinder labor mobility, which was necessary for the diversification of the economy. The safeguard mechanism, agreed when indexation had been restored, should be promptly brought into play if wage pressures got out of hand.

The Luxembourg authorities had continued to follow prudent fiscal policies, to the extent that there had been a surplus in the accounts of both the Central Government and the general government in 1984, Mr. Templeman noted. In the difficult areas of health and pension expenditures, large deficits had been avoided. The intention to reduce gradually the direct tax component of steel restructuring special taxes was also welcome. Since the ratio of general government revenues to GDP was already about 50 percent--several points in excess of the European Community average--a reduction in the tax burden seemed entirely appropriate. The indexation of income tax rates should contribute to that objective.

He supported the authorities' move to more flexible interest rate policies, Mr. Templeman concluded, but he was concerned about the effect of interest rates on saving deposits, in that they had generally been negative in real terms in the past few years, although they seemed to be marginally positive at present. The recent changes in bank supervision were also welcome, particularly the adoption of a system to supervise Luxembourg banks and their foreign branches on a consolidated basis.

Mr. Zecchini observed that in the past ten years there had been a significant reorientation in Luxembourg's productive structure, away from metal production and toward marketable services. The services sector had more than compensated for the 50 percent fall in the share of metal industries in GDP. While the adjustment had been prompted by a corresponding change in relative market demand, it was remarkable that the country had been able to maintain, in recent years, a relatively stable growth rate in overall output, an acceptable balance in the accounts of the public sector, and a comfortable external position. Much of that success appeared to be due to the good financial management of the authorities, particularly in the fiscal area--the degree of tax coverage of public expenditures had traditionally been high and often higher than originally budgeted. As a consequence, the size of the public sector debt was very moderate by international standards, and the debt service burden had remained minimal.

Given the uncertainties surrounding steel markets and the inherent volatility in the demand for bank services, particularly in recent years, Mr. Zecchini stated, would be desirable for the authorities to create conditions for a diversification of exports into nontraditional areas. The exchange rate policy appeared to have been consistent with that objective, and it would be interesting to know whether the authorities had contemplated other incentives to stimulate growth and export prospects for such nontraditional sectors as high-technology equipment and investment goods in general. In addition, it would be useful to discover whether the large amount of subsidies in the public sector's budget was mostly devoted to the support of the steel sector, or if subsidies were evenly spread over the various subsectors of industry.

The external accounts had shown a persistent deficit in the trade component and a larger and equally persistent surplus in the services component, Mr. Zecchini noted. Luxembourg had enjoyed, for many years, a current account surplus of about 10 percent of GNP. In light of the recommendations of the Executive Board to other countries in similar circumstances, perhaps the authorities could be encouraged to pursue policies for faster growth in a way that would offset Luxembourg's structural current account surplus. The sluggish growth in many components of aggregate demand in recent years was certainly an argument in favor of such policies. However, the high degree of integration of Luxembourg's economy with the economies of larger neighboring countries, as well as the volatility of the services component of the balance of payments, were arguments on the other side. Finally, it would be helpful to know how the authorities could express "their satisfaction about the favorable development of the external balance in 1984" if, as pointed out in a footnote to Appendix II of the staff report, no foreign account data were available for that year.

Mr. Scholten noted that Luxembourg's structural readjustment program had been successful; if Luxembourg's prudent fiscal stance were continued, the overall policy mix would remain satisfactory. There were three important points however. First, in a small open economy without an independent exchange rate policy, employment and output growth were heavily dependent on nominal wage developments. It was a cause for concern that personal income growth had probably been excessive, especially as the excess appeared to be concentrated in the steel sector, which was already structurally weak and effectively under government supervision. Not surprisingly, the pressures for wage gains were spreading, given that the large increases in steel wages had occurred at the same time as new public aid to the steel industry had been introduced, financed by solidarity taxes. The authorities had to answer the question of how they intended to contain the upward pressure on real wages across the entire economy, particularly at a time when wage indexation was being restored.

His second point concerned the banking industry, whose increased supervision by the authorities was welcome, Mr. Scholten said. There existed a high rate of loan loss provisioning, most of which concerned sovereign borrowing. A favorable tax treatment of such provisioning might act as an inducement to foreign banks to maintain their operations in Luxembourg. Banks with a less favorable tax treatment at home might go as far as concentrating their loss provisions in Luxembourg, particularly when banking supervision in the home country was on a consolidated basis. It would be interesting to know to what extent that practice occurred and what its impact on fiscal revenues might be.

Third, while a reduction in direct taxes would be desirable, once revenues from the solidarity taxes began to exceed the needs of the steel sector, a lowering of the high marginal tax rates could be expected to elicit a positive supply-side response, Mr. Scholten remarked. He wondered how much further the authorities wanted to go with the reconstitution of the central government reserves and whether they wanted to restore gross reserves to the high levels of 1978 to eliminate the Central Government's net debt altogether--a policy that would require further sizable surpluses. On the one hand, a move to lower direct taxes would be welcome. On the other, new expenditure programs should be considered with caution, particularly if they were as ambitious as a minimum income guaranteed to all households. An increase in official development assistance would also be desirable.

Mr. de la Herrân pointed out that the authorities of Luxembourg had made remarkably successful efforts to adapt an economy based on one sector--steel--in crisis. The smoothness of the adjustment process had been reflected in figures showing a slow rate of inflation and an enviably low level of unemployment. Fiscal policy seemed to be under control. The external sector was in an increasingly strong position. The flexibility of Luxembourg's economic system had been demonstrated by the development of activities that, in a sense, paralleled the need for deep adjustment as a consequence of changes in the steel sector. The restructuring, involving a shift of resources toward the banking sector while at the same time maintaining government financial support for the steel sector, had taken place in a particularly effective manner.

The efficient control of public expenditure had been a key element in the attainment of a comfortable public sector position, Mr. de la Herrân said. Revenue was sufficiently high to admit the possibility of certain tax reforms. Finally, there was a need for caution in the area of wage developments and in the reintroduction of full indexation. Since a policy followed in the steel sector might influence the rest of the economy, a moderate and cautious wage policy within that sector ought to be followed.

The staff representative from the European Department explained that the authorities did not have any specific institutional means at their disposal to enforce a particular form of incomes policy. They could, however, exert leadership on that issue and make the facts of the case known to the population, so as to achieve some consensus on a moderation of wages.

Luxembourg's regional policy had its origin in the fact that the steel industry was very heavily concentrated in the south of the country, thereby raising particular problems for employment and activity in that region, the staff representative continued. Accordingly, the authorities had offered specific investment incentives for the creation of economic zones in that region. Given the size of the country, negotiations of such incentives were largely a bilateral matter with the prospective investors, and they would logically choose a location where infrastructure, labor, and other resources were particularly abundant. Subsidies from the public government budget were not restricted to the steel industry and had been made to such public enterprises as the railroads. While the provision of subsidies for the diversification of industries could result in misallocation of resources, the policy of investment incentives was broadly coordinated within and limited by the European Community.

The key objective of the policy of financing the restructuring of the steel sector, without running down reserves, was eventually to finance the restructuring program out of taxes, the staff representative said. The authorities would not want to set a specific reserve target, nor to increase the level of disposable reserves of the Treasury over the medium term, especially as certain fluctuations in that level were almost inevitable. The use of reserves over the past two years had been a transitional feature.

The high provisioning of potential losses permitted to commercial banks was almost certainly a factor that attracted banking business to Luxembourg, the staff representative added. The view of the Luxembourg authorities was that eventually the loss provisions would either be needed to cover actual losses or could be reintegrated into the income of the bank and then taxed. The tax incentive provided by the authorities was not therefore a complete remission of tax but simply a postponement of its assessment.

The Fund had a broad number of indicators for most of the elements of the external accounts of 1984, the staff representative explained, but did not have the detailed figures that were normally required for insertion in a table. However, the facts were sufficiently well established to allow the authorities to express satisfaction with the outcome for 1984.

While the current account was in surplus there was little scope for demand stimulation, the staff representative noted. First, there was still great uncertainty as to the extent of Luxembourg's current account surplus, and it was not possible to determine how much room for maneuver the authorities had. Second, the Luxembourg economy was extraordinarily open. The ratio of imports or exports to GDP was of the order of 100 percent. Faster growth would be a function of an improvement on the supply side, either by increasing competitiveness of existing lines or by developing new products. That had happened in the banking sector, in the diversification of industry, and in the restructuring of the steel industry. Those were the policies that over the medium term would give the authorities potential for growth. The current account surplus, maintained at the cost of extremely high taxation, did not per se justify an expansion in demand.

The staff representative from the Exchange and Trade Relations Department noted that in determining the length of the consultation cycle, the staff took into account the preferences of the authorities, in accordance with the views of the Executive Board, on the procedures for surveillance. Two other important factors should be considered in determining a possible shift toward a 24-month cycle. First, the banking and financial sector of Luxembourg was extremely important in a global sense and, therefore, required close attention. Second, the situation in Luxembourg had not always been so satisfactory, as the 1983 Article IV consultation, held 18 months previously, demonstrated.

Mr. de Groote noted that the successes of the Luxembourg economy--a 10 percent current account surplus, a 2 percent surplus in the government budget, increasing employment, and a continuous increase in output during the period of adjustment--had not been obtained without extremely high costs. The authorities had introduced, before any other industrial country, extremely courageous fiscal and wage measures. Accordingly, they remained extremely cautious because even after the first phase of technical and financial adjustment in the steel sector, and diversification within the banking sector, there might be need for a further period of substantial adjustment. The steel market had been unusually favorable in 1984, but it would be unrealistic to expect that trend to continue. Thus, the rather unusual decision to build up treasury reserves would enable the authorities to finance the restructuring of the steel sector. At first sight, the authorities' desire to retain financial flexibility was somewhat at odds with the present wage policy and the reintroduction of indexation, one of the less attractive features of the present economic situation. The introduction of rigidity into the wage structure was not a welcome development. However, it was important to note that Luxembourg had been the only country, in similar circumstances, to have done more than suspend indexation and to have allowed substantial falls in the real wage in the steel sector.

With the significant increases in productivity, Mr. de Groote continued, it was inevitable that certain requests for income increases would occur in order to catch up with the losses sustained during the period of adjustment. The Government, nevertheless, had full powers to suspend or oppose any decisions that might prove counterproductive. Indeed, the danger of social unrest resulting from a failure to reintroduce indexation might have been much greater than those dangers that had resulted from the re-establishment of an incomes policy under control and surveillance of the Government. It was important to remember that the Luxembourg Government had the strong social support of about 85 percent of the electorate. The high degree of social consensus was evidenced by the ability of the authorities to increase direct taxation and avoid excessive fiscal borrowing in order to finance readjustment programs.

The country was fully aware of its extreme dependence upon foreign trade and of the need for a high degree of competitiveness, Mr. de Groote remarked. Luxembourg's total exports were about the same as those of Greece or Portugal; about 40 percent less than those of India; and 40 percent more than those of Colombia. Given the high degree of consensus that existed within the society about the need to maintain international competitiveness, the reintroduction of indexation should not be viewed with too much concern, especially as the arrangements could be suspended in case of need.

The decision taken by the Luxembourg authorities to increase ODA deserved further elaboration, Mr. de Groote observed. In Luxembourg a large flow of development assistance already went through private channels. One reason was that there were no public channels through which such aid could be diverted; Luxembourg had a very small administrative apparatus, with members of the Government generally combining several functions in a way reminiscent of the nineteenth century in many other countries. The Government had a practice of supporting both private initiatives and those of local entities by increasing the amount of private development assistance and offering subsidies. ODA would soon be organized on a national basis; also, it took the form almost exclusively of an outright grant, although further improvements were still possible in that area.

It might seem somewhat paradoxical that there should be concern in such a small country about regional policies, Mr. de Groote remarked. Implementation of those policies was intimately related to the preoccupation of the authorities with the preservation of equality of opportunities in what was a rather unique country. The population in the north had to be given employment opportunities if there was to be no mass movement of the population to the city of Luxembourg. The authorities wished the size of the city to remain moderate in relation to the country.

Incentives for investment by multinationals in high technology were an important aspect of industrial policy in Luxembourg, Mr. de Groote concluded. Two or three major multinational companies were interested in investing in Luxembourg in the near future. The introduction of new technologies would also be a principal instrument in improving the supply-side structural features of the economy.

The Chairman made the following summing up:

> Executive Directors commended the Luxembourg authorities on the positive developments in the economy in 1984. The steel sector had improved its productivity and had increased its responsiveness to market demand. Activity in nonsteel industrial sectors had firmed and the international banking sector had diversified, thereby gaining stability. Those developments had contributed to the outstanding employment performance of the country. Directors commended the authorities for supporting those developments by a carefully executed adjustment program that had avoided large and lasting fiscal deficits.
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> Directors observed, however, that the improvement in 1984 had been aided by exceptional circumstances and that the future of the world steel markets remained uncertain. Directors accordingly expressed concern and some disappointment over recent wage developments and the return to full wage indexation. Large and probably excessive real wage increases had been granted in 1984, particularly in the steel sector. Those increases reduced the prospects that continued structural adjustment would take place without renewed public sector support programs. Executive Directors noted with concern that large increases in real wages in the steel sector had occurred at the same time that a new aid package had been introduced by the authorities. Directors observed that the return to full indexation was likely to hamper wage differentiation and labor mobility, and had reintroduced a rigidity in the economy. They stressed that a prudent incomes policy was essential to maintain competitiveness and to attract the investment necessary to pursue essential diversification of productive activity.
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> Directors commended the Luxembourg authorities on the broad orientation of their fiscal policy and agreed that it was desirable that the structural adjustment program should be completed without

relaxing the fiscal stance. However, the need to improve incentives for both domestic and foreign investors also required that the exceptional increases in the tax burden, imposed in connection with the restructuring program, be scaled back fully. To the extent that a restructuring of the tax burden toward indirect taxes was desired, the scaling back implied offsetting reductions in direct taxes which were high by international standards. It was important not to compromise that goal by new transfer programs which, in any case, needed to be scrutinized in terms of their longer-term financial implications.

Directors supported the strengthening of bank supervision in line with international practice. They encouraged the authorities to pursue a somewhat more flexible interest rate policy. They also noted the authorities' commitment to an exchange rate policy that would keep the Luxembourg/Belgian franc in the zone of the more stable currencies within the EMS. Luxembourg's low level of official development assistance was regretted and it was hoped that, given in particular the country's recurrent balance of payments surpluses, development assistance could be stepped up rapidly.

Directors considered that it might be reasonable, with the concurrence of the authorities, to hold Article IV consultations with Luxembourg on a two-year cycle.

2. NIGERIA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Nigeria together with a proposed decision concluding the 1985 Article XIV consultation (SM/85/149, 5/21/85). They also had before them a report on recent economic developments in Nigeria (SM/85/155, 5/31/85).

Mr. Mtei made the following statement:

The Nigerian economy, like the economies of other OPEC countries heavily dependent on petroleum, has been confronted with major problems since 1981. A weakening of demand for oil rooted in the recent worldwide recession resulted, inter alia, in a GDP cumulative decline of 11.5 percent over the last four years. However, in 1984 owing to some improvement in the petroleum and agricultural sectors, the rate of decline in real GDP was only 0.6 percent compared with a contraction of 6.4 percent in 1983. The value of petroleum exports in 1984 had fallen to $10 billion compared with nearly $25 billion in 1980 and this had serious implications on government revenues, about 70 percent of which are derived from the petroleum sector, and on foreign exchange earnings, over 95 percent of which are from petroleum exports. Consequently, the external payments position remained tight with gross official reserves only sufficient to cover about 7.6 weeks of imports at the end of 1984. Inflationary pressures were exacerbated by shortages, particularly of raw materials, spare parts, and other essential commodities, with the rate of inflation accelerating to 40 percent in 1984.

In the circumstances, the new Government, which assumed power on the eve of 1984, introduced stringent austerity measures aimed at scaling down national expectations and aspirations to realistic levels. Public expenditures were sharply reduced in 1984; capital outlays were reduced by over 47 percent and transfers to state governments severely curtailed. In fact, the states contributed over ₦ 200 million to the federal government budget in the form of new repayments compared with a net transfer to them of over ₦ 1 billion in 1983.

Gross lending to public enterprises would have been considerably reduced but for a loan of ₦ 200 million to the Essential Commodities Committee to help it establish a revolving fund to stabilize the prices of essential imports. Other expenditure-reducing measures included a continued freeze on civil service pay and a general tightening of expenditure controls effected through the introduction of quarterly expenditure releases. On the revenue side, the authorities increased the rate and coverage of excise taxes. The federal government budgetary deficit was consequently reduced from ₦ 7 billion, or 11 percent of GDP, in 1983 to less than ₦ 4 billion, or about 5 percent of GDP.

In the 1985 budget, the authorities have continued their 1984 stringent austerity policy with the aim of reducing overall public expenditure in absolute terms and to a budgetary deficit of no more than 4 percent of GDP for the year. To improve growth prospects, however, capital expenditure has been selectively allowed to increase by 80 percent to cover priority or "core" investment projects in line with the recommendations of the World Bank review of Nigeria's public expenditure program carried out in 1984. Under that review, the public sector investment program was divided into "core" or high-priority quick-yielding projects with maximum positive impact on the balance of payments and "non-core" projects. Most of the latter, including a number of ongoing capital-intensive projects and some new projects were, in principle, excluded. Current expenditure is to be reduced by 36 percent. Transfers to state governments and public enterprises will continue to be curtailed and many services hitherto offered free of charge have been abolished. New measures include an increase in the rate of deduction at source of rents, dividends, and royalties, which were also raised from 12.5 percent to 15 percent; a limit of four on the number of years' losses that may be carried forward to offset company profits; and limitations on the annual amount of capital depreciation allowed, to 75 percent of profits in the case of manufacturing companies and 66 2/3 percent for others, except for agro-allied companies, which are exempt. A ₦ 500 levy is also imposed on dormant companies. The state authorities which have been asked to balance their budgets are aware of the need to widen their revenue base. To this end, state governments have imposed various fees and levies.

Monetary policy was also more restrained in 1984 as the budgetary financing requirements were much reduced and private sector credit demand was weak as a result of to the low tempo of economic activity. Net domestic credit, which had expanded by 29.3 percent in 1983, increased by 10.6 percent in 1984, with credit to the private sector expanding by only 4.5 percent. In 1985, the authorities intend to continue the restrained monetary policy and to keep bank financing to about 7 percent. Strict penalties are to be imposed by the Central Bank for noncompliance with its credit guidelines. In an effort to allow banks greater flexibility in determining the composition of their loan portfolios, the number of sectoral categories under the central bank credit guidelines has been reduced from 15 to 9; and the requirement that about 90 percent of all credit be extended to indigenous Nigerian enterprises has been rescinded. Meanwhile, the Central Bank has floated the Twenty-Third Development Stock for ₦ 300 million, which has been heavily oversubscribed and therefore did not involve central bank participation.

The authorities are aware that real rates of interest have fallen to negative levels because of accelerating rates of inflation, but they believe that the trend will be reversed shortly as their anti-inflation policies continue to yield positive results. They have pointed out that increasing interest rates at a time of slack demand for domestic credit and widespread excess capacity in the economy will be counterproductive. It was noted that the acceleration in the rate of inflation in 1983 to 23.2 percent from 7.7 percent a year earlier was due to the effects of adverse weather on the domestic agricultural sector as well as the expansionary policies of earlier years. In 1984 the rate of inflation rose to 40 percent 1/ mainly due to a sharp reduction in the supply of imported goods at the time when the industrial sector was operating at 30 per cent of capacity owing to the acute shortage of imported raw materials. As the supply situation has improved and fiscal and monetary policies have been tightened, the rate of inflation has started to decelerate from 40 percent in December 1984 to 36.6 percent in February 1985, and it is expected to decline to 30 percent by the end of the year. Rather than allow interest rates to

1/ The 44.8 percent rate of inflation used by the staff is an overestimate as it does not take fully into account downward movements in prices of major commodities such as rice, sugar, milk, and vegetable oil.

chase the inflation rate, the authorities have decided that the latter should be brought down; they thus took other measures, including the strengthening of the financial infrastructure, to enhance the mobilization of domestic savings. To this end, they have intensified their efforts to promote the geographical spread of commercial bank branches into the rural areas. They have also directed the banks to ensure that credit to rural borrowers achieve a specified minimum share of total deposits originating from the rural areas.

The improvements in the external sector, where the current account deficit was reduced from 5.7 percent of GDP in 1983 to 1.2 percent in 1984, are a reflection of the demand management and other policies in the framework of foreign exchange budgeting. Although the overall balance of payments deficit was reduced sharply from $4.8 billion in 1983 to $0.3 billion in 1984, difficulties were encountered in clearing the accumulated trade arrears. As noted by the staff in the report on recent economic developments, all 1984 import payment claims that were checked and verified by the Central Bank were paid. The stock of trade arrears of $6.81 billion included $1.13 billion yet to be processed by the Central Bank. If account was taken of this, it is obvious that part of the arrears as at end-December 1983 had been paid. However, the authorities view the arrears with concern and are intensifying their efforts to refinance those that have been reconciled and accepted. The importance attached to servicing outstanding external debt is underlined by the budget allocation of ₦ 3.5 billion to debt servicing in 1985, representing 44 percent of total anticipated foreign exchange earnings. As a result of a strict reconciliation and verification exercise, many doubtful claims have been discovered.

With regard to the application of exchange rate policy to complement demand management policies, the authorities are of the view that, given the present tight austerity measures, devaluation of the size necessary to achieve the required relative price corrections at one go is not socially or politically feasible. To ensure the availability of essential imports of both consumer goods and raw materials in the short run, and to avoid the emergence of large payments imbalances, they have opted for foreign exchange budgeting. In the meantime, specific features are being devised and built into the import licensing and foreign exchange allocation system to discourage continued reliance on imported raw materials. This was being done in the framework of a detailed study of the industrial incentive system under way in conjunction with the preparation of the next five-year development plan.

The authorities are aware that the naira is overvalued, but given the predominance of the oil sector in the economy, the small size of the traditional export sector, and the sociopolitical implications of a massive devaluation, they have decided to continue their declared policy of eliminating the overvaluation over time through a gradual downward crawl while at the same time bringing down the rate of inflation. Thus, by June 4, 1985 the naira had been depreciated by about 10 percent to ₦ 1.00 = US$1.1172 from its end-December 1984 rate of 1:1.2403. They believe that the recovery of the traditional sector and economic diversification depend not only on exchange rate action but also on other factors, including more aggressive crop purchasing by the marketing board, rehabilitation schemes, favorable weather conditions, and export promotion. These factors, coupled with producer prices that had been set at levels well above world market prices, provided fairly good results in 1983 and 1984.

The present Nigerian exchange and trade policies are aimed at reducing overdependence on imports while local sources of raw materials are being developed with the medium-term objective of insulating, as much as possible, the manufacturing sector from the uncertainties of foreign exchange availability. The authorities have stated that contrary to the views of the staff, the exchange and trade measures were not intensified in 1985 but only streamlined to ensure the attainment of their stated objectives. The two measures introduced, namely, payment of import duties at the point of opening of letters of credit and the establishment of domiciliary accounts in Nigeria by Nigerian-registered companies and nationals, were aimed at boosting government revenue and encouraging the repatriation of funds held abroad by Nigerians. The advance payment of import duties, in addition, will minimize the fraudulent practice of importers overloading invoices or importing different goods from those described in the invoices. The advance import deposit that gave rise to multiple currency practices has been abolished. Likewise, broken cross rates and the attendant arbitrage having similar effects have been eliminated since April and have not re-emerged.

In the medium to long term, the solution to Nigeria's imbalances lies in the diversification of the economy. Projections indicate that without major structural changes, fiscal and external gaps will remain wide through the end of this decade and the debt service burden will be high. The authorities are therefore placing a high priority on medium-term development efforts to tap the great potential in the agricultural sector and stimulate industrial production to reduce further reliance on petroleum. In this regard, apart from the five-year development plan under preparation, the authorities have been working closely with the World Bank, and they are now finalizing an investment program with emphasis on agricultural development, covering the period until 1987.

Mr. Hansen, noting the serious setbacks that Nigeria had suffered in its economic performance during recent years, observed that the outlook remained difficult despite a substantial tightening in economic policies in 1984 and a significant reduction in the fiscal and external deficits. The authorities' heavy reliance on inward-oriented economic strategy, based on import substitution and a pervasive set of restrictions and controls, was bound to distort the economy and delay the necessary adjustment process. Although there might be a sociopolitical reason for such a strategy, there was an accumulation of evidence that policies that placed emphasis on earning foreign exchange instead of saving it were more likely to foster viable economic growth and to be self-sustaining in the medium term. Accordingly, a determined relaxation of the complex system of government interference would seem to be a precondition for reducing domestic and external imbalances and for diversifying the economy.

According to recent press reports, Nigeria was about to conclude countertrade arrangements, based on oil swaps, of up to $2 billion, Mr. Hansen noted. He wondered to what extent the authorities were likely to encourage barter arrangements as a means of promoting international trade in the future. In addition, according to Table 1 of the staff report, consumer prices had advanced much faster than the GDP deflator since 1981, in particular during 1984, suggesting that imported inflation could have contributed significantly to overall price developments in Nigeria. It remained unclear whether that conclusion was a real development or a statistical problem.

Mr. Polak observed that the Nigerian authorities had made progress in 1984 in tightening fiscal and monetary policies. It was therefore all the more disappointing that they had been unable to adopt a full-fledged adjustment program, accompanied by credits from the Fund and World Bank and a normalization of relations with creditors. The exchange rate was the major sticking point. In 1983 and 1984, the authorities had resisted devaluation on the basis that its inflationary effect would be unacceptable. However, in 1984, the authorities' policies had resulted in rising inflation without the benefits that the adoption of a Fund-supported program would have provided.

During its discussion of the 1984 Article IV consultation, the Board had debated the appropriateness of the naira rate, Mr. Polak continued. There was no doubt that it had become significantly overvalued; the crawling peg arrangement had resulted in a 5 percent real appreciation in 1985 on top of the overvaluation that had existed at the beginning of the year. As a result, Nigeria's foreign trade was organized more along the lines that were common many years ago in planned economies before the advantages of international price signals had been discovered by socialist countries. The gross distortions that had consequently been introduced had had a negative effect on domestic production. Supply bottlenecks had worsened to such an extent that a sharp devaluation, in the context of a comprehensive program that included liberalization of imports, would actually lower inflation. One could only wonder about the political power of those privileged groups that benefited from the tremendous profits to be made through access to import licenses in the present situation. Certain calculations, made by World Bank staff, showed that with a Fund-supported program, per capita income might be expected to stay at its present level. Without such a program, per capita income would in all likelihood continue to fall sharply at least until the end of the decade.

The Nigerian authorities had taken positive steps during 1984, including the tightening of the fiscal stance and its continuation in the 1985 budget, Mr. Polak commented. The thorough review of the public investment program, conducted in cooperation with the World Bank, and the tightening of control over the financial position of the individual states were also positive steps. However, on both the domestic and the international fronts, the disregard for the role of relative prices continued to hamper supply-side performance.

On the external account, the continued importance attached by the authorities to servicing the external public debt was welcome, Mr. Polak said. Important progress had been achieved in 1984 in addressing the problem of mounting trade arrears to private nonbanks, which held more than one third of the total external debt. However, it was not clear how much progress had been made in issuing the necessary promissory notes, or whether new trade arrears had continued to rise. On the other hand, relations with export credit agencies were an area where progress inevitably awaited a Fund-supported program. Although barter trade might seem to provide a temporary escape route, it was an expensive way to conduct international trade.

The proposed decision, correctly in his view, did not approve Nigeria's exchange restrictions or its multiple currency practice, Mr. Polak concluded.

Mr. Ortiz said that he recognized that Nigeria's problems had been compounded by the very drastic fall in oil revenues since 1980. Like other high-absorbing, oil exporting countries, the country had embarked on an ambitious development program in the 1970s, financed by rapidly increasing oil revenues and newly acquired access to international capital markets. Oil revenues had exerted a pervasive influence on every aspect of economic activity--from government finances and the balance of payments to the structure of production and the determination of relative prices. As the oil market had weakened, revenues had diminished sharply, and the Nigerian economy had been forced to adjust to the new situation. The size of the revenue shortfall and the sharp limitation imposed on Nigeria's access to international capital markets had been the main determinants of both the magnitude and speed of the adjustment, which had taken place in the context of an economy that was expanding at a very rapid pace. Investment projects were at different stages of completion, and the key relative prices--exchange rate, interest rate, and wages--were in line principally with a situation of rising oil revenues and favorable terms of trade.

Output in Nigeria had declined for four consecutive years, Mr. Ortiz continued. Inflation was on the rise and the sizable foreign exchange reserves accumulated by the authorities during the 1970s had been significantly run down, at the same time as a buildup of payments arrears had taken place. Those facts suggested that the implementation of adjustment measures had been postponed longer than had been desirable, especially as the realities of the oil market were indicating the inevitability of economic adjustment. Postponement of orderly and timely adjustment often implied the need, later on, for the implementation of much more drastic measures. Measures taken by the new Government since 1984 represented a more realistic approach to the situation. Especially important was the message that national expectations had to be scaled down in accordance with the reduced level of resources envisaged, at least in the medium term. The authorities should be commended for reducing the fiscal deficit, which had been cut by more than one half since 1983. Similarly, the budget in 1985 had maintained the general thrust of fiscal austerity.

Two aspects of fiscal policy were worrisome, however, Mr. Ortiz considered. First, the bulk of the expenditure cuts had affected capital expenditure. Greater emphasis on the reduction of current expenditure should be sought, especially in a country such as Nigeria, where the Government financed the bulk of investment activity. The fall in both savings and investment, by more than 20 percent and 14 percent of GDP, respectively, showed the lopsided nature of the adjustment process. The staff report, however, did not clarify to what extent the fall in the savings rate could be attributed to government dissaving or to a reduction in the private saving propensity. Nor was there any analysis of the evolution of government expenditure either in real terms or as a proportion of GDP. Second, the tightening of controls on the operation of public enterprises and of the state finances was important for the continuation of fiscal adjustment.

Monetary developments in Nigeria were largely determined by the stance of fiscal policy, Mr. Ortiz commented. As the fiscal stance had become more restrictive, credit policies had also tightened. However, in spite of the drastic reduction in the budget deficit that took place in 1984, government debt still formed the bulk of the financial resources available in the economy--about 90 percent of total credit expansion--indicating that the deficit was probably still too large in relation to the availability of savings in Nigeria. Since gross domestic savings had fallen from 31 percent of GDP in 1980 to an estimated 10.4 percent in 1984, the size of the fiscal deficit still accounted for over half of gross domestic savings.

The authorities had decided not to raise domestic interest rates, despite their negative real level, but instead to wait for inflation to come down in order to improve the real returns on financial instruments, Mr. Ortiz noted. Although there was a certain validity to the authorities' view that abrupt changes in the interest rate, in order to offer positive yields, were not always conducive to economic efficiency, it was important to remember that if interest rates were negative for a considerable period of time, they would have a discouraging effect on the flow of financial savings, thereby further complicating the financing of public and private expenditures.

The argument of the authorities in favor of a gradual realignment of the exchange rate contained some logic, especially as a sharp devaluation in the exchange rate would not have a significant short-term impact on export volumes, since non-oil exports were not very substantial, Mr. Ortiz said. It was also true, however, that the maintenance of a misaligned exchange rate for extended periods of time resulted in enormous complications for economic management. The need for import controls and the reluctance of Nigerian nationals to repatriate foreign exchange earnings were related to the level of the exchange rate. While the fears of the authorities that a sharp realignment in the exchange rate might import inflation possessed some legitimacy, inflationary pressures would not be entirely outside the Government's control, the authorities would continue to allocate foreign exchange earnings according to national priorities. While some import controls and foreign exchange allocation were probably needed in the context of Nigeria's adjustment efforts, the lack of alignment between official and market exchange rates should not become too pronounced. Because the staff report did not comment on the operation of the parallel exchange market, it was difficult to ascertain the extent of the overvaluation of the naira. A depreciation of the exchange rate would contribute to a significant reduction in internal and external imbalances, since oil revenues were the most important source of both foreign exchange earnings and government income. It would be interesting to see some projection of the extent of a naira devaluation necessary to bring about fiscal balance.

Mr. Goos said that it was difficult to understand the policies the Nigerian authorities had adopted in dealing with the country's economic problems. The measures adopted seemed bound to exacerbate the underlying structural distortions and to render the adjustment task more costly and painful. The authorities had adopted an impressive demand management program, which could provide a powerful ingredient for a comprehensive adjustment strategy, but their concern for domestic activity and the standard of living of the population had prevented them from supplementing their restrictive demand management policies with necessary exchange rate measures. By maintaining an unrealistic exchange rate and by resorting to administrative controls on the internal and external sectors, there was no doubt that the authorities would undermine further the productive capacity of the economy. By creating artificial bottlenecks in the supply of goods and services, they had added further impetus to the cost-price spiral, which in turn had caused further appreciation in the real exchange rate and a loss of international competitiveness. The fact that the industrial sector was operating at only 30 percent of capacity in 1984, because of a shortage of imported raw materials, made the situation clear.

The inconsistencies in the Government's economic strategy were all the more apparent, considering that a devaluation would probably have a relatively small inflationary impact, Mr. Goos continued. A large part of the limited supply of imports was being traded in the black market, resulting in high profits for importers. A devaluation, together with trade liberalization to increase the supply of imported goods, would lower those profit margins and hence limit the inflationary impact on the consumer price index. The authorities seemed to have a misguided perception of the economics of devaluation, and the argument that political reasons rendered devaluations difficult was something that required further elaboration.

He agreed with the staff appraisal, Mr. Goos noted; the difficult medium-term outlook underlined the need for a further reduction in the fiscal deficit. Restructuring and privatizing certain public enterprises would be a useful initiative. Moreover, there were doubts about the appropriateness of certain measures mentioned in Mr. Mtei's introductory statement--concerning the carry-over of company losses to subsequent years and depreciation regulations--which seemed further to reduce the profitability of already financially weakened enterprises and which were therefore inconsistent with the need to strengthen the supply capacity of the economy.

Monetary policy should play a more active role as a stabilizing factor, Mr. Goos observed. The existence of negative real interest rates was particularly disturbing in that it could undermine the adjustment effort. The strong acceleration of inflation, which had occurred in 1984, was surprising given the significant slowdown in credit expansion during previous years and the actual negative real growth of monetary aggregates in 1984. It would be useful to know what, in addition to the reduced supply of imported goods, had contributed to that result.

Given its very high debt service ratio, Nigeria would have to rely on foreign financial assistance for many years, Mr. Goos noted. In the circumstances, it was critical that the country should improve the credibility of the adjustment effort by adopting a comprehensive stabilization program. Such a program would go a long way toward encouraging potential creditors to contribute to the financing of Nigeria's balance of payments. An early agreement on a Fund-supported adjustment program would be of particular importance.

The staff had not addressed the recent attempts made by the Nigerian authorities to solve their external payments problems by recourse to barter agreements, Mr. Goos remarked, and he asked the staff for its assessment.

Mr. Rye recalled that the 1984 Article IV consultation with Nigeria had seemed at the time to be a forerunner of a negotiated arrangement with the Fund. The main "sticky point" had been an unwillingness by Nigeria to adjust the exchange rate and liberalize its trade and payments system. Although the Board had been divided in 1984 about the usefulness of a devaluation, it was to be hoped that a more unified view might emerge in the present meeting. Restoration of Nigeria's external competitiveness, through early and substantial depreciation of the naira, was a critical requirement for the economy's return to viability. In the face of an effective appreciation of the naira of over 80 percent between early 1983 and November 1984, it was hardly surprising that non-oil exports had dwindled toward the vanishing point. The Nigerian authorities had opposed a devaluation in the exchange rate because of the potential inflationary impact. However, an equally valid case would be that inflationary pressures had been caused by the present strategy that Nigeria had adopted--one based upon quantitative restrictions on imports. Those fortunate enough to have import licenses were enjoying higher profits, whereas the export sector would be the main beneficiary of a realignment in the exchange rate.

The small size of the traditional export sector was a reflection of past and present exchange rate policies, Mr. Rye continued, and it would not be logical to use the limited supply-side response of that sector as a reason not to change policies. Nor was it clear that the sociopolitical arguments provided an attractive basis for opposing exchange rate reform; present policies also had their sociopolitical costs. The use of trade and payments restrictions had failed to reduce imports in a noninflationary way. Rather, they had contributed to the demise of the non-oil export sector, through their inflationary effects and the arbitrary way in which access to necessary raw material and capital goods imports had been curtailed.

The strategy of the authorities struck him as being paradoxical, especially as it relied so heavily on demand restraint and economic retrenchment, the approach the Fund was often accused--wrongly--of advocating at any cost, Mr. Rye remarked. Although the authorities had shown their resolve to make an economic adjustment program work--as evidenced by the efforts in the fiscal area--there could be no respite from austerity until the underlying price and cost structures had been corrected. An early and large adjustment to the exchange rate should be made, and trade and payments restrictions phased out. It would be a great pity if failings in that area prevented Nigeria from seeking a Fund arrangement which, inter alia, would enable the country to normalize its relations with creditors.

Mr. Wicks said that he agreed with the staff appraisal. The large fiscal and current account deficits that had developed in the early 1980s had been brought on in large part by the weakening of the oil market, but more fundamentally they reflected failure over a number of years to tackle the serious structural problems in the economy. There had been a heavy dependence of both exports and government revenues on oil, resulting in the stagnation of the non-oil sector, with industry working at about 30 percent of capacity, and also in the decline in the agricultural sector.

Since the 1984 Article IV consultation, the authorities had made an important start in dealing with their problems, Mr. Wicks continued. There had been a substantial reduction in both the fiscal and the current account deficits, although largely through administrative measures to cut imports. However, those measures had not been accompanied by other policies to tackle the underlying structural problems of the economy. There was a need for tariff reform, increases in domestic interest rates, and the devaluation of the exchange rate. The authorities had taken the austerity measures needed in the adjustment program, but they had not yet taken the growth-inducing measures by correcting relative prices. As a consequence, the adjustment process in Nigeria was proving to be much more costly than it might have been, and might prove difficult to sustain in the future. Nigeria's economic problems would be best tackled through a program supported by the Fund, and given Nigeria's structural problems, close collaboration with the World Bank would be extremely important.

Although the fiscal deficit had been substantially reduced, Mr. Wicks pointed out, it still required substantial recourse to domestic bank financing. Further action was necessary, perhaps with an emphasis on the revenue side. One possibility was a reduction in the subsidy on petroleum products; another was tariff reform. The authorities' intention to restructure the parastatals was welcome. Since the statistics in that area were poor, technical assistance from the World Bank or the Fund might be extremely helpful.

Monetary policy had resulted in real interest rates that were highly negative and that had compounded the distortions inherent in the credit allocation system, Mr. Wicks continued. As there had also been a sharp decline in the savings ratio in recent years, the authorities ought to take action in that area.

In the external sector, Mr. Wicks considered a move toward a more competitive exchange rate to be an essential element for any adjustment strategy, aimed at reviving agriculture, cutting back excessive import profits, bolstering investor and consumer confidence, stabilizing expectations, and stemming capital flight. It was not clear how Nigeria could diversify its economy without a fundamental reform of the exchange rate. While he appreciated the authorities' concern regarding the inflationary effects of a devaluation, the maintenance of an overvalued exchange rate had not succeeded in restraining inflationary pressures in recent years. It would be interesting to know what effect a devaluation might have on the overall price level and also on the fiscal position. Despite a gradual depreciation of the naira in nominal terms, the high rate of inflation in Nigeria had resulted in a real appreciation in the exchange rate. Although broken cross rates had more or less disappeared on April 16, 1985, they had reappeared when the dollar had strengthened against sterling. Since the exchange system remained very restrictive, it would not be right to approve the current arrangements. As regards the contribution made by countertrade to the balance of payments position, some further information on the longer-run implications would be useful.

In the medium term, Mr. Wicks concluded, if very large financing gaps were to persist through the end of the decade, financed through external borrowing, the result would be an unsustainably high debt service ratio. The figures in the staff report implied gross new medium-term to long-term official borrowing of some $2 billion in 1985, falling to $500 million by 1989. It remained unclear whether those amounts would be available in the absence of a Fund program.

Mr. Ismael noted that the performance of the Nigerian economy in 1984 was cause for concern. There had been a substantial worsening of inflation and little improvement in the non-oil sector, despite a narrowing in the balance of payments deficit. While the authorities should be commended for their determination in maintaining a fiscally restrictive stance, deep-rooted structural problems remained an impediment to better economic performance.

The stance of continued fiscal austerity, planned for the 1985 budget, appeared to be appropriate, especially in the area of current expenditure, Mr. Ismael went on. The authorities' intention to encourage the states and public enterprises to improve their own budget positions was welcome. However, given the present outlook for oil markets, the prospects for higher revenue were limited in the absence of a significant improvement in the non-oil sector. Most of the overall government deficit continued to be financed by domestic bank credit, but private sector credit demand was low because of the decline in economic activity. It was an open question therefore whether positive real interest rates would, by increasing the supply of loanable funds, provide an incentive to greater investment.

The lopsidedness of the economy, the result of past policies, could be redressed only through the adoption of medium-term measures, Mr. Ismael added. Measures of fiscal restraint would need to be supported by strong structural adjustment policies, which were designed to decrease dependence on imports and to improve incentives to investment and production in the non-oil sector, particularly in the agricultural sector. Possible measures included fiscal and nonfiscal investment incentives, a rationalization of the pricing structure, a simplification of the bank regulatory framework, and changes in policies that regulated economic behavior in the external sector. Those adjustments involved a particularly difficult balancing of different sets of costs and benefits. There were occasions when it was necessary to resort to ad hoc measures in order to stem reserve losses. The immediate effect of a devaluation would be price increases for the general public, unless alternative supplies became immediately available. However, having made certain initial steps toward revising in a downward fashion national expectations and expenditures, it would be a great pity if no real gain were achieved in the external sector. The devaluation would only be successful if accompanied by a set of supporting measures in other areas of the economy.

Distortions arose in the external sector, not only through the overvaluation of the exchange rate, but also because of highly complex exchange and trade restriction, Mr. Ismael observed. As the need for emergency protective measures became less immediate, it would be appropriate to dismantle some of the restrictions and adopt a more medium-term perspective. Despite their external difficulties, the Nigerian authorities had correctly pursued a responsible external policy, attaching great importance to servicing external debt. The program of refinancing arrears on uninsured trade credits, through the issuance of promissory notes, was appropriate and, together with an early agreement with Nigeria's creditors on the settlement of other outstanding arrears, should help to provide the breathing space necessary for a comprehensive adjustment effort.

Support from the World Bank was a key element in Nigeria's adjustment efforts, Mr. Ismael stated. Agreement on a Fund-supported program would also be extremely helpful. Finally, he could accept the proposed decision.

Mr. Suraisry noted that Nigeria was continuing to experience substantial problems in achieving any sort of internal or external balance. It was time for the authorities to tackle the problems firmly in the context of a realistic medium-term strategy. The authorities had made an encouraging start in the fiscal area. The policy restraint, which was further tightened in 1985, had reduced total outlays and compressed the fiscal deficit. The curtailment of transfers to state governments and the continued freeze on civil service pay were particularly commendable. However, much of the fiscal gain realized in 1984 had been achieved through a sharp reduction in capital outlays. Given the projected increase in those outlays in 1985, it was debatable whether the deficit could reasonably be expected to stabilize, especially since the budgetary allocation for current expenditures had also been increased.

There was an urgent need to strengthen the finances of the state governments and public enterprises on a lasting basis, Mr. Suraisry considered. At present, the expenditures of the states were equivalent to those of the Federal Government and their deficits amounted to about one half of their expenditures. The recent directive, requiring state governments to introduce balanced budgets, was therefore welcome. For all the states to comply with that order, more effective monitoring procedures were needed. The rapid growth in government lending to nonfinancial corporations was also cause for concern. Comprehensive measures were required to improve the operation and management of those institutions, so that scarce budgetary resources could be put to more productive use.

Strengthening the public finances was also a question of raising additional domestic revenues, Mr. Suraisry added. While that was not easy, given the decline in economic activity, the authorities should consider every possible option to broaden the revenue base. Money and price developments in Nigeria had also illustrated the need to strengthen the public finances. The large financing requirements of the public deficits had been an important factor behind the growing pressure on prices. Fiscal restraint was therefore critical in bringing inflation down and should be supported by monetary measures designed to improve the incentive to save and to prevent capital flight.

The proliferation of exchange and trade restrictions was a matter of concern, Mr. Suraisry remarked. While those measures might have been necessary under the circumstances, they did not address the underlying problems of the economy. Indeed, such restrictions often complicated the task of adjustment and should be phased out. The real appreciation of the naira had increased the already heavy import dependence of domestic production. A more flexible exchange rate policy would help to correct relative prices, stem capital flight, and re-establish incentives for domestic production; in that way, it would make an important contribution to restructuring and diversifying the productive base of the economy over the medium term. The recent devaluation of the naira had been a move in the right direction and was consistent with the courageous adjustment measures taken by the authorities so far. In the medium term, Nigeria's prospects were uncertain. The heavy burden of debt service was troubling, given the outlook for the balance of payments. The authorities ought to intensify their adjustment efforts in order to lay the supply-side basis for repaying arrears and for appropriate debt rescheduling on a multilateral basis.

Nigeria's room for maneuver was limited, Mr. Suraisry concluded. The underlying imbalances in the economy would have to be tackled with more appropriate policies in collaboration with the Fund and the World Bank. The authorities and the Fund should reach an agreement on a stabilization program as soon as possible. Nigeria was rich in natural resources and with appropriate policies and determination could fulfill its undoubted potential. Finally, he supported the proposed decision.

Mr. Flamant noted that attempts had been made by the authorities to correct some of the major imbalances affecting the Nigerian economy, but the measures taken to reduce the budget deficit, to tighten monetary policy, and to scale down the balance of payments deficit had not been carried out in any systematic fashion, and their overall efficiency had been impaired as a result. The measures had consisted mainly of a number of administrative regulations, which had given rise to several exchange restrictions that themselves were contrary to the obligations of Nigeria under the Articles of Agreement. Therefore, he endorsed the decision not to approve those restrictions, and he urged that they be removed. Further, the expulsion of immigrant workers and the closure of Nigeria's borders--an act that constituted a unilateral trade restriction--had been extremely harmful to the economies of all the surrounding countries. The Board should also be aware of the refusal by Nigeria to comply with its obligations to Benin with respect to two joint ventures, the Savé Sugar and Onigboto Cement companies, which was jeopardizing the viability of those otherwise sound projects.

The medium-term outlook indicated that large financing gaps remained until 1989, Mr. Flamant added. If Nigeria's difficulties were to be addressed in a responsible manner, more needed to be done, particularly in the area of the exchange rate. The real effective exchange rate of the naira, taking 1978 as the index base year, stood at 268 in March 1985. The continuation of such a huge overvaluation entailed wide distortions in the system of relative prices, constituting a major hindrance to all the measures aimed at diversifying the economy away from its heavy reliance on oil production. A sizable devaluation of the naira was therefore a precondition to any serious adjustment effort. The experience of other African countries that had taken the same policy step suggested that the adverse consequences feared by the Nigerian authorities would not necessarily materialize. The actual effects on the inflation rate would be to a large extent cushioned, since actual prices already reflected, at least in part, the real parallel market value of the currency. Moreover, a devaluation would give room for increased producer prices, particularly in the agricultural sector, thereby strengthening the incentives provided to farmers and helping to revitalize the agricultural sector, with a beneficial consequence on the level of food imports. In the fiscal field, an appropriate exchange rate would bring about higher tax revenues from customs duties as well as from oil exports, and would therefore contribute to a reduction in the fiscal deficit.

The fact that oil receipts accounted for three fourths of total revenue supported the need for a broadening of the tax base, with a view to offsetting the dramatic decline of government revenue as a share of GDP, from 25 percent in 1980 to less than 10 percent in 1984, Mr. Flamant stated. The increase in the excise tax was clearly insufficient to achieve that objective, and further information on the income tax system would be useful. The actions taken to redress the imbalances in Nigeria's economy had been taken in a piecemeal fashion, without the support of an effective adjustment effort, particularly in the area of exchange rate reform. The authorities should reconsider their position not to intervene in that area and thereby open the way for a collaborative effort with the Fund.

Mr. Coumbis observed that the authorities had made a serious effort to redress the problems of internal imbalance in 1984. In the external sector, however, there had been no change in the stance of the authorities with respect to import controls and exchange rate policies. On the fiscal front, the authorities had curtailed capital expenditure by more than 50 percent in 1984, limited the growth of current expenditure to 8 percent, and selectively raised excise taxes. The overall budget deficit of the Federal Government had been reduced to 5.2 percent of GDP in 1984 as against 11 percent in 1983. The 1985 budget was characterized by the same restrictive stance. Total expenditure was expected to decline by 6 percent, and a significant reduction was expected in the ratio of the overall budget deficit to GDP. The brunt of adjustment was to be borne by current expenditure, especially by a reduced outlay on wages and salaries. Capital expenditure would be permitted to increase so as to cover projects considered viable by the World Bank. The states were expected to introduce balanced budgets and public enterprises to improve significantly their financial performance; however, lack of data on the execution of the budgets of those entities limited the analysis of any progress that had been made.

The adjustment in the fiscal area had been accompanied by a substantial tightening of credit, Mr. Coumbis noted. The permissible annual increase in commercial bank credit to the private sector had been lowered to 12.5 percent in 1984 from 25 percent in 1983, and would be further reduced to 7 percent in 1985. Unfortunately, interest rates had not been adjusted upward. Incomes policy, on the other hand, was quite restrictive. Both public and private sector wages had been frozen in 1984, and similar policies were expected to be followed in 1985.

Although demand management policies had been appropriately carried out by the authorities, Mr. Coumbis considered, they had been ineffective in changing the trend rate of inflation, growth of GDP, or the level of employment. The rate of inflation had jumped to 40 percent in 1984 from 23 percent in 1983, GDP had decreased by 0.6 percent, while non-oil GDP had decreased by 2.1 percent. There was a substantial improvement, however, in the current account deficit as well as in the overall deficit of the balance of payments. The former had been reduced to 1.2 percent of GDP from 5.7 percent in 1983, and the latter to $0.3 billion in 1984 from $0.8 billion in 1983. Those developments were due mainly to a sharp reduction in imports as a consequence of administrative controls on the allocation of foreign exchange.

The stance of the authorities with respect to the exchange rate and trade policy had not changed, Mr. Coumbis stated. Several restrictive exchange measures had been adopted, and import controls had been tightened once more in 1984. In 1985, the allocation of foreign exchange had been centralized again and a system of advance payments for import duties introduced, replacing the scheme of advance import deposits, which had been abolished at the end of 1984. The naira had appreciated steadily in real effective terms and ought to be devalued significantly. The authorities should also carry out some major restructuring of the tariff system and phase out quotas and import licensing. The evidence from 1984 did not support the counterinflationary theory of the authorities, and the devaluation of the naira was not necessarily inconsistent with a reduction in the rate of inflation. The issue was not whether there should be a devaluation of the exchange rate, but what the size of that devaluation should be. An agreement between the authorities and the Fund on a comprehensive adjustment program should be reached as soon as possible. The medium-term outlook prepared by the staff indicated that Nigeria would be faced with a large financing gap of $1.5 billion in 1985 and annual gaps of a similar magnitude accumulating to about $5 billion during 1986-89. The debt service ratio would rise to 48 percent in 1985 and would remain about 34-40 percent in 1986-89 if the financing gap during that period were filled through new external borrowing. While some of the figures in the analysis were open to debate, the overall trend was extremely disturbing.

Finally, Mr. Coumbis said that he was in agreement with the staff appraisal and supported the proposed decision.

Mr. Dallara said that he regretted that 16 months had passed since the 1984 Article IV consultation with Nigeria even though the member was on a 12-month cycle. He commended the authorities for the substantial progress they had made in reducing the fiscal deficit from 11 percent of GDP in 1983 to 5.2 percent of GDP in 1984. However, the progress was insufficient to contain the internal and external imbalances. Nigeria continued to rely on extensive controls over trade and foreign exchange transactions--evidence that excess demand remained in the economy. There was a clear need for demand restraint together with a wide range of supply-side measures in an effort to reduce inflation, diversify the economy, return to positive economic growth, and generate employment.

Such measures should encompass a broad range of policies, Mr. Dallara observed. An exchange rate adjustment would restore producer incentives in the non-oil export sector, which had been virtually ignored during the past decade. While devaluation would not affect oil exports, it would make other exportables more profitable, leading to expanded production and employment. Palm oil, cotton, and groundnuts were no longer exported at all, and Nigeria had to import cotton for its textile industry. An increase in non-oil exports could permit a relaxation of trade and payments restrictions and finance the imports needed to revitalize the economy and renew lagging development efforts.

While welcoming the increased budget for capital expenditures for development projects, Mr. Dallara questioned whether that effort would be successful without basic changes in the structure of relative prices within the economy. Nevertheless, it was gratifying that the authorities were working in close collaboration with the World Bank and that they appeared to be placing greater emphasis on diversification of the economy, including a reallocation of resources toward the agricultural sector.

The budgeted reduction in the federal government deficit for 1985 was a continuation of the restrictive stance in macroeconomic policy that should not go unnoticed, Mr. Dallara continued. Developments in the consolidated fiscal sector, however, remained unclear, despite the new government regulation that state governments must run a balanced budget. The lack of comprehensive data made it very difficult to assess the overall fiscal sector, including the exact operating position of the public enterprises. Federal government loans to public corporations had increased by almost 25 percent in 1984, giving rise to doubts about any reversal of that trend, especially in light of the authorities' reluctance to increase utility tariffs. Costly petroleum subsidies by the Central Government continued to limit the additional adjustment that could be obtained in that sector's deficit. The subsidies should be eliminated, not only to increase public sector savings but also to encourage a more rational allocation of Nigeria's resources.

Very restrictive credit ceilings had accompanied the tightened fiscal policy and had helped contain the external deficits, Mr. Dallara noted. The resulting economic contraction had reduced the private sector demand for credit. Revitalization of the productive base of the economy would require a strengthened private sector, with access to credit. One positive development had been the elimination in February 1985 of the restriction on credit to nonindigenous enterprises. A continued relaxation of the credit allocation system would be conducive to economic growth. Higher interest rates, to compensate for inflation, might generate some additional savings, although the response was likely to be marginal given the stagnant state of the economy. The more important potential effect of high interest rates, as well as the relaxation of foreign exchange controls, would be the return of foreign capital to Nigeria. There was at the present time no incentive for a Nigerian living abroad to repatriate earnings or capital. Higher rates of return could stem capital flight, enhancing the short-term and medium-term balance of payments outlook for Nigeria.

The reopening of the economy to foreign trade and investment was as important as appropriate exchange rate adjustments, Mr. Dallara explained. Without access to foreign exchange and imports the private sector could not function, and indeed the economy would continue to contract needlessly unless a policy of liberalization were implemented. While the authorities were trying to place priorities on foreign exchange needs, the underlying allocation of resources in the economy was not changing because of the structural rigidity in relative prices. As a consequence, the demand for foreign exchange, and the authorities' priority list, continued to reflect a domestic production and consumption mix that was basically inappropriate, given developments in the world economy.

The pervasive control exercised by Nigeria over economic activity had stifled foreign investor interest in Nigeria, an important source of foreign capital that could asssist in ameliorating the medium-term outlook for the economy, Mr. Dallara continued. Nigeria's large economy could be quite attractive to foreign investors, if such investment could be made profitable. Direct investment inflows in the non-oil sector had peaked in 1981 and then declined in 1982 and 1983 when the naira had appreciated significantly in real terms. A substantial liberalization of the external sector, in conjunction with an exchange rate adjustment, could restore competitiveness to the Nigerian economy, thereby stimulating growth and diversification and regenerating the interest of foreign investors. That type of inflow would ease the debt-servicing burden by freeing the foreign exchange currently allocated to capital imports. Furthermore, direct investment would not lead to future debt service payments. In the absence of exchange rate and pricing adjustments, the medium-term outlook for Nigeria implied growing debt-servicing difficulties that could be avoided only by the implementation of the needed policy changes. The growing tendency to encourage countertrade was simply another reflection of the present inefficiencies in the Nigerian economy. The Nigerian authorities should adhere to their commitment to foreign creditors to eliminate arrears as scheduled and to avoid the accumulation of new arrears on current transactions.

The widespread use of trade and exchange controls had not addressed the fundamental disequilibria in the Nigerian economy, Mr. Dallara said, and he urged the authorities to complement their demand management policies with structural adjustment policies centered around realignment of relative prices, especially the exchange rate. Only then would there be an economic recovery coupled with a sustainable balance of payments position in Nigeria. He supported the proposed decision.

Mr. Alhaimus agreed with other speakers that the Nigerian economy had continued to encounter severe difficulties since 1981. The persistent sharp fall in oil export proceeds and the inadequate adjustment to changes in the international oil markets had had serious effects on all major aspects of economic performance. Output growth had been negative, with particularly sharp falls in 1983, the inflation rate had recently moved upward with a sharp rise in the consumer price index, and the fiscal position had steadily deteriorated with the overall deficit reaching 11 percent of GDP in 1983. In the external sector, large current account deficits had been recorded, together with a sharp fall in external reserves and a rapid accumulation of arrears. The set of trade and fiscal measures introduced in 1982 had not been sufficiently comprehensive and their implementation had been inadequate. It was particularly difficult to reverse the deeply entrenched expectations generated by the high revenues of the oil boom. A more ambitious approach had been pursued since 1984, however, and had already yielded positive results. A fundamental feature of the new approach was that national expectations and expenditures were to be scaled down to realistic levels. There had also been a welcome shift in emphasis to improving the efficiency of public administration, restructuring expenditure policies, and streamlining financial relations between the Federal Government and other public entities.

Significant achievements had been made in the past year in response to measures taken in the fiscal and external fields Mr. Alhaimus continued. The 1984 budget had been rightly described by the staff as the "first decisive move toward effective overall demand management" (SM/85/149). The fiscal deficit had been reduced to 5.2 percent of GDP in 1984 and a further reduction in the deficit, as a percentage of GDP, was expected in 1985. The restrained fiscal stance was accompanied by a more restrictive credit policy. As a consequence, some abatement in the rate of inflation had already been achieved.

The authorities had resorted to administrative measures in the face of the crisis in the external accounts and mounting indebtedness, Mr. Alhaimus commented. The measures, especially import controls, had contributed to a sharp reversal in the external accounts, which had manifested itself in a drastic reduction in the current account deficit in 1984 to 1.2 percent of GDP and considerable improvement in the overall balance. Large losses had been eliminated through the implementation of antismuggling measures; up to 100,000 barrels a day of petroleum products had been saved.

The strong measures adopted by the authorities in the area of demand management had undoubtedly eased the crisis situation to a considerable extent, Mr. Alhaimus remarked. The fundamental question that had to be faced was whether and how those achievements could be sustained and consolidated. The crucial issue in that respect was whether growth in the economy could be resumed in a noninflationary environment, thus ensuring a more solid basis for external and internal balance.

The task was made especially difficult by domestic pressures and the increasing external debt situation. The authorities seemed, as the staff had reported, to be fully aware of the major difficulties confronting them and were determined to pursue their adjustment path, taking into consideration the circumstances of the country. Particularly interesting was their deep concern over the high dependence of the Nigerian economy on imported consumer goods and raw materials and the emphasis of their strategy on stimulating economic development based on the comparative advantage of Nigeria. Their attitude regarding a massive devaluation of the currency was understandable. While not ruling out a more flexible exchange rate policy, the authorities seemed to be apprehensive about the social and political impact of a large devaluation in circumstances of deteriorating living standards and high unemployment. A gradual approach to exchange rate adjustment seemed already to have been put into effect; a 10 percent depreciation of the naira had recently been recorded.

Developments since early 1984 indicated that there had been some alleviation of the serious financial problems in the economy, Mr. Alhaimus concluded. The authorities had shown considerable determination to take difficult decisions, even at a high social cost. It was unfortunate, therefore, that agreement could not be reached on a role for the Fund to play in assisting the adjustment effort of Nigeria. With other large debtor countries, the Fund had attempted a variety of imaginative approaches and had introduced innovations that departed substantially from established concepts and practices. The flexibility shown by the Fund, both in arranging financing and in designing adjustment programs, had helped secure the necessary multilateral agreement in those cases. Against that background, the lack of agreement in the case of Nigeria, also a large market debtor, was conspicuous and had given the impression of a lack of flexibility on the part of the Fund. The prospects for an agreement on a Fund-supported program could be enhanced by moving toward a program design based on strong demand management policies and a gradual approach to relative price adjustment. The absence of an agreement with the Fund was bound to prolong the reluctance of Nigeria's creditors to ease the debt burden, making it more difficult for Nigeria to continue its strong adjustment course.

Mr. Govindarajan said that Nigeria's difficult economic and financial situation had been caused primarily by a sharp decline in oil revenues. The economy had experienced, for the fourth successive year, a fall in GDP, high and rising inflation, and increasing underutilization of capacity and unemployment. Nigeria's experience was typical of a country totally dependent on a single commodity--oil--for its revenues as well as its foreign exchange earnings. The Nigerian authorities had, however, taken substantial steps to offset the fall in oil revenues through the introduction of austerity measures in 1984, resulting in scaled-down capital expenditures and a reduction in transfers to state governments. The initial focus of economic policy had been on increasing the efficiency of public administration, restructuring expenditure policies, and streamlining the financial relations between the Federal Government on one hand and the state governments and nonfinancial public enterprises on the other. Despite a severe slowdown in monetary growth and improvements in fiscal discipline through expenditure control, in 1984 the rate of inflation had risen by 40 percent, mainly because of reduced availability of imported supplies.

There had been a modest increase in oil revenues in 1984, Mr. Govindarajan observed, but it was unlikely that the high levels of 1980-81 would be regained. The authorities therefore needed to pursue policies of adjustment, including those on the supply side of the economy to diversify production and to increase export and import-substitution capacity. The principal challenge was to combine demand management policies with measures to restructure the economy through diversification, the revitalization of the agricultural sector, the reduction of excessive dependence on the oil sector and on imports, and the attainment of a viable and external payments position in the medium term. The fiscal policy of Nigeria had so far been oriented toward reducing expenditures. Austerity measures had resulted in the reduction of the fiscal deficit from 11 percent of GDP in 1983 to 5.2 percent in 1984. The thrust had been maintained in 1984 and the deficit was expected to be only 4 percent. The authorities were restructuring their budget expenditures in order to improve growth prospects with a sharp reduction in current expenditures and a substantial step-up in capital expenditures. With the reduction in federal transfers, the state governments would need to take actions to rationalize and balance their budgets, possibly through an increase in local taxes. The Federal Government would also have to increase revenue yields, perhaps through an increase in domestic prices of oil and oil products, which were heavily subsidized. Such a price rise could support energy conservation measures as well as yield substantial revenues to allow the authorities to undertake priority investments in essential import-substitution and export-promotion areas.

The authorities had taken steps to reduce monetary growth, Mr. Govindarajan continued, and they would need to continue that policy, especially given the high rate of inflation. While positive real interest rates could be an incentive to saving, it was doubtful whether in a period of high inflation, interest rates ought to chase the inflation rate. However, the matter should be kept under constant review.

The difference in opinion on the appropriateness of the exchange rate remained as great as ever, Mr. Govindarajan observed. The staff considered that a shift to a realistic and flexible exchange rate policy was necessary to correct relative prices, bolster confidence, stem capital flight, and create a suitable environment for recovery. On the other hand, the view of the authorities was that while the naira was potentially overvalued, gradual depreciation was preferable to an immediate large discrete devaluation. In view of the predominance of oil in Nigeria's exports, any large devaluation at the present time would have an immediate impact on the import side of the balance of payments. Any reduction in imports could result in underutilization of capacity and the shortage of supplies, fueling the already high inflation rate. The exchange rate correction would have to be implemented in a way that was consistent with policies that sought to address other imperfections in the economy. An agreement on that matter would prepare the way for a Fund program.

Given the severe balance of payments situation, it was not surprising that Nigeria was maintaining exchange restrictions, Mr. Govindarajan commented. The medium-term outlook indicated that Nigeria would have to implement substantial adjustment measures for the next few years; but the continuation of restrictions would preserve distortions in the economy. However, the elimination of restrictions would have to be gradual and in line with the recovery of the economy and the improvement of the balance of payments.

The solution to the imbalances in the Nigerian economy in the medium term and long term lay in diversification, Mr. Govindarajan concluded. The steps taken to finalize an agricultural development program, in collaboration with the World Bank, were gratifying. Nigeria would have to implement a comprehensive program to reduce the fiscal and external gaps that were expected to continue through the end of the decade. The debt service ratio was very high, and restructuring of the debt by commercial banks should help to bring down the projected gaps in the balance of payments. Availability of external savings would be important for the success of comprehensive adjustment efforts by Nigeria. The close cooperation of the Fund, the authorities, and commercial banks was critical to the success of any adjustment operation.

Mr. Salehkhou noted that Nigeria's economic and financial difficulties remained severe despite the authorities' determined efforts to correct existing imbalances. The overall fiscal deficit had been reduced from 11 percent of GDP in 1983 to only 5.2 percent in 1984, and the increase in government net domestic borrowing had been contained at 17 percent, compared with almost 50 percent in 1983 and 116 percent in 1981. A significant reduction in the external current account deficit had also been recorded in 1984, although it largely reflected a shortage of foreign exchange and the adoption of strict import restrictions. Nevertheless, 1984 was a year of steep recession and of negative real growth, accompanied by an acceleration of the rate of inflation and a further deterioration in the underlying external position, in spite of fiscal restraint. Although total exports had increased by 11.2 percent in 1984 and the external accounts had been adversely affected, there had nevertheless been an additional accumulation of external arrears, continued excessive dependence of economic activity on imports, and aggravated distortions induced by the real appreciation in the naira.

The Government's main response to that economic crisis had been aimed at adjusting expenditures and consumption to the sharp reduction in foreign exchange receipts, Mr. Salehkhou observed. Given the dominance of oil revenues in fiscal and development financing and the fact that they had been reduced by 50 percent since 1980, such an adjustment was an urgent first step. However, in light of the magnitude of the distortions that had built up in the Nigerian economy during years of high oil revenues and expansionary policies, excessive reliance on fiscal policy and on administrative restrictions was unlikely to be sufficient to restore balanced growth. Demand management measures implemented by the authorities in 1984 and 1985 were impressive and included considerable cutbacks in the capital investment program, a prolonged freeze on civil service pay scales, liquidation of a number of political institutions, tax revenue measures, and a significant curtailment of net transfers to state governments and public enterprises. Those measures would be only partially successful so long as the authorities did not deal with the structural disequilibrium in the budget that resulted from excessive dependence on oil revenues. Indeed, non-oil receipts had declined further, and the deficit continued to be entirely financed through domestic bank credit. However, the reduced deficit had permitted a considerable decline in the growth of domestic credit and a containment of money expansion, which appeared inconsistent with the acceleration of inflation in 1984. The increase in consumer prices was apparently related to shortages of goods and uncertainties regarding medium-term developments.

A wide set of measures aimed at alleviating the pressures on the balance of payments emphasized direct import and foreign exchange restrictions and short-term considerations, Mr. Salehkhou said. While public accumulation of external arrears pointed to little progress in dealing with Nigeria's huge external debt, no arrears had been incurred in respect of external debt service and the Government's initiatives had permitted satisfactory settlement of the problem of uninsured credit. Efforts were being made to facilitate the settlement of remaining obligations, even though it had not been possible to agree on a financial program that could be supported by the Fund.

The authorities did not appear to agree with the prognosis of the staff, Mr. Salehkhou observed. The differences in their positions were due principally to the short-term priorities of the Nigerian authorities, who were understandably concerned with the immediate effects of a large devaluation of the naira on inflation and on living standards of the majority of the population, particularly given the prolonged economic recession and the existing shortage of goods. Some of the policies suggested by the Fund and Bank staffs had already been implemented by Nigeria. Certain restrictions on international transactions had been abolished, and development efforts were increasingly directed toward the rehabilitation of the agrarian sector and diversification of the productive base of the economy away from the oil sector. A detailed study of the industrial incentive system was under way, in conjunction with the preparation of the new five-year development plan. Although the authorities were not prepared to take the exchange rate action in one step, they were seeking a gradual elimination of the present overvaluation through a crawling depreciation as well as efforts to contain inflation.

Mr. Joyce remarked that despite concern about the immediate prospects for the Nigerian economy, the authorities deserved support for the important steps that they had taken to address the country's fiscal imbalance. Monetary and fiscal policies were now more restrictive, and further steps had been taken to rationalize capital expenditures. Nevertheless, policy initiatives in other areas had been far from adequate. The authorities continued to rely heavily on complex exchange, trade, and financial controls to contain the external payments deficit that had resulted in structural rigidities in the economy and in a loss of competitiveness in both the manufacturing and agricultural sectors. Some progress had been made recently in reducing both the current account and overall balance of payments deficit. Nevertheless, arrears had continued to grow and the debt service ratio in 1984 had increased sharply. The existence of large financing gaps in the balance of payments forecast for the medium term, and the further increase in the debt service ratio projected for 1985, demonstrated that the adjustments made in the economy had not been sufficient and that Nigeria was still some considerable distance from achieving a viable balance of payments position.

The Nigerian authorities would have to continue the relatively strong fiscal adjustment started in 1984 for some time to come, Mr. Joyce considered. They would be well advised to reconsider their other policies. Rather than relying so heavily on administrative control to reduce the external deficit, the authorities would have to implement measures to correct the deeply rooted structural imbalances and relative price distortions in the economy. While the authorities had to make their economic decisions based on the sociopolitical realities of their country, the question remained whether the policies proposed by the authorities would suffice to restore the economy to a balanced growth path, and if they would not, what the consequences might be for the welfare of the people.

Perhaps the most important area of change ought to be exchange rate policy, Mr. Joyce explained. The exchange rate had become significantly overvalued and a shift toward a realistic exchange rate policy was needed to correct relative prices, bolster investor and consumer confidence, stabilize expectations, and stem capital flight. A more moderate devaluation coupled with foreign exchange rationing and a whole panoply of other measures compounded uncertainty and was unlikely to create an environment conducive to new investment or to orderly economic recovery. The longer the changes in the restrictive exchange and trade system were delayed, the more difficult the eventual adjustment would be.

The authorities had taken strong measures on the fiscal front, Mr. Joyce noted, and he commended them for their intention to reduce the fiscal deficit to 4 percent of GDP in 1985. Although that action was important, the authorities would have to consider other ways to reduce dependence of revenues on the oil sector and to increase the elasticity of the tax system. Perhaps a first step would be to strengthen the returns from the newly broadened domestic excise tax by relaxing controls on ex factory prices and reducing or eliminating the economic subsidy on domestic petroleum products. On the expenditure side, government outlays had been reduced substantially, as a percentage of GDP, through a freeze on civil service pay scales and significant cutbacks in capital expenditures. The authorities were right to restore capital expenditures to levels considered adequate by the World Bank staff. However, appraisal of public sector activity would be impossible in the absence of better data on public enterprises and state governments. Technical assistance could be provided by the Fund in that area. The increased budgetary restraints since 1984 had been accompanied by a tightening of credit policy. Given that the federal government deficit had been financed largely by the domestic banking system, the ability to tie down monetary growth would depend on the authorities' success in reducing the budget deficit further. The continuation of real negative interest rates in 1985 was a policy that the authorities ought to reconsider because of its many adverse effects.

The measures adopted since May 1984 to rationalize tariffs around a low and uniform range and to simplify the customs code were only a first step, Mr. Joyce considered, and the authorities had to move ahead to phase out the complex and highly restrictive imports system. On external debt, Nigeria should complete its program of refinancing uninsured trade credits through the issuance of promissory notes.

The authorities should be commended for the difficult steps they had taken, Mr. Joyce said. But he wondered whether their optimism that the continuation of present policies would yield a diversification of the economy, a reduction of the present dependence on oil revenues, and a correction in the fiscal payments imbalances was justified. A partial adjustment program was insufficient and without a comprehensive set of policies, the free development of the economy would be impeded.

He supported the proposed decision and welcomed its call for comprehensive adjustment policies to resolve Nigeria's external payments difficulties, Mr. Joyce concluded.

Mr. Yao commended the introduction by the authorities of a series of austerity measures in 1984 to restore the internal and external balance, rehabilitate the agricultural sector, and restructure the state enterprises. Despite certain improvements in the financial situation of the country in 1984, the economy remained structurally weak, mainly because of the continued soft international demand for oil on which the Nigerian economy was heavily dependent.

Total government expenditure had been reduced substantially through a freeze in wages and salaries, the liquidation of certain government agencies, and a curtailment of transfers and subsidies, Mr. Yao observed. The authorities' intention to maintain a restrictive fiscal policy in 1985 in the face of continuing economic recession and rising unemployment was commendable. Under the austerity program, total expenditure would be reduced by 6 percent while capital outlays were due to increase significantly. The reduction in total expenditure would be achieved essentially through a limitation on transfers to public enterprises and to state governments, while the increase in the capital expenditure account would be due mainly to the Government's emphasis on the development of agriculture. The close collaboration between the authorities and the World Bank in preparing of the capital expenditure program was a process that ought to be encouraged and, if possible, strengthened.

There were, however, two unfavorable developments on the fiscal front, Mr. Yao noted. First, the authorities seemed to rely heavily on expenditure cuts to achieve the reduction in the budget deficit. Second, the tax/GDP ratio had declined steadily from 31.4 percent in 1980 to 16.14 percent in 1984, largely reflecting the decline in oil revenue. It would be interesting to know how much further the authorities could pursue adjustment by relying principally on expenditure cuts. A broadening of the tax base was called for in order to reduce the dependence of government revenue on oil production and exports. The introduction of new measures by the Government was a step in the right direction.

The trade and exchange restrictions had been streamlined in order to achieve the desired reduction in the current account deficit, Mr. Yao said, and a system of advance payment of import duties had been introduced with a view to raising revenue. In 1984, the shortage of imported goods together with a very low utilization rate of industrial capacity had led to a sharp increase in the rate of inflation despite a moderate growth in the money supply. Those developments underscored the need to undertake a comprehensive structural program that would lay the foundation for balanced economic growth. The authorities' plan to introduce a wide set of incentives to stimulate domestic production, based on the comparative advantage of Nigeria, was to be encouraged. A study of industrial incentives should be completed quickly and appropriate measures taken.

The medium-term prospects for the Nigerian economy would continue to be dependent on developments in the oil market, which, Mr. Yao pointed out, were far from encouraging. The budget deficit as a percentage of GDP was expected to rise as a consequence of the heavy debt service burden and continued depressed oil market. Further, the external payments position would remain under pressure, given that a financing gap of about $1 billion a year had been projected over the next four years. Such an outlook suggested that the restrictive demand management policies being implemented ought to be continued, in combination with measures that would improve the supply-side response of the economy, particularly in agriculture. The Nigerian authorities were facing deep-rooted economic and financial problems that needed to be tackled on all fronts. The authorities should be commended for their efforts to address those problems and restore the viability of the Nigerian economy--one that had particularly high growth potential.

Mr. Zhang said that, all things considered, he sympathized with the Nigerian authorities in their view that a gradual devaluation of the naira was preferable. First, devaluation could not be regarded as a panacea for a large country with a diversified resource base where the ratio of foreign trade to GDP was not as important as in other developing countries at a similar stage of economic development. Second, investment was not being accorded sufficient importance by the staff in the structural adjustment program. Investment in Nigeria had been falling, and it was doubtful whether future growth could be based entirely upon an expansion of nontraditional exports. Third, the ratio of gross domestic savings to GDP had fallen since the beginning of the 1980s, a shift that could not be attributed entirely to the negative real rate of interest. It would be interesting to know to what extent the fall had been affected by the rise in consumption out of oil income.

The Executive Directors agreed to continue their discussion in the afternoon.

APPROVED: April 2, 1986

JOSEPH W. LANG, JR.
Acting Secretary