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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/99
and Correction
10:00 a.m., June 21, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	M. Lundsager, Temporary
	G. Ercel, Temporary
	X. Blandin
	N. Haque, Temporary
	H. Kobayashi, Temporary
	W.-R. Bengs, Temporary
J. E. Ismael	
	G. D. Hodgson, Temporary
	H. A. Arias
	A. K. Juusela, Temporary
	A. Abdallah
F. L. Nebbia	
	G. R. Castellanos, Temporary
	E. M. Ainley, Temporary
P. Pérez	G. Ortiz
	J. de Beaufort Wijnholds
	A. J. Tregilgas, Temporary
	H. Alaoui-Abdallaoui, Temporary
	A. Vasudevan, Temporary
	D. J. Robinson, Temporary
	N. Coumbis
Zhang Z.	Wang E.

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

Also Present

African Department: A. D. Ouattara, Director; P. A. Acquah. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; N. E. Weerasinghe. External Relations Department: H. P. Puentes. IMF Institute: C. Corado, J. L. Rodas, Participants. Legal Department: J. M. Ogoola. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, C. Cha, R. A. Elson, J. Martelino. Advisor to Executive Director: J. Hospedales. Assistants to Executive Directors: M. B. Chatah, J. de la Herrân, J. E. Rodrîguez, C. A. Salinas.

1. GUATEMALA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Guatemala (SM/85/153, 5/28/85). They also had before them a report on recent economic developments in Guatemala (SM/85/162, 6/7/85; and Cor. 1, 6/21/85), together with an information notice on the real effective exchange rate of the Guatemalan quetzal (EBS/85/156, 6/20/85).

Mr. Castellanos made the following statement:

Until the 1960s, Guatemala's growth originated mainly from exports of traditional products. During the 1960s and early 1970s, industrial growth was encouraged by the Central American Common Market. Real GDP growth, which averaged 6 percent a year during 1970-75, accelerated to 7.5 percent in 1976-77 as exports increased and the terms of trade improved. However, during the past few years, economic growth weakened owing to a decline in major commodity export prices, the worldwide recession, and the particular political circumstances of the Central American region. After two years of negative growth, in 1984 the Guatemalan economy showed signs of recovery in its traditional environment of low inflation.

During the 1960s and most of the 1970s, fiscal and monetary policies were managed conservatively by the Guatemalan authorities. From 1979 on, however, and as a consequence of the adoption of countercyclical policies and the implementation of infrastructure projects, both fiscal and monetary policies began an expansionary trend. Although these projects were financed in part by international institutions, failure to find complementary financing and unexpected increases in project costs led to a more intensive use of the country's international reserves. In addition, the reduced supply of foreign exchange due to the continuing deterioration of prices of the main export products and the erosion of confidence brought about a depletion of international reserves. In 1982, as a result of the lower level of reserves, the country began to accumulate commercial arrears, and the authorities had to adopt restrictive measures to prevent an accelerating accumulation of those arrears. The measures included a system of import quotas and a strengthening of the limits on allocation of foreign exchange for invisible transactions. The following year, an adjustment program supported by the Fund aiming at reducing fiscal and monetary imbalances and setting a schedule for the settlement of commercial arrears was put into effect by the Government. The quantitative ceilings of the program were met in 1983 and the first three quarters of 1984, although government revenues were lower than expected. In the last quarter of 1984, the country adopted a set of fiscal measures that were complemented by the introduction of a free exchange rate and an auction market for foreign exchange, in addition to the official one. At the beginning of 1985, the monetary authorities strengthened the free exchange rate market by legalizing exchange houses to promote competitiveness.

Since 1982, the authorities have made considerable progress in reducing the government deficit. The overall deficit of the Central Government was reduced from 7.4 percent of GDP in 1981 to about 3 percent in 1983 and 1984. The authorities expect to maintain that level in 1985 and are considering the adoption of appropriate measures to attain that objective. The reduction in the overall deficit has been made possible through more adequate expenditure management.

During the 1960s and the first part of the 1970s, capital expenditures were managed conservatively. However, toward the end of the 1970s, the implementation of some projects--especially in the field of hydroelectric power generation--changed the traditional pattern of central government capital expenditures, which increased rapidly between 1978 and 1981. Once the projects were completed, the conjunctural increase of capital expenditures was expected to diminish to a level conforming to their historical trend. Indeed, capital expenditures were reduced after 1982, when the most important projects reached their final stages. Thus, capital expenditure reductions should be interpreted as a normal result of the completion of those projects and not as the outcome of a deliberate policy. On the other hand, the introduction of new social projects within the framework of capital expenditures and the so-called microprojects in rural areas, mainly in Indian villages, have required time for their financing and implementation. Additionally, when these projects were evaluated in 1984 and the amount of capital expenditure was under revision, the budget's external financing was very low, which explains the low level of capital expenditures during 1984. At present, the authorities are working closely with international development organizations to negotiate loans for the financing of such projects.

For 1985 and subsequent years, capital expenditure will progressively increase together with the implementation of microprojects. Clearly, the authorities realize that only through the promotion of sound investment expenditures will the country be able to achieve growth rates compatible with development needs and the improvement of the nation's welfare.

Through a freeze on salaries of public employees and a stricter administrative control of expenditures during 1982 and 1983, current expenditures were reduced from their 1981 level. In 1984, current expenditures were somewhat higher owing to the increase in interest payments and the outlays arising from the democratization process in which the authorities are currently engaged. For 1985, however, the authorities expect to reduce current expenditures further, while taking care not to jeopardize the acceptable level of operations of the Central Government.

The decline of government revenue since 1981 reflects the slowdown of economic activity which, in turn, is largely explained by unfavorable prices for the country's main export products and quantitative restrictions--namely, quotas--that have been applied in the international market for two of these products, coffee and sugar. Another contributing factor is the change in the tax structure implemented to reduce fiscal dependence on revenues from the external sector (export duties have been reduced to a very low level). An effort has been made to offset this revenue loss through the application of taxes related more to internal activity. In this regard, significant progress has been made with the introduction of the value-added tax (VAT), although quantitative results have fallen short of expectations, owing mainly to technical factors. Revenues expected from the VAT were initially overestimated because of the difficulties in computing the amount of transactions subject to the VAT and because of the higher than expected degree of tax evasion, among other reasons. In view of the problem of tax evasion, the authorities decided to reduce the rate of the VAT from 10 percent to 7 percent and to revise the collection mechanisms, adopting additional measures to strengthen administrative controls. The authorities expect that these improvements, together with a widened tax base, will result in higher VAT revenues.

In 1984, imports increased steadily, reflecting the progressive flexibility attained in the administration of import quotas, as well as the elimination of exchange restrictions in the last quarter. The deficit in the services account also tended to increase owing to the implementation of the bona fide clause for invisible transactions in February 1984, as stipulated in the stand-by arrangement. In this regard, the authorities wish to point out that the deficit in the current account of the balance of payments is a structural result of the circumstances involving Guatemala's commercial flows. This deficit has traditionally been offset by capital inflows. These inflows have, however, diminished drastically since the beginning of the 198^s, worsening considerably the overall balance of payments position.

In September 1983, the authorities framed an adjustment program supported by the Fund. For an objective evaluation of the results of this program, it is convenient to distinguish two periods: the first, comprising the last part of 1983 and the first three quarters of 1984; the second, including only the last quarter of 1984. During the first period the country observed all the quantitative ceilings included in the adjustment program, in spite of some imbalances that existed between quantitative ceilings and targets. My authorities wish to emphasize that the reduction of arrears was made without the support of the financial package contemplated in the adjustment program and also without making two of the last three purchases under the stand-by arrangement. During the first period, the authorities implemented all the possible financial measures considering the political stance of the country in order to meet the quantitative ceilings of the stand-by program. In the last quarter, results were strongly influenced by the curtailment of the external finance that had been envisaged. Consequently, despite the adoption of new fiscal measures, credit to both public and private sectors increased very rapidly to compensate for the reduction of external financing.

Notwithstanding that my authorities are in broad agreement with the staff's quantification of the amount of U.S. bonds issued by the Bank of Guatemala, they consider it useful to make a distinction between the nature and characteristics of these bonds, since it is not appropriate to consider the totality of these bonds as representing external arrears. In fact, the Bank of Guatemala issued two series of bonds. The bonds issued before November 1984 were a formal recognition of arrears of the country with foreign commercial creditors. However, most of the bonds issued after November 1984 represented exclusively exchange rate guarantees offered by the Central Bank, and thus should not be regarded as reflecting external arrears.

For 1985, the authorities expect a moderate redressment of the country's economic and financial situation. The implementation of the package of measures designed last April was postponed and is currently under revision in order to obtain a broader social consensus. The authorities, however, have the firm intention of gradually adopting measures in line with the recommendations of this Board, in order to reduce substantially both internal and external imbalances in the medium term. The Government has set up a committee including representatives of labor, business, banking, and the Administration to discuss alternative economic and financial options regarding the continuation of adjustment efforts. My authorities are convinced that without a consensus of all economic and financial forces it would be difficult to design and implement a package of wellcoordinated and effective measures. The committee is in the final stages of its discussions, and the authorities expect that the committee's conclusions and proposals will be submitted to the Government in the near future.

For the second half of 1985, the authorities plan to improve tax collection, reduce public expenditures, and make the new exchange rate system more flexible. The objective continues to be the elimination in the medium term of the deficit in the central government accounts. Revenues will be boosted by the introduction of new taxes, expenditures will be further restrained, and changes in the level of monetary aggregates and interest rates will closely support the fiscal measures. On the other hand, the monetary authorities are looking forward to a simplification and unification of the exchange rate markets. They recognize that the maintenance of a multiple exchange rate system should be temporary and are committed to obtaining a gradual reunification of present rates. In addition, the Government will continue to promote the diversification of export products; to this end, the reduction of the overvaluation of the quetzal will be most helpful, since the competitiveness of nontraditional exports to new markets outside the Central American Common Market will be strengthened. The authorities strongly feel, however, that in addition to the country's efforts toward export diversification, the cooperation of other industrial countries with potential markets for Guatemalan products will be needed in order to diminish the growing protectionist trend of the past few years.

Although the measures that the Guatemalan authorities intend to implement in the second half of 1985 have to be viewed as a first step of the second phase of an adjustment program in the medium term, they are in line with the recommendations of this Board and have to be evaluated within the framework of the future adoption of complementary measures. The particular circumstances of the country do not lend themselves to the adoption at once of all the measures that the authorities would consider appropriate. However, those already enacted and others being contemplated are a step in the right direction. Finally, my authorities would like to emphasize their appreciation for the well-balanced work done by the staff during the recent mission and for the useful exchange of views regarding the economic situation of the country and the alternative policies needed to continue the adjustment efforts of the Government. They look forward to maintaining a close relationship and cooperation with the Fund.

Mr. Arias said that he was in general agreement with the thrust of the staff appraisal of Guatemala's recent economic performance. Guatemala faced serious economic difficulties, and the authorities' commitment to strengthening the adjustment program was therefore welcome.

In 1984, slippages had occurred in the stabilization program introduced in mid-1983 that had aimed at adjusting the deep-seated structural imbalances arising from the secular decline in the country's terms of trade and the resulting large reduction in real income, Mr. Arias continued. The economic situation had deteriorated further as real GDP per capita had continued to decline and persistent fiscal and balance of payments deficits had emerged.

The Guatemalan authorities therefore faced a challenging task, and the policy environment needed to be improved urgently so that the adjustment process could be intensified, Mr. Arias considered. The deep-seated structural nature of the imbalances required adjustment within an extended framework. Most important, the fiscal position needed to be strengthened to reduce pressure on the balance of payments and create conditions conducive to sound and sustainable growth. Reduced economic activity had contributed in part to the unsatisfactory trend in revenue performance. The Guatemalan authorities should act without delay in carrying out their intention to introduce more effective revenue measures as well as to monitor closely and improve tax administration.

The restraint in public expenditure was welcome, but the scope for its continuation was limited as both current and capital expenditure had been squeezed, Mr. Arias remarked. Furthermore, the resumption in the growth of capital expenditure would be important for overall capital formation and for the enhancement of economic activities. A boost in public revenues was therefore needed, and the measures recently announced were an important step in that direction. The weak fiscal position had coincided with loose monetary policies that were primarily responsible for the slippages in meeting performance criteria under the stand-by arrangement with the Fund. The strengthening of the fiscal position therefore should be accompanied by an appropriate monetary policy. The decision to raise interest rates was a welcome first step toward exploiting the country's savings potential.

The authorities' management of the exchange rate underlined the importance that they attached to achieving external and internal balance, Mr. Arias observed. While the staff considered the adoption of a more flexible exchange rate policy to be an important step in the restructuring process, they had called for an immediate reunification of the recently implemented three-tier exchange rate system, thereby ignoring the structural and longer-term aspects of the problem. Clearly, the authorities viewed the three-tier system as a temporary measure warranted by conditions; he shared their view that the transitional arrangement under which the depreciation of the quetzal was taking place gradually was necessary, considering the long-established, fixed relationship of the exchange rate with the dollar and the need to ensure a more equitable sharing of the burden of adjustment among the main segments of society. Undoubtedly the operational difficulties associated with the complex arrangement would disappear as the authorities became more familiar with it. Moreover, the greater flexibility of exchange rate policy would improve the international competitiveness of the economy and facilitate export growth, thereby contributing to the recovery of economic activity. The recent tariff reform would be a key underpinning to those transitional arrangements.

The authorities did not regard the totality of the stabilization bonds denominated in dollars as representing external arrears--a position that differed with that taken by the staff, Mr. Arias noted. He invited further staff comment on that matter.

Ms. Lundsager noted that in recent months the Guatemalan authorities had made some efforts to address the economic imbalances confronting their country. Notably, the exchange system that had been in place for more than half a century had been disbanded and replaced by one having greater flexibility, which had resulted in a substantial real depreciation of the quetzal. Unfortunately, efforts to implement stronger fiscal and monetary policies in support of the exchange system had fallen short of what was needed, so that the system had not worked as had been envisaged. With domestic adjustment lagging, the internal and external imbalances remained, as reflected in the large increase in external arrears, with deleterious effects on Guatemala's creditworthiness.

Postconsultation developments caused concern, particularly since prospects for speedy implementation of adequate adjustment measures appeared less than favorable at present, Ms. Lundsager remarked. The authorities' recent efforts to develop a national consensus on the need for economic adjustment was therefore welcome.

A broadly based adjustment effort, beginning with a reduction of the fiscal deficit, was required, Ms. Lundsager continued. While the deficit--at about 3-3.5 percent of GDP--was much smaller than that of many other countries, fiscal adjustment was nonetheless important because in coming years available foreign financing was expected to be relatively small. A more rational tax system also was required in view of the historical reliance on export taxes. Supply functions for exports in many countries had proved to be more elastic than had been expected; as a result, exports subject to taxes had decreased in the long run. Considering Guatemala's need to expand exports to finance imports and debt service, export taxes should be avoided; the recent reduction of export duties to low levels was a step in the right direction.

The authorities expected a large hydroelectric project to be completed in the near future, with cost overruns paid off by 1986, Ms. Lundsager noted. The project had been financed with external borrowing; she would be interested to hear about prospects for the electric company earning an operating surplus that would help service the external debt. Would there be additional adjustments in utility rates?

Monetary policy clearly must be more restrictive and would be facilitated by a reduction in the fiscal deficit, Ms. Lundsager commented. The operating losses of the central bank were in fact part of the overall fiscal deficit, although typically the operations of the central bank were not included in the aggregate fiscal accounts. She asked whether the staff had any estimate of the size of those losses and what the overall fiscal deficit would be if they were included.

The authorities were to be commended for cutting the peg between the quetzal and the dollar, Ms. Lundsager commented. The next step would be to improve the functioning of the exchange system, since at present it was quite complicated, with export surrender requirements determined both by type of product and by destination. The authorities had little choice but to aim for an early unification of exchange markets. The difficulties in segmenting the market were becoming apparent, since it was virtually impossible for supply to equal demand in each market segment. The rates were moving in the various segments, but as the unauthorized parallel-market rate was higher than the other three rates, sizable imbalances clearly remained.

Stronger adjustment measures must be implemented in Guatemala, Ms. Lundsager concluded. The authorities were aware of that need and were beginning to generate support for such measures. The committee that was discussing the adjustment effort expected to complete its study in the near future, and she urged swift implementation of actions to contain the fiscal and external deficits and to improve the exchange system. External arrears could then be reduced, restoring Guatemala's creditworthiness. Finally, in view of the current policy stance in Guatemala, she agreed with the staff recommendation that Guatemala's exchange restrictions and multiple currency practices not be approved.

Mr. Hodgson stated that during the past two years the Guatemalan authorities had shown a willingness to consider a number of corrective actions to address their difficult economic situation, which was similar to that of other Central American countries. Some positive measures had been implemented, most notably the large real effective devaluation of the quetzal, but not all the measures that had been discussed with the Fund and endorsed by the Executive Board had been acted upon.

The political turmoil in the region and difficult external conditions had made policy formulation difficult, Mr. Hodgson noted, but domestic considerations had also been allowed to intrude. At present, the authorities needed to take some strong, positive adjustment measures to correct the imbalances in the economy.

For the most part, he agreed with the staff's assessment of the macroeconomic situation and endorsed its recommendations, Mr. Hodgson said. It was disappointing that the authorities had been unable to carry out the wide-ranging fiscal and monetary measures planned for early April 1985. Reform in respect of government revenue, interest rate policy, and the central bank's capacity to manage credit growth were essential to strengthening Guatemala's macroeconomic management and were also needed to buttress the exchange rate action already taken. His chair appreciated the delicate political circumstances in which the decision not to carry out those measures had been taken, as well as the need to form a broad social consensus for any adjustment effort. He hoped that some common view could be reached on corrective policy measures as a result of consultations among a wide number of groups in Guatemalan society that were currently in progress. Nevertheless, the need for such action had not diminished. In that regard, he invited the staff or Mr. Castellanos to provide more detail on the measures being considered for the second half of 1985.

The Guatemalan authorities were to be congratulated for unpegging the quetzal from the dollar in the fall of 1984, which had yielded a sizable real effective devaluation of the quetzal over the first part of 1985, Mr. Hodgson continued. The shift to a three-tier exchange system was an important transitional step toward fuller exchange rate flexibility. However, the instability in the exchange market in early 1985 was evidence that a multiple rate system could cause uncertainty and result in resource misallocation. The authorities therefore should move toward reunification of the exchange rate without undue delay, perhaps by initially merging the official and banking market rates. He invited the staff to comment on whether the current rate in the auction market was a market-clearing rate or whether some overshooting had occurred.

Since any further cuts in capital outlays would be counterproductive, he agreed with the staff recommendation that fiscal policy should concentrate on improving government revenues, Mr. Hodgson remarked. Prior to the decision taken in April to delay implementing the revenue package, the authorities also appeared to have shared that view, and he encouraged them to strengthen the fiscal position as a prerequisite to other fundamental reforms.

The removal of legal barriers to variable interest rates was welcome and should be followed by other steps to allow financial markets to function more freely, Mr. Hodgson commented.

Mr. Nebbia remarked that during the past few years the economic and financial position of Guatemala had deteriorated substantially, reflecting adverse external developments as well as the lack of an appropriate domestic policy response to the new circumstances faced by the economy. Domestic output had fallen considerably, and the external position had remained weak, with an accumulation of payments arrears since 1982. In addition, outstanding external public debt had risen substantially in the past five years, leading to a marked increase in the debt service ratio in the years ahead and thus endangering the capacity of the country to honor its external commitments while achieving the goals of a resumption of reasonable economic growth and stability.

In recognition of the imbalances existing in the economy, the authorities had framed an adjustment program in late 1983 that had been supported by the Fund, Mr. Nebbia observed. Unfortunately, the program had fallen short of expectations, and substantial deviations had been recorded for most of the quantitative performance indicators, which had led to the interruption of the program after May 31, 1984. Since then, the authorities had implemented several additional measures to strengthen the balance of payments position, reduce payments arrears, restore fiscal equilibrium, and reduce the rate of inflation. Most of those measures had been steps in the right direction and in line with the Fund's policy recommendations, although some of them had proved insufficient to deal appropriately with the large imbalances existing in the economy.

The authorities had succeeded in reducing inflation from an annual rate of more than 11 percent in 1981 to only 3.6 percent in 1984, a commendable achievement in view of its positive implications for the wage adjustment policies to be followed and the potential gains in competitiveness that could derive from a lower domestic inflation rate, Mr. Nebbia continued. The results with regard to fiscal policy, however, were mixed. The overall deficit of the Central Government had declined from the equivalent of 7.4 percent of GDP in 1981 to about 3 percent of GDP in 1984, but the improved performance of central government operations was almost exclusively the result of a sharp cutback in capital expenditures rather than an increase in revenues or current expenditure restraint. If such a policy were maintained, the prospects for economic growth would be endangered, given the low level of overall investment. Moreover, cutbacks in capital outlays had reduced the volume of foreign financing available, so that despite the reduction in the overall central government deficit, domestic financing had been larger than expected, and, consequently, fewer resources had been available to the private sector.

He agreed with the staff that efforts should be concentrated on improving the revenue performance of the Central Government and on restraining current expenditures, Mr. Nebbia remarked. In that regard, he noted the authorities' commitment to implementing a package of measures in 1985, including the improvement of tax collection, the introduction of new taxes, further restraint in expenditures with emphasis on current expenditure, and monetary management in line with fiscal measures.

The adoption of a more flexible exchange rate policy in November 1984 had been an important step toward reducing external imbalances, Mr. Nebbia added. However, the current system was not only unduly complex but also discriminatory and had introduced unnecessary additional distortions into the resource allocation process. Moreover, almost two thirds of total transactions were still being settled at the official rate of Q 1 = $1, which had led to the emergence of large imbalances in the official market and induced more pressures in the unauthorized parallel market. The prompt reunification of the exchange rate at a level reflecting market forces would be most welcome. The authorities might achieve that reunification by gradually shifting transactions from the official to the banking market and by eliminating the auction market. The sooner they acted, the easier it would be to dismantle a system that was currently creating distortions in certain sectors of the economy. Moreover, as a larger number of transactions were settled at the banking market rate, the rate for the quetzal would become more stable and would better reflect the real cost of foreign currency. An appropriate exchange rate policy, together with fiscal and monetary discipline, would yield substantial gains in competitiveness, reduce external arrears, and contribute to the resumption of economic growth in the context of a reasonable domestic and external balance.

The staff representative from the Western Hemisphere Department remarked that the cost overruns of the State Electricity Institute (INDE)--the largest enterprise in Guatemala, accounting for about two thirds of all public enterprise operations--had been recently financed by loans from the World Bank, the Inter-American Development Bank, and the Italian Government. The contracts for those loans specified that a certain profitability should be guaranteed to meet INDE's rising debt obligations in coming years. That guarantee included the periodic adjustment of electricity tariffs to reflect any increase in operating costs. Accordingly, the staff expected that in the long term, INDE would be able to meet its debt obligations from its its own resources.

Arrears bonds had been issued in respect of pending foreign exchange requests by the private sector that were not met by the Bank of Guatemala, the staff representative explained. There were two kinds of arrears bonds: those that were accepted by foreign creditors, for which the interest rate was 1 percent above the rate for five-year U.S. treasury notes payable in dollars, and those that were not accepted by foreign creditors, for which the interest rate was 6 percent payable in local currency. The staff considered all arrears bonds to be part of external arrears, for two reasons. First, the technical memorandum of understanding for the stand-by arrangement defined all outstanding arrears bonds as part of external arrears, a mechanism for monitoring the amount of past due foreign obligations and thereby measuring the adjustment effort that had been made. Second, arrears bonds were issued unilaterally, and the option given to foreign creditors was limited. If the foreign creditors did not accept arrears bonds, the obligation remained in arrears, with the domestic importer holding the bonds and receiving 6 percent interest payable in local currency. Consequently, the acceptance of arrears bonds did not necessarily constitute a voluntary agreement for foreign creditors. The Guatemalan authorities believed that not all outstanding arrears bonds constituted arrears, because some of the foreign obligations for which arrears bonds were issued had already been paid by the private sector through the parallel market. However, the amount of such arrears that had already been settled through the parallel market was not known.

The operating losses of the Bank of Guatemala and the issue of the reunification of the exchange markets were closely related, the staff representative commented. The suggestion that the three-tier exchange system be gradually reunified, in view of the particular economic situation of Guatemala, presented serious problems because of large imbalances in the exchange markets, particularly the official market, which would continue to produce large exchange losses for the Bank of Guatemala. The authorities had estimated the imbalance in the official market to be on the order of $100 million in 1985. Moreover, a gradual reunification would substantially reduce the impact of the exchange rate depreciation on the external position, as the effect of the depreciation would be limited to a small portion of total foreign exchange transactions. In the past several months, the weighted average depreciation of the quetzal had been 50 percent, whereas the devaluation of the quetzal in the banking market had been about 200 percent. Since the banking market represented only one fourth of total transactions, even a large depreciation in that market had only a limited impact on overall foreign exchange transactions. Moreover, the present system was overly complex and resulted in the arbitrary allocation of resources.

To cover the imbalance in the official market, the staff representative continued, the Bank of Guatemala had sold about 20 percent of its gold holdings. In addition, it had been buying dollars in the banking market to feed the official market; the resulting exchange losses, combined with large interest payments abroad, had been substantial. In 1984, there had been no exchange losses, but operating losses arising from interest payments had amounted to about Q 50 million, equivalent to about 1/2 of 1 percent of GDP. In the first five months of 1985, the total losses of the Bank of Guatemala resulting from high interest payments and exchange losses were estimated to have been between Q 100 million and Q 130 million. The more the exchange rate depreciated, the more the losses would increase, posing difficulties for the future management of monetary policy.

It was difficult to say whether the large depreciation of the quetzal in recent months had represented underlying market forces or whether there had been some element of speculation, the staff representative from the Western Hemisphere Department remarked. After the introduction of the new measures in November 1984, the rate had been quite stable at about Q 1.50 per dollar, which had been the prevailing rate in the unauthorized parallel market at the time of the introduction of the three-tier system. Most of the depreciation had taken place in mid-April, soon after the cancellation of the announced adjustment measures. The depreciation could therefore reflect several factors, such as the large imbalances in the economy, some speculation associated with the implementation of the new exchange system, and the concern of the private sector over the lack of adjustment and the large foreign obligations of the Bank of Guatemala.

The Deputy Director of the Exchange and Trade Relations Department said that it was difficult to determine clearly whether arrears bonds constituted external arrears. The bonds had been introduced to verify the extent of outstanding arrears, a convenient technique often used in countries where the local currency was deposited in the central bank and attracted a rate of interest or an exchange guarantee. The staff had always regarded those bonds as part of arrears. The question in Guatemala was whether the creditors considered that the obligation to them had been eliminated by their acceptance of the bonds. As the staff representative from the Western Hemisphere Department had explained, there was an element of unilateral action by the member country in the issuance of those bonds. There were also questions concerning the interest rate, which was a market interest rate, as well as the redemption of the bonds according to a lottery. The precise extent of the arrears would probably be decided only if Guatemala entered into a financial program with the Fund.

Mr. Castellanos said that the measures adopted in April 1985 were being revised in order to achieve a broader national consensus. For that purpose, the Government had established a committee including representatives of labor, business, banking, and the Administration, to discuss alternative economic and financial options related to the continuation of adjustment efforts. The committee was in the final stages of its deliberations and would shortly submit its conclusions to the authorities.

Among the adjustment measures that the authorities intended to adopt as a result of the committee's recommendations was a new tax that would cover all external flows and would increase public revenues to Q 72 million per semester, Mr. Castellanos continued. In addition, a tax of at least Q 0.50 would be levied on each gallon of gasoline. Expenditure would also be restrained by Q 72 million. Despite those measures, his authorities were very cautious about expecting a rapid and sustained upturn in government revenue flows unless exogenous factors, such as the regional economic slump and recovery in the prices of Guatemala's main export products, evolved favorably in the near future.

His authorities, Mr. Castellanos stressed, were extremely interested in adopting corrective measures in order to reach equilibrium in the external financial position in the medium term. However, bearing in mind the current political situation of the country, they believed that gradualism in the adoption and implementation of measures was necessary. In that sense, they agreed with the recommendations of the staff, although some differences continued to exist concerning the timing of adjustment.

Experience with the new exchange system was limited, and thus no definite conclusions could be drawn about its benefits, Mr. Castellanos continued. Directors should bear in mind that Guatemala had had a fixed exchange rate policy for almost 60 years; consequently, the adoption of a free exchange market had required a constant monitoring of the administrative process. The performance of the new system as well as the exchange rates themselves were becoming more stable. The authorities assumed that the speculative forces were being eliminated from the market and that, consequently, the supply and demand of foreign exchange reflected more clearly the needs of the productive sector for domestic liquidity and foreign currencies. Moreover, the authorities intended to reunify the exchange markets and expected that, by the end of 1985, only public debt payments would remain in the official market.

His authorities were in broad agreement with the staff's estimate of the amount of dollar bonds issued by the Bank of Guatemala, but they considered it useful to draw a distinction between the nature and characteristics of the two bond issues, Mr. Castellanos remarked. The bonds issued before November 1984 had been a formal recognition of the country's arrears with foreign commercial creditors. Those issued after November 1984, however, had had a dual purpose because one part had represented arrears, while the other part had covered obligations of the Bank of Guatemala taken as an exchange rate guarantee. Also, part of the first and second bond issues had been freely accepted as payment by commercial creditors, and thus did not constitute arrears in the technical sense but rather represented a bilateral renegotiation of debt from the short term to the long term.

The second bond issue could be viewed in three ways, Mr. Castellanos added. From a legal point of view, the free-market exchange rate system had been instituted under the provisions of the Monetary Act, which required that the Bank of Guatemala, before adopting a free-market exchange rate system, pay or formalize all outstanding obligations through bilateral arrangements. There had been many bona fide demands for foreign exchange that the importer could at any moment present to the central bank, even though they had not been presented to that institution before November 1984 and had already been paid with resources obtained in the unauthorized parallel market. The central bank had had no choice but to accept them and to surrender foreign exchange or bonds equivalent to the amount of the transaction. From a financial point of view, the Bank of Guatemala had given the exchange rate guarantee to avoid other financial problems that could result from noncompliance with obligations still pending under the bona fide rule, such as financial bankruptcies, because the overrun of foreign exchange was not included in the selling price of the goods.

His authorities believed that Guatemala's external arrears were currently less than the amount mentioned in the staff paper, Mr. Castellanos remarked. The difference between the authorities' estimates and the amount cited by the staff should be regarded as an exchange rate guarantee of the Bank of Guatemala or as payments freely accepted by commercial creditors. His authorities considered that it would be useful for the Executive Board to have a more specific analysis of the bonds issued before and after November 1984, and, in that connection, they had requested technical assistance from the Fund in order to prepare a study of the new exchange rate system, including an evaluation of the bonds, that would provide a more balanced assessment of outstanding arrears.

The Acting Chairman made the following summing up:

Directors were in general agreement with the thrust of the appraisal in the staff report for the 1985 Article IV consultation with Guatemala. Directors noted that Guatemala's performance under the previous stand-by arrangement had fallen short of expectations, in part owing to the difficult external environment, but mainly as a result of fiscal slippages. Directors also noted with concern that the economic situation had deteriorated, real GDP per capita had declined, and Guatemala's external position had weakened further, including the accumulation of external payment arrears.

To strengthen Guatemala's external position and improve the prospects for economic growth, Directors stressed the need for stronger adjustment measures in the fiscal, monetary, and exchange rate areas. Directors welcomed the adoption in November 1984 of a more flexible exchange rate policy. They noted, however, that the new system was unduly complex and that there was a large imbalance in the official market. Directors emphasized that steps should be taken that would lead to an early reunification of the exchange rate system. They further emphasized that a more flexible exchange rate policy should be supported by appropriate fiscal and monetary policies. In this connection, Directors regretted that the adjustment measures announced in early

April had not been implemented, but were encouraged to learn that efforts were being made by the Guatemalan authorities to develop the necessary national consensus on the required measures.

In the fiscal area, in the light of the declining trend in public sector savings in the past several years, Directors felt that efforts were needed to raise tax revenues, including an improvement of tax administration. On the expenditure side, Directors encouraged continued restraint on current expenditures, but stressed that further cuts in capital outlays could have adverse effects on economic growth.

In the monetary field, Directors viewed favorably the recent elimination of the legal barriers to the adoption of variable interest rates in the banking system, an initiative that should be followed by action allowing interest rates to reflect market conditions. Directors supported the authorities' intention to pursue a more restrictive credit policy.

Directors expressed concern over Guatemala's large debt service burden in the coming years and emphasized the importance of prudent debt management coupled with policies that would promote export growth over the medium term. Directors endorsed the planned tariff reform at the regional level, which, together with a flexible exchange rate policy, could be expected to enhance the international competitiveness of the Guatemalan economy.

It is expected that the next Article IV consultation with Guatemala will take place on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/98 (6/17/85) and EBM/85/99 (6/21/85).

2. ISLAMIC BANKING - STAFF VISIT TO THE ISLAMIC REPUBLIC OF IRAN

The Executive Board approves staff travel to the Islamic Republic of Iran to explore the implications of the Islamization of the banking system for the effectiveness of monetary policy and for the supervisory authority of the Bank Markazi and to attend a seminar on Islamic banking, as set forth in EBD/85/145 (6/14/85).

Adopted June 19, 1985

3. SRI LANKA - TECHNICAL ASSISTANCE

In response to a request from the Sri Lanka authorities for technical assistance to review the tax system and its administration and the customs administration, the Executive Board approves the proposal set forth in EBD/85/147 (6/18/85).

Adopted June 2^, 1985

4. JOINT COMMITTEE ON REMUNERATION OF EXECUTIVE DIRECTORS - SUBMISSION OF REPORT TO BOARD OF GOVERNORS

1. Section 14(e)(ii) of the By-Laws states that Reports of the standing Joint Committee on the Remuneration of Executive Directors and their Alternates shall be submitted to the Board of Governors for a vote on any recommendations contained therein without meeting, in accordance with Section 13 of the By-Laws.

2. The Board of Governors is therefore requested to vote upon the recommendations of this Committee without meeting, pursuant to Section 13 of the By-Laws of the Fund.

3. The Secretary is authorized and directed to send on Wednesday, June 26, 1985, to each member of the Fund by airmail or other rapid means of communication the following letter of transmittal, together with the Report of the standing Joint Committee to the Board of Governors:

> The standing Joint Committee on the Remuneration of Executive Directors and their Alternates has adopted a Report and recommendations to be submitted to the Board of Governors. At the request of the Joint Committee, I am transmitting its Report and recommendations herewith. The Joint Committee neither discussed with nor disclosed to Executive Directors its Report and recommendations prior to their transmittal to the Governors.
>
> The Board of Governors has been requested to vote without meeting, pursuant to Section 13 of the By-Laws of the Fund, on the Resolution attached to the Report. The Executive Board has decided, pursuant to Section 13(d) of the By-Laws, that no Governor shall vote on the Resolution until July 3, 1985.
>
> To be valid, votes on the Resolution must be cast by Governors or Alternate Governors and must be received at the headquarters of the Fund on or after Wednesday, July 3, 1985, but not later than Friday, August 2, 1985. Votes received before July 3, 1985, or after 6:00 p.m., Washington time on August 2, 1985, will not be counted.

It would be appreciated if you would transmit the Report to the Governor of the Fund representing your country with the request that he vote on the Resolution attached to the Report. No particular form of vote is required, so long as the Fund receives a clear indication as to whether the Governor approves or disapproves the proposed Resolution; such communication should be signed by the Governor or Alternate Governor, or there should be a clear indication that he has given instructions that his vote be transmitted by the sender.

4. All votes cast pursuant to this decision on the proposed Resolution shall be held in the custody of the Secretary until counted. As soon as practicable after the poll is concluded, the Secretary shall canvass the votes on the proposed Resolution and report thereon to the Executive Board. Any Executive Director may challenge the Report or the status of any vote counted or disqualified, in which case the Executive Board determines the result of the vote.

5. The effective date of the Resolution of the Board of Governors shall be the last day allowed for voting.

6. The Secretary is authorized to take such further action as he shall deem necessary or appropriate in order to carry out the proposes of this decision.

Adopted June 19, 1985

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/155 (6/14/85) and EBAP/85/156 (6/17/85) and by Advisors to Executive Directors as set forth in EBAP/85/145, Supplement 1 (6/14/85), EBAP/85/156 (6/17/85), EBAP/85/159 (6/18/85), and EBAP/85/161 (6/19/85) is approved.

6. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/85/158 (6/17/85) is approved.

APPROVED: April 2, 1986

JOSEPH W. LANG, JR.
Acting Secretary