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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/110

11:30 a.m., July 22, 1985

J. de Larosière, Chairman

| Executive Directors | Alternate Executive Directors |
| --- | --- |
| | L. K. Doe |
| | M. K. Bush |
| J. de Groote | H. G. Schneider |
| B. de Maulde | |
| M. Finaish | T. Alhaimus |
| | H. Kobayashi, Temporary |
| | D. Hammann, Temporary |
| J. E. Ismael | |
| | G. D. Hodgson, Temporary |
| | J. Hospedales, Temporary |
| | H. Fugmann |
| | A. Abdallah |
| | J. J. Dreizzen, Temporary |
| | J. E. Suraisry |
| | J. de la Herrán, Temporary |
| | J. de Beaufort Wijnholds |
| | A. V. Romuáldez |
| | H. Alaoui-Abdallaoui, Temporary |
| | A. S. Jayawardena |
| | R. Fox, Temporary |
| | N. Coumbis |
| | Wang E. |

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

Also Present

European Department: L. A. Whittome, Counsellor and Director. Exchange and Trade Relations Department: J. T. Boorman. Legal Department: W. E. Holder, J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; E. J. Bell, S. H. Hitti, B. A. Karamali, S. M. Thakur, G. Tomasson, M. Yaqub, M. Zavadjil. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: K. A. Hansen, G. Nguyen. Assistants to Executive Directors: S. Geadah, O. Isleifsson, M. Sarenac.

## 1. UNITED ARAB EMIRATES - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with the United Arab Emirates (SM/85/181, 6/26/85). They also had before them a report on recent economic developments in the United Arab Emirates (SM/85/192, 7/8/85).

Mr. Finaish made the following statement:

Between 1975 and 1981, the United Arab Emirates experienced exceptionally rapid growth, which was made possible by the large increase in foreign exchange earnings from oil exports. During that period, economic policy had focused on using those earnings, through government expenditure programs, to develop the country's economic and social infrastructure. This in turn stimulated the rapid expansion of private sector activity, particularly in construction and services, and also brought about a large influx of foreign workers. The strains associated with the rapid growth, including a sharp rise in prices, prompted the authorities in the late 1970s to restrain the growth of government spending. However, the need to curtail spending was made more urgent by the substantial drop in receipts from oil exports since 1981. Indeed, between 1981 and 1983, government expenditures were reduced by about 20 percent. Although this reduction did not prevent a change in the fiscal position from a surplus of 4 percent in 1981 to a deficit of 5 percent in 1983 relative to GDP, fiscal policy during the period was actually contractionary, as net domestic expenditures declined significantly. Reflecting the contractionary stance, domestic liquidity expansion and non-oil GDP growth declined sharply. The drop in imports associated with the economic slowdown softened the impact of reduced export receipts on the external current account balance, which remained in surplus, though at a reduced level. The overall balance, however, did register a deficit amounting to 1.5 percent of GDP in 1983.

The policy of fiscal adjustment was continued and strengthened in 1984. In spite of a further decline in net budgetary receipts from oil exports of about 7 percent, total government revenue increased in 1984 mainly as a result of the decision in late 1983 by all Gulf Cooperation Council (GCC) member countries to raise customs tariffs from 1 percent to 4 percent. Government expenditures, on the other hand, were reduced by 12 percent, thus cutting the 1984 fiscal deficit by more than half from the 1983 level. The further tightening of public finances was reflected in the continued low rate of growth of non-oil GDP, although some sectors of the economy, such as agriculture and large-scale manufacturing (notably petroleum refining and aluminum industries), continued to perform strongly. The combined efforts of reduced government spending and the general slowdown in economic activity resulted in a further substantial drop in imports. The current account surplus increased to about $7 billion, and the overall balance of payments was restored to surplus. While the fiscal adjustment required by the drop in oil revenues inevitably led to a decline in aid flows from the generous levels of the 1970s and early 1980s, these flows remained significant.

A focus of central bank policy in 1984 was the correction of the deficiencies in the commercial banking sector that had been brought to light by the general slack in the economy in recent years. A number of steps were taken to improve accounting practices and reserve policies of banks, particularly with respect to questionable loans, and to strengthen central bank supervision. These included the nonaccrual to profit-and-loss accounts of interest on loans overdue by more than six months, an increase in provisions against bad and doubtful debts, periodic inspection visits to commercial banks by supervisors, and improved analysis of bank data. Although problems in individual smaller banks whose liquidity position was relatively weak were not completely eliminated, the commercial banking system as a whole remained fundamentally sound, with capital and reserves amounting to as much as 40 percent of total bank credit. One factor behind the weak position of some smaller banks is the excessive number of banks and branches in the country. For this reason, mergers are being encouraged through close cooperation between Emirate authorities and the Central Bank.

For 1985, no major change from the 1984 economic outcome is foreseen. Although the budget has not yet been formally approved, fiscal expenditures are expected to be maintained at the 1984 level, while revenues will probably decline somewhat as a result of the reduction in the volume of oil exports. Notwithstanding the likely increase in the deficit, the monetary and balance of payments developments are expected to be broadly similar to those of 1984, with the drop in exports being offset by a decline in imports and net service payments. No growth in real non-oil GDP is expected in 1985.

Looking beyond 1985, the authorities recognize that the rapid expansion of the late 1970s and early 1980s should be viewed as exceptional and that further domestic adjustments to the international oil situation may be needed. It should be emphasized, however, that despite the reduction in oil receipts, the United Arab Emirates' resources remain substantial relative to the size of the population, and ample opportunity remains for future growth in domestic economic activity through careful selection of investment possibilities. In the private sector, although the profit margins achieved in the years of rapid expansion are no longer available, considerable scope remains for profitable activity. An important policy objective over the medium term will be to enhance the role of this sector and shift its focus from the construction and real estate sectors, where considerable excess capacity is evident, to the manufacturing sector. Plans already exist for a number of publicly owned entities to sell part of their stock to the private sector. At the same time, and despite the weak international market, the oil development and exploration program will continue. Another objective will be to strengthen the legal and institutional framework of the Emirates to foster better coordination in economic and financial management. Finally, in formulating economic policy in the period ahead, the authorities will continue to attach importance to cooperation within the GCC.

Mr. Suraisry observed that the United Arab Emirates had adjusted to the sharp decline in oil revenues since 1982. Government expenditures had been sharply reduced, and domestic aggregate demand had declined, leading to a reduction in imports and consequently to a correction in the balance of payments. At the same time, non-oil GDP had continued to grow, although at a substantially reduced rate. Together with other member countries of the Gulf Cooperation Council, the United Arab Emirates had introduced several measures to increase the role of the private sector in the economy's development, and additional measures were being explored. All GCC member countries considered that economic diversification was an overriding and timely objective that could best be achieved through greater involvement of the private sector. Moreover, the GCC members believed that diversification would be greatly facilitated by the coordination of economic and financial policies, the completion of major infrastructure, and an increase in the number of entrepreneurs in GCC member countries.

The authorities had adopted a prudent fiscal stance in response to the sharp decline in oil income, Mr. Suraisry noted. Expenditures had been reduced, while increased reliance had been placed on non-oil revenues. In that context, a number of commendable measures had been adopted by the authorities in the past few years. The subsidization of petroleum products had been discontinued, and import duties, along with those of other GCC member countries, had been raised in 1983. More recently, additional steps had been undertaken to strengthen the fiscal position and to promote the rationalization of the consumption of public services. The authorities recognized that more adjustment measures were needed in the period ahead to achieve a sustainable fiscal position and were determined to continue their efforts.

Substantial progress had been made in strengthening commercial banking, Mr. Suraisry observed. The accounting practices, reserve positions, and supervision of the commercial banking system had been tightened in 1984. The authorities also were encouraging the consolidation of the banking system through mergers, which would reduce the excessive number of banks and branches without undermining confidence in the financial system.

He concurred with the staff regarding the appropriateness of U.A.E. exchange rate policy, Mr. Suraisry remarked. The authorities' liberal exchange and trade systems were commendable, as was their generous foreign aid, which, despite the sharp reduction in foreign exchange receipts, had exceeded UN guidelines.

It was proposed that the next Article IV consultation with the United Arab Emirates be held on the standard 12-month cycle, Mr. Suraisry noted. However, in view of the size of the economy, the appropriate adjustment policy followed by the authorities, and the fact that the economy was not faced with a serious problem that warranted close monitoring, consideration should be given to placing the consultations on an 18-month cycle.

Mr. Alaoui-Abdallaoui noted that the U.A.E. economy was dominated by the oil sector, which represented 87 percent of budgetary revenue and 73 percent of merchandise exports. Like many oil exporting countries, the United Arab Emirates was adapting its economy to the sharply reduced revenues following the recession of 1982, when both oil prices and production had declined significantly. However, because of the small population, accumulated surpluses, and cautious economic and financial policies, the country had been able to maintain a relatively stable income and cushion the impact of declining oil revenues on the budgetary and external positions. The authorities had appropriately reacted to the deterioration of their oil revenues by significantly curtailing public sector expenditures, with the burden of adjustment borne mainly by development outlays, although some reductions had also occurred in the current budget. In that regard, the sharp decline in federal subsidies and transfers achieved since 1981, including the near-elimination of petroleum product subsidies, was noteworthy. Foreign grants and loans had also been sharply reduced, a conservationist policy had been adopted in the oil sector, the implementation of ongoing projects had been slowed, and new projects had been canceled. However, the new policy of constraint had quickly led to a significant curtailment of imports and a slowdown of economic activity, as indicated by a sizable drop in non-oil GDP.

The challenge facing the United Arab Emirates was how to maintain adequate economic growth while continuing to preserve a sustainable balance of payments position, Mr. Alaoui-Abdallaoui observed. While customs revenues could yield extra receipts to the Treasury, the United Arab Emirates would have to charge higher prices for public utilities to alleviate the budget deficit, as the scope for reducing government expenditures appeared to have reached its limit. Further cuts would undoubtedly jeopardize the maintenance of infrastructural projects and prevent the private sector from contributing to the growth of the economy, in spite of the authorities' desire to enhance the role of that sector in promoting growth, particularly through export diversification.

During the previous Article IV consultation, Mr. Alaoui-Abdallaoui recalled, Executive Directors had stressed the need for diversification, especially in the gas and oil sectors. While development of those sectors would represent a comparative advantage for the United Arab Emirates, such diversification--at great capital cost--was increasingly being hampered by protectionism in major industrial countries.

He was in broad agreement with the staff's appraisal, Mr. Alaoui-Abdallaoui remarked. Furthermore, the authorities' maintenance of foreign assistance at a high level in terms of GDP and by international standards, despite the recent austerity program, was commendable. Finally, he would support Mr. Suraisry's views on the extension of the consultation cycle to 18 months, provided that such an extension was agreeable to the U.A.E. authorities.

Mr. Hammann said that he was in broad agreement with the staff appraisal. The authorities had continued to react to changing external conditions in a prudent and responsible manner. Growth was expected to be positive again, government expenditures had been curtailed further, and the overall external payments balance had again registered a surplus. However, in the absence of a foreseeable reversal in world oil market conditions and given the need to diversify the economy, further fundamental policy changes were required.

The authorities should examine different fiscal policy options for offsetting the continued slack in budget oil revenues, Mr. Hammann remarked. A successful strategy should probably embrace direct or indirect taxation, more realistic public utility prices, and further current expenditure cuts. In that regard, he invited the staff or Mr. Finaish to provide further information concerning the prospects for introducing a system of taxation and for public utility pricing. Public expenditure cuts also would be desirable as a means of enhancing private sector activities.

He would appreciate more detail on the rationale of the authorities' present exchange rate policy, which tied the dirham to the dollar instead of to the SDR as had previously been planned, Mr. Hammann went on. Also, what had the staff meant by "attaching a larger allocative role to the exchange rate"? The extent to which the allocative role of exchange rates could be enhanced was determined by the economy's production possibilities, particularly the scope for diversification and for non-oil activities. The close link to the dollar in recent years had led to a sizable appreciation of the dirham, which indicated that exchange rate policy had not yet provided the incentives necessary for stimulating non-oil activities. Therefore, the authorities should consider alternative exchange rate policy options.

An 18-month consultation cycle would be preferable, Mr. Hammann commented, but he would respect the views of the authorities concerning that matter.

Mr. Romuáldez stated that he fully agreed with the staff appraisal and supported the suggestion that an 18-month consultation cycle be considered, if that were acceptable to the authorities.

The staff representative from the Middle Eastern Department explained that the present link between the dirham and the dollar had its origin in the expansionary policy pursued in the early 1980s, which had generated strong pressures on prices. Allowing the dirham to appreciate along with the dollar had been perceived at that time as a useful tool to moderate price increases. In addition, the authorities watched closely the cross-rates of the currencies of a number of countries in the region, which were also tied to the dollar to some extent. Since the early 1980s, the situation had changed: inflation was no longer an issue, the GCC countries were collectively reassessing their exchange rate policies as well as the uses of exchange rate policy for economic development, and had initiated a number of cooperative steps, such as the unification of external tariffs. Policies on investment by nationals of other GCC countries had been liberalized, and an expansion of trade, investment, and the movement of labor was expected. The staff considered that the present U.A.E. exchange rate policy was appropriate from a strictly balance of payments viewpoint, but that the authorities could usefully consider, in concert with their partners in the GCC, the contribution of the exchange rate to the broader economic objectives of the GCC countries.

The GCC was attempting to coordinate the policies of member countries with respect to taxation and the pricing policies of public utilities, the staff representative continued. A decision had been taken on a unified price for public utilities, effective from October 1, 1985, and some increase in charges was expected. Bearing in mind social considerations, a split tariff was expected for electricity whereby consumption at or below a certain minimum level would be priced lower than consumption above that level. According to information available to the staff, the question of taxation would be considered at a later time.

The staff mission had discussed the possibility of an 18-month consultation cycle with the authorities and had explained the guidelines adopted by the Executive Board regarding the appropriateness of consultation cycles in specific cases, the staff representative from the Middle Eastern Department noted. At the time, the authorities had expressed a preference for retaining the 12-month consultation cycle.

Mr. Finaish stated that the U.A.E. authorities had asked him to provide certain clarifications. On page 7 of the staff report, an estimate of the accumulated surpluses managed through the Abu Dhabi Investment Authorities had been mentioned; the U.A.E. authorities wished to point out that the figure was the staff's estimate. Moreover, they would have preferred verification of the figure before its inclusion in the report. Moreover, on page 10 of the staff report, it was stated that the Central Bank had announced the introduction of certificates of deposit in mid-1984. The Central Bank had not made such an announcement, although discussions about certificates of deposit had been held throughout 1984; the certificates of deposit had been issued in early 1985.

Clearly the economic situation had changed because of recent developments in the world oil market, Mr. Finaish remarked. The authorities considered the period prior to 1981 to have been an exceptional one that was unlikely to be repeated, not only because the international oil market had changed, but also because the needs in many areas of economic activity, such as construction and communications, had been largely met. The rapid expansion of the economy that had been generated by the development of infrastructure had subsided, mainly because those activities had been completed. Nevertheless, the authorities were aware that the decline in export revenues might necessitate further adjustment to reduce current fiscal expenditure and increase non-oil revenues. In their view, the formulation of specific policies in those areas should be undertaken within a broader medium-term analysis of the economy and in concert with other members of the GCC. Of course, substantive measures, particularly in the fiscal area, had already been taken in 1981-83, when government spending had been cut by almost one third.

The overall economic situation of the United Arab Emirates was not unsatisfactory, Mr. Finaish pointed out. Resources were still substantial in relation to the population, and opportunities for both private and direct foreign investment were available. The authorities intended to encourage private sector activities, particularly in manufacturing, and were prepared to explore all useful policy tools for that purpose. The authorities had noted the statement in the staff report that it was hoped that further cuts in foreign aid would not be contemplated. He pointed out that the aid given by the United Arab Emirates in terms of GDP was still substantial compared with that of industrial countries, and it was still above the UN target. Moreover, the aid was derived from a depletable resource and was not motivated by any global interest. The United Arab Emirates had also provided indirect aid in the form of remittances abroad, which had reached $1.5 billion in 1984. Foreigners still constituted about 75 percent of the labor force, and a similar proportion of the population was expatriate. Despite the policy of stabilizing the foreign population at about the 1980 level, the number of expatriates was estimated to have increased by about 15 percent from 1981 to 1983. The authorities continued to appreciate the contributions of foreign labor to development, and any change in their labor policy would be gradual and linked to changes in the labor requirements of the economy.

If the general view of the Board was that an 18-month consultation cycle would be more appropriate in the case of the United Arab Emirates, that view would be acceptable to the U.A.E. authorities, Mr. Finaish remarked.

The Chairman made the following summing up:

> Executive Directors generally agreed with the thrust of the views expressed in the staff appraisal.

Directors noted that the period after 1981 had been marked by sharply reduced oil export receipts, which in turn had led the authorities to reduce total budget expenditures substantially, following several years of rapid growth in outlays. Although the reduction in expenditures had contributed to a significant slowdown in domestic economic activity, Directors were of the view that the authorities' restrained fiscal policy stance had been appropriate and necessary under the circumstances and that the United Arab Emirates' external position had remained strong. They noted that the authorities intended to maintain a restrictive expenditure stance in 1985, including the stabilization of budget subsidies and the improvement of pricing policies for public services, in order to limit the budget deficit, but it was suggested that expenditure restraint might be supplemented by measures to enhance domestic revenues.

Directors observed that the recent slowdown in domestic economic activity had revealed weaknesses in the asset portfolios of some commercial banks and noted the authorities' intention to encourage the consolidation of the commercial banking system through mergers and to enhance surveillance over the domestic banking system.

The recent slowdown in domestic economic activity had also highlighted the extent to which activity in the non-oil sector of the U.A.E. economy remained dependent on the level of government domestic expenditures. Directors therefore welcomed the intention of the authorities, acting in concert with the other member states of the Gulf Cooperation Council, to consider appropriate means of encouraging the autonomous development of private sector economic activity. In this connection, it was suggested that the authorities might wish to explore the role of exchange rate policy over the medium term. Directors commended the U.A.E. authorities for their continuing generous foreign aid program.

It is expected that the next Article IV consultation with the United Arab Emirates will be held on an 18-month cycle.

## DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/109 (7/17/85) and EBM/85/110 (7/22/85).

## 2. SFF SUBSIDY ACCOUNT - SUBSIDY PAYMENTS FOR JULY 1, 1984 THROUGH JUNE 30, 1985

1. In accordance with the Instrument establishing the Supplementary Financing Facility Subsidy Account, subsidy payment shall be made with respect to charges paid on holdings of currency

referred to in Section 7 of the Instrument for the period July 1, 1984 through June 30, 1985, in the amount indicated to each of the eligible members as listed in the table of EBS/85/168 (7/15/85).

2. The subsidy payment shall be made in U.S. dollars to each eligible member on July 24, 1985, or as soon thereafter as the member has paid all overdue charges, if any, on balances eligible for the subsidy, on the basis of the SDR/U.S. dollar exchange rate in effect three business days before the payment date.

Decision No. 8037-(85/110) SBS, adopted July 18, 1985

## 3. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/85/185 (7/16/85).

Adopted July 18, 1985

## 4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/152 and 84/153 are approved. (EBD/85/176, 7/15/85)

Adopted July 19, 1985

## 5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/180, Supplement 1 (7/16/85), EBAP/85/184 (7/17/85), and EBAP/85/187 (7/18/85), and by an Advisor to Executive Director as set forth in EBAP/85/187 (7/18/85) is approved.

APPROVED: April 10, 1986

LEO VAN HOUTVEN
Secretary