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10:00 a.m., July 26, 1985

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	L. K. Doe
	A. R. Ismael, Temporary
C. H. Dallara	M. K. Bush
J. de Groote	H. G. Schneider
B. de Maulde	
	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
J. E. Ismael	Jaafar A.
R. K. Joyce	
A. Kafka	H. A. Arias
H. Lundstrom	H. Fugmann
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	G. Ortiz
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuâldez
	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
	T. A. Clark
S. Zecchini	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

Central Banking Department: L. M. Koenig, Deputy Director. European Department: L. A. Whittome, Counsellor and Director. Exchange and Trade Relations Department: J. T. Boorman. IMF Institute: S. El-Khouri. Legal Department: G. P. Nicoletopoulos, Director; P. L. Francotte, J. V. Surr. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; E. J. Bell, J. G. Borpujari, M. A. El-Erian, S. H. Hitti, B. A. Karamali, K. Nashashibi, A. Ouanes, S. M. Thakur, G. Tomasson, S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director; M. S. Khan, P. R. Masson, A. Muttardy, P. Wickham. Treasurer's Department: D. Williams, Deputy Treasurer; B. Von Numers. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. E. Bonangelino. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, E. M. Ainley, P. E. Archibong, G. R. Castellanos, D. Hammann, K. A. Hansen, S. M. Hassan, J. Hospedales, G. Nguyen, G. W. K. Pickering, M. Z. M. Qureshi, T. Sirivedhin, E. M. Taha, A. Vasudevan, M. A. Weitz, K. Yao. Assistants to Executive Directors: Bo T., M. B. Chatah, J. de la Herrán, A. K. Diaby, G. Ercel, C. Flamant, R. Fox, G. D. Hodgson, Z. b. Ismail, H. Kobayashi, S. Kolb, J. A. K. Munthali, K. Murakami, D. J. Robinson, J. E. Rodríguez, A. A. Scholten, B. D. White, Yang W.

1. SAUDI ARABIA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Saudi Arabia (SM/85/187, 6/28/85; and Cor. 1, 7/1/85). They also had before them a report on recent economic developments in Saudi Arabia (SM/85/197, 7/9/85).

The Director of the Middle Eastern Department stated that the projections in the staff report had been based on assumptions that oil prices would remain unchanged, oil production would recover moderately after the first quarter of 1985, and merchandise imports would decline by about 14 percent in 1985 and 6 percent in 1986. However, developments in the past three months indicated that Saudi Arabia's external current account deficit would be larger than projected for both 1985 and 1986. World oil markets and demand for OPEC oil had been weaker than expected in the first half of 1985 as economic growth in major industrial countries had been slower than projected, non-oil energy production and consumption had increased considerably more than expected, and oil production in non-OPEC countries had also been somewhat larger than estimated. More important, Saudi Arabia had continued to absorb the bulk of the fall in demand for OPEC oil; consequently, Saudi Arabia's share of OPEC production had declined from about 26 percent in 1984 to well under 20 percent in recent months. Saudi Arabia's crude oil production was estimated to have fallen from slightly less than 4 million barrels a day in the first quarter of 1985 to some 2.5 million barrels a day in June 1985. It had been decided at the OPEC meeting on July 25, 1985 that the prices of medium and heavier crude would be reduced by between 20 and 50 cents a barrel. As a result, Saudi Arabia's weighted average oil export price would be approximately 25 cents a barrel lower than previously.

Saudi Arabia's oil production was expected to recover somewhat in the second half of 1985, possibly reaching three and one half million barrels a day by year-end, through a partial restoration of Saudi Arabia's share in OPEC production and some increase in the demand for OPEC oil in late 1985, the Director indicated. Nevertheless, Saudi Arabia's annual production and export volume was projected to be about 900,000 barrels a day lower than expected in 1985 and 1986. Assuming that oil prices would remain unchanged through end-1986, the value of Saudi Arabia's total oil exports would be some \$8-9 billion lower than projected for 1985 and 1986. Those projections continued to be surrounded by considerable uncertainties in terms of both volume and prices. The outcome would depend, to a large extent, on the actions of other OPEC members, particularly whether they adhered to agreed production quotas and eliminated price discounting practices. If oil prices declined by \$1 a barrel, and assuming output of 3.5 million barrels a day, Saudi Arabia's oil receipts would be reduced by about \$1.2 billion annually. Although the external payments situation would be more difficult than expected, the staff had not revised its projections in the staff paper, given the extreme uncertainties surrounding prospective oil export earnings.

Mr. Nimatallah made the following statement:

In the past 15 years, Saudi Arabia has faced two main challenges. The first has been to put oil revenues to productive use and build a modern, diversified economy. Since 1982, an additional challenge has been to adjust the economy prudently to the sharp decline in oil revenues.

The authorities have met both challenges through careful planning, in a medium-term framework, taking full account of the international effects of domestic policies. Considerable progress has been made in developing the economy under well-defined five-year plans. In the recently completed plan, for example, real non-oil growth averaged about 8 percent, well in excess of the planned target. The physical and financial infrastructure needed for sustained and stable growth has been largely completed. The transporation system and port facilities are now highly developed; and the major petrochemical, oil-refining and steel plants at Yanbu and Jubail are already operating. The manufacturing sector is growing rapidly, with over 2,000 operating industrial plants. Agricultural production is also expanding. The contribution of the private sector to GNP is now 33 percent, compared with 13 percent ten years ago.

The economy was thus well placed to deal with the second challenge: declining oil revenues. Fiscal policy and development planning have been carefully adapted to changing circumstances, again within a clear, medium-term framework. Government spending has been reduced gradually, in a way that has helped to avoid disrupting the domestic economy and the international adjustment process. In 1982/83 and 1983/84, for example, budgetary expenditures were reduced by 22 percent, compared with a fall of 60 percent in oil revenues. A similar policy was followed in 1984/85. The consequent budget deficits were financed from reserves accumulated earlier as a result of prudent financial management.

The twin challenge of rapid development followed by the transition to a more sustainable growth path, has been tackled while maintaining the social values of the country. The Saudi people have adjusted well, initially to the rapid expansion, and now to the gradual contraction, in the rate of growth of the economy. Our traditions have been preserved, thereby strengthening the political stability that the country enjoys.

Looking ahead, the staff suggests that the policy of balancing the budget in order to maintain a comfortable level of foreign assets might be unduly contractionary under present circumstances. Instead, the staff maintains that it may be advisable to formulate an expenditure policy in a medium-term context in order to prevent sharp fluctuations in expenditures from year to year. It should, however, be emphasized that the Government is following a medium-term expenditure policy. This policy has led at times to surpluses, and at other times to deficits. This year's balanced budget is fully consistent with the gradual reduction in expenditures at this stage and with the uncertain fiscal outlook in the period ahead.

More generally, the economy of Saudi Arabia has to adjust at a time of sharply declining oil revenues and considerable uncertainty in the international oil market. Saudi Arabia's oil policy has consistently aimed at stabilizing oil prices internationally and securing an orderly supply of oil. At the same time, Saudi Arabia must maintain reasonable oil exports to secure the necessary revenues for its economic development needs. While my authorities feel that Saudi Arabia has sacrificed a great deal for the objective of stabilizing international oil prices, they intend to protect their national interests. They are searching for the right point of reconciliation between national and international interests.

In the light of these uncertainties, it is both realistic and forward looking, particularly as unemployment is negligible, to reduce economic activity gradually to an appropriate level that can be sustained and is consistent with Saudi Arabia's financial means. In the meantime, and until the economy becomes more diversified, we believe that it is better not be deplete Saudi Arabia's financial reserves and expose the country to possible difficulties. An interim period of a few years is needed until the role of the oil sector in the economy is reduced to a reasonable level. A comfortable level of reserves is required to cover this period. We, therefore, believe that it is prudent to adjust our policies now, from a position of financial strength. Saudi Arabia's objective is to live within its means over the medium term, while continuing to follow a sound policy of steady growth and development.

This policy is central to the Fourth Development Plan, which began in the current fiscal year. The major objectives of the Plan include:

> First, to continue to reduce the economy's reliance on crude oil exports as the main source of national income, by diversifying Saudi Arabia's economic base.
>
> Second, to develop the country's human resources to ensure a steady supply of skilled manpower to meet the needs of all sectors in the economy. Manpower development and training together with the continuing transfer of high technology to Saudi Arabia will be given high priority.

Third, to improve the quality of life for the people of Saudi Arabia.

The strategy adopted to realize these objectives is to strengthen the private sector and reduce the role of the Government in the economy. The contribution of the private sector to GNP has already grown sevenfold in the past decade. As the staff indicates, this contribution should increase significantly during the Fourth Plan period. The Government will continue to encourage the private sector to play a greater role in the economy with appropriate incentives and provide the necessary economic, legal, and administrative framework for promoting private sector activities.

An additional objective under the Fourth Plan is to strengthen economic and social ties among the member countries of the Cooperation Council for the Arab States of the Gulf (GCC). My authorities see considerable potential benefits for the region in expanding the markets for trade and services among these countries, and enhancing incentives for investment, particularly by the private sector. The pace of economic integration among the GCC members is expected to accelerate during the period of the new plan.

This, briefly, is the picture in Saudi Arabia for now and the near future. While there may be new elements, the underlying objective of progress with stability remains unchanged, as does my authorities' commitment to the well-being of the international community. They will continue to pursue prudent oil and foreign asset investment policies, to help the developing countries directly and indirectly through regional and international organizations, and to adhere to the policy of free trade and payments. Finally, my authorities will continue to cooperate fully with the Fund and its members to maintain a sound international financial system.

Extending his statement, Mr. Nimatallah pointed out that not all the assets of $107 billion referred to in the last sentence of page 3 of the staff report (SM/85/187) belonged to the Government; therefore, not all were usable.

Mr. de Groote stated that he broadly endorsed the staff appraisal. Despite the sharp decline in export earnings and budgetary revenues in the recent past owing to developments in the world oil market, the Saudi Arabian authorities had successfully dealt with the twin challenges of building a modern, diversified economy and adjusting to the sharp decline in oil revenues. The authorities' farsighted decision to implement medium-term policies in the early 1980s had been one of the determining factors that had led to smooth economic adjustment and a satisfactory performance in the past two years. If the authorities continued to carry out their development activities flexibly with due regard for balance of payments and adjustment needs, the economy was likely to continue to perform satisfactorily in the years ahead. Despite the uncertain outlook for the oil market, Saudi Arabia's balance of payments position might improve by 1988, although projections were difficult to make. A favorable evolution would provide the authorities with sufficient room for maneuver to reassess the priorities set in their Fourth Development Plan.

The authorities had not only adopted successful domestic policies, but also participated in the international adjustment process in a highly responsible manner through their oil supply and pricing policies, management of the country's foreign assets, and assistance to developing countries, Mr. de Groote observed. All members of the international community had greatly benefited from Saudi Arabia's concern for the external consequences of its particular payments situation.

The staff's view regarding the authorities' aim to balance the budget by 1985/86, while at variance with typical Fund advice, was appropriate in Saudi Arabia's case, Mr. de Groote considered. A temporary fiscal deficit would strengthen economic activity, especially in the non-oil sector, which, in turn, would increase long-term growth and alleviate the adjustment effort. However, the authorities faced a difficult choice between their longer-term objective of promoting conditions for sustainable growth and their immediate objective of avoiding a further drawdown of official foreign assets. They should therefore take advantage of any stabilization in oil market conditions to formulate fiscal policies with long-term objectives. An improvement in the tax system, particularly an increase in its income elasticity and a broadening of the tax base, was required.

The staff considered that the real effective appreciation of the riyal in 1981-84 might have been overstated, owing to the inclusion of subsidized commodities in the consumer price index, Mr. de Groote stated. The authorities' exchange rate policy was designed to promote stability and private activity in the non-oil sector. Given the high volatility of the dollar in that period, it was questionable whether that goal could have been achieved by eliminating the real effective appreciation of the riyal. Moreover, the consumer price index included a number of commodities that were subsidized in different ways. Import taxes and duties could also have the same effect as a subsidy. Because of the technical difficulties in measuring precisely the effect of the subsidy policy on prices, both domestically and abroad, it was hard to judge whether an appreciation or depreciation of the real effective exchange rate was understated or overstated. Finally, the authorities should be commended for continuing to provide generous amounts of foreign aid to other developing countries despite the decline in oil revenues.

Mr. Alhaimus noted that in the past several months, reports on the Saudi Arabian economy carried by the media sought to dramatize the uncertainties and tensions that the economy was passing through. Much had been made of the strains confronting the economy as it adjusted to the sharp drop in oil income. In reflecting on such versions of developments of the Saudi Arabian economy, two important aspects should usefully be taken into account. First, given the steep fall in oil proceeds, adjustment in Saudia Arabia had so far been relatively smooth: no violent shocks had been experienced in the economy. That fairly smooth transition had been made possible by the policy of gradual adjustment that the authorities had adopted and by the availability of large external reserves that had been saved during the previous decade.

A second aspect of the new era, Mr. Alhaimus continued, was that the fall in oil revenues and the consequent retrenchment in government outlays was bound to induce new attitudes that would contribute to better economic management and the elimination of wasteful practices in both the public and the private sectors. That aspect of the new era seemed to be gaining ground in government and business circles. It was a highly positive attitude in that those circles did not consider the sharp fall in oil revenues as a passing cloud but as a possibly much more enduring phenomenon that called for a more determined response at all levels. There were certainly numerous difficulties in adapting the economy to the sharp fall in oil income; there were also vast opportunities to improve economic performance and bring about a more efficient use of resources. It was against that background that developments in the various sectors of the economy should be assessed.

The oil sector, the cornerstone of the Saudi economy, had undergone drastic changes in the past few years, Mr. Alhaimus observed. Oil production had contracted to a level that was less than a fourth of its peak production levels four years previously. That dramatic change had posed delicate issues for the authorities in terms of their response in the area of production and pricing of crude petroleum and the proper adjustment in the structure of the oil industry. The authorities' response in production and pricing policies was in line with the common efforts of OPEC to stabilize the international oil market despite various pressures and temptations. Those efforts had not been helped by some other producers who chose to respond to the weakening oil market by expanding to full capacity. Nevertheless, and despite the numerous difficulties, OPEC members had persisted in their efforts to maintain a stable world oil market, as had again been demonstrated at their recent conference. Therefore, discipline was almost entirely exercised by OPEC members, while a large measure of freedom of action was enjoyed by many other oil producers. If that situation persisted, and unless more global cooperation were ensured, it would be no surprise if other OPEC members, in addition to Saudi Arabia, would, in Mr. Nimatallah's words, be "searching for the right point of reconciliation between national and international interests."

Policies of Saudi Arabia's major trading partners had also not helped to ease adjustment in Saudi Arabia, Mr. Alhaimus noted. The natural course that Saudi Arabia had pursued for the past several years had been to diversify the economy toward production of petrochemical and refined products. Considerable investments had been made, in many cases on the basis of joint ventures with large multinational corporations. As products had gradually entered the market recently, serious difficulties in market access had emerged in many industrial countries. The uncertain prospects for access seemed to have already contributed, for example, to a reappraisal of previous plans by the authorities to expand refining capacity. In that respect he shared the strong dissatisfaction expressed by the Saudi Arabian authorities, as reported in the staff report, with the policies of some of their trading partners who had imposed or were contemplating the imposition of restrictions on imports of petrochemicals and refined products. Mr. Nimatallah's reminder of the liberal import policies pursued by Saudi Arabia in previous decades was highly relevant. In fact, Saudi Arabia had allowed about $500 billion of imports in past years virtually tariff free; 70 percent of that large volume had been imported from the United States, Europe, and Japan. Against that background, the authorities' call for reciprocity in trade was appropriate. He wondered whether the staff could confirm indications that the conference of the International Energy Agency (IEA) held in early July 1985 had agreed to some liberalization of imports for refined products and, if so, whether the staff could assess its practical implications for Saudi Arabia's exports.

The course of budgetary policies pursued in the past five years clearly reflected the gradual approach that the authorities had followed to avoid violent shocks to the economy, Mr. Alhaimus pointed out. Despite the sharp fall in revenues, expenditures had been reduced gradually at the cost of a considerable drawdown of reserves. However, the balanced budget, which the authorities had opted for in the current year, seemed to have led the staff to voice some concern about whether the budget might be unduly contractionary under present circumstances and to suggest that it might be advisable to formulate expenditure policy in a medium-term context. In considering the various aspects of that issue, he felt strong sympathy for the authorities' view. As the prospects for oil revenues, even in the short term, remained uncertain, a further drawdown on reserves might raise doubts about the country's ability to cope with possible adverse developments. An equally important consideration was that a more accommodating budgetary policy might generate false hopes and expectations throughout the public and private sectors just when the country was slowly accepting the new realities and exploring ways and means to change and adapt.

Looking ahead toward the medium term, the broad lines of policies were clear in the Fourth Development Plan for the next five years, Mr. Alhaimus remarked. Commendable aspects of the Plan were the increased attention to economic criteria and cost efficiency in government projects and programs, the efficient maintenance and operation of completed projects, and the rationalization of subsidies. A more significant aspect of the Plan was the focus on the role of the private sector and the expectation that it would shoulder an increasing responsibility for growth in the coming period. While the emphasis on the private sector was appropriate, the limitations of that sector should be kept in mind to avoid unrealistic expectations about its future contribution. The authors of the Plan seemed to have a clear awareness of the problems involved, as they stated that "the expansive environment of the last decade has ended, and now the Saudi Arabian private sector faces world conditions where business success will depend on tight financial controls, high standards of product quality and service, efficient and well-planned marketing strategies." The private sector could certainly contribute significantly to future progress if it could grasp those new realities.

Finally, he commended the Saudi Arabian authorities for their record on official assistance, which they had maintained at a high level even though the country had been facing difficulties and uncertainties, Mr. Alhaimus stated. Saudi Arabia's assistance in the past decade and a half had reached nearly $40 billion, not a small contribution for a developing country.

Mr. Ismael commented that the uncertain situation in the global oil market in the past three years had changed the circumstances of many oil producers. The oil market conditions of the 1970s were unlikely to be repeated. Many countries had come to terms with the new situation and had adjusted their economies. The Saudi Arabian authorities had demonstrated the foresight and flexibility to restrain their program of economic development and adjust to the weakening oil market. Their adjustment program was exemplary. The differences of view between the staff and the authorities were few and concerned only matters of emphasis. He agreed with most of the staff appraisal.

The authorities' objective of diversifying away from oil was appropriate, as the risks associated with overdependence on a single source of income for revenue and other purposes were too high, Mr. Ismael considered. However, as the country enjoyed the enviable position of having one of the largest proven oil reserves and enjoying an extremely favorable comparative advantage in oil production, it could be expected that Saudi Arabia would diversify heavily into downstream operations in the oil industry. Nevertheless, the authorities could face limited access to overseas markets, as other producers and some major consumers had also ventured into downstream operations, especially refining and petrochemical production. Could Mr. Nimatallah or the staff indicate the extent to which the major petrochemical and related industries were affected by market barriers overseas? What were the prospects for those industries in Saudi Arabia?

While the authorities' aim to be self-sufficient in agricultural production was laudable, some words of caution were called for, Mr. Ismael considered. Industrial and agricultural ventures that were placed in the private sector would not survive unless they were subject to market forces. Farm subsidies in Europe, the United States, and some countries that he represented had made it impossible for the agricultural sector to remain viable without raising production and increasing subsidies. Therefore, he fully supported the staff's comments on the danger of according excessive protection and permanent subsidies to nonviable activities in Saudi Arabia. The authorities should make every effort at an early stage to minimize subsidies and protection.

The authorities had adjusted to the decline in oil revenues since 1982 in a flexible and timely manner through expenditure restraint and a drawdown of external reserves, Mr. Ismael noted. The aim to balance the budget in fiscal year 1985/86 at SRl 200 billion was noteworthy, although the uncertain outcome on the revenue side was cause for concern. As a non-oil revenue accounted for only 12 percent of total revenue, the staff's suggestion to broaden the tax base and increase the income elasticity of the tax system was appropriate. A broader tax base, through the introduction of either an income tax or a sales tax, would be appropriate and would provide the authorities with an extra policy instrument should circumstances call for it in the future.

The staff's rationale for urging the authorities to strive for a less precipitous decline in government spending was unclear, Mr. Ismael commented. Its advice seemed contrary to the Fund's normal stance. While he understood the need to prevent an abrupt drop in Saudi Arabia's external reserves in order to preserve the stability of the international monetary system and because of the amount of Saudi riyals held abroad, he failed to understand the basis for tolerating a fiscal deficit. The authorities' aim to achieve a balanced budget in 1985/86 was sensible, and an expenditure cut of 12 percent was appropriate to that end. Could Mr. Nimatallah shed more light on his authorities' position on fiscal policy? Finally, Saudi Arabia should be commended for its pursuit of a generous foreign aid program despite present difficulties and for its so-called swing producer role, which had been adopted in an effort to promote stability in the world oil market.

Mr. Abdallah noted that Saudi Arabia was well endowed with natural resources, including hydrocarbons, uranium, bauxite, coal, iron, zinc, silver, copper, and gold. Saudi Arabia had a special role in the Islamic religion, as Muslims from all parts of the world traveled to the country to perform the pilgrimage. It was partly that religious role that had fostered among the people of Saudi Arabia a responsible international outlook, which had grown stronger in the recent past.

The authorities had adjusted their expenditure to declining income since 1982, when oil prices had begun to weaken, Mr. Abdallah remarked. Adjustment had been undertaken within a medium-term framework, and impressive progress had been made. Mr. Nimatallah had lucidly presented his authorities' case for maintaining a cautious fiscal policy and for balancing the budget in 1985/86. The staff argued that the authorities should leave room for maneuver by maintaining a temporary budget deficit. In fact, the 1985/86 budget was more likely to register a deficit than to be balanced, as expenditure cuts did not generally reach the expected targets and revenues tended to be lower than expected.

In 1985, the authorities apparently planned to collect all the zakat dues from the public; in previous years, only one half of the dues had been collected, Mr. Abdallah observed. The zakat was a religious obligation that should be spent only on specified categories of expenditure, and it was of some concern that the staff report on recent economic developments in Saudi Arabia (page 27) included the zakat among domestic revenues of the Government, implying that it might contribute to general expenditure. Muslim organizations from all parts of the world relied on voluntary funding from businessmen and wealthy individuals in Saudi Arabia who donated the second half of their zakat, and extra funds, to those organizations. He was concerned that Islamic organizations outside Saudi Arabia would suffer if the second portion of the zakat were collected. As the authorities were keen to promote a strong private sector within Saudi Arabia, they should not pursue a practice that militated against private initiative.

The Fourth Five-Year Development Plan appropriately sought to enhance the role of the private sector in the development process, Mr. Abdallah commented. He was concerned about how that policy would be pursued and implemented. The staff also had similar doubts and expected that the task of promoting the growth of the private sector would be a challenging one in the current phase of contractionary fiscal policy. The authorities had asked the Fund, the World Bank, and the IFC to carry out a study on ways to promote the private sector. The authorities intended to sell some public corporations to the private sector and to encourage new economic arrangements within the Gulf Cooperation Council (GCC). How could anyone promote the discernment of profitable opportunity, a willingness to assume risk, the quest for profits as an end in itself, the gambling spirit, and the competitive urge? Businessmen were never created or manufactured by governments, but emerged as a result of their own enterprise and initiative and generally ended up causing many problems for the authorities in the form of smuggling, black markets, and the informal sector. He was concerned that the authorities were pursuing the promotion of the private sector within a bureaucratic framework. The staff report on recent economic developments revealed that the money changers were among the most successful private sector operations in Saudi Arabia. They had played the role of a bank by taking deposits and granting loans to the public until the Saudi Arabian Monetary Authority (SAMA) had limited their activities; the money changers had been given three years in which to stop their banking practices and to confine their activities to buying and selling foreign exchange. Was that the way to promote the private sector?

He was raising those questions because he agreed with the authorities' aims but felt that the Saudi Arabian population, and also the Arab world, had a strong tradition of trade, Mr. Abdallah commented. The activities that could be undertaken within the resources available were already in operation. However, the large industrial projects were outside the experience of most entrepreneurs and were too costly. The private sector could be strengthened through less government direction rather than more intervention.

The authorities had allowed the Saudi Arabian riyal to appreciate in order to maintain the stable relationship between the riyal and the currencies of other GCC countries, Mr. Abdallah observed. While that objective was laudable, it could lead to rigidities and might be inconsistent with the policy of promoting the private sector. Such an exchange rate arrangement presented difficulties, as evidenced by experience in the West African Monetary Union. It was difficult to prevent the population from viewing the exchange rate as a national symbol, more or less like a national flag. Finally, he commended the authorities for their generous official development assistance.

Mr. de Maulde remarked that the Saudi Arabian authorities conducted their domestic and external economic policies in a most responsible way. Although the staff considered that the current stance of fiscal policy was too restrictive, he agreed with the authorities that a balanced budget was appropriate. He was less convinced about the authorities' exchange rate policy, but would suspend his judgment on that issue to see how the exchange rate of the dollar developed.

The output growth of the non-oil sector had been strong, Mr. de Maulde observed. However, it was questionable whether that sector could survive in the absence of the considerable protection and subsidies that it was receiving. The conclusion of the joint study by the Fund, the World Bank, and the IFC on the working of the private sector would be interesting. The priority being given to manpower development and training was appropriate to strengthen that sector. Finally, he congratulated the authorities for maintaining a high level of official development assistance (ODA).

Mr. Nebbia stated that he was in broad agreement with the staff appraisal. The Saudi Arabian economy had adjusted in an orderly way to the rapid decline in oil exports, having registered high rates of growth in the non-oil sector until 1982. The authorities should be commended for their efforts to maintain stable conditions in the oil market in the past several years. They rightly felt that some reconciliation between national and international interests should be achieved. Could Mr. Nimatallah provide additional information on that important objective? What was the likely impact of a drop in oil prices, as proposed at a recent OPEC meeting, on Saudi Arabia's economy if production levels remained unchanged?

The authorities had made commendable efforts in the previous few years to cut nonessential expenditures, rationalize the consumption of energy, and reduce some subsidies in order to adjust the economy to declining oil export earnings, Mr. Nebbia noted. Given the uncertainties in the medium term, the authorities should maintain a prudent and restrained fiscal policy so as to avoid future imbalances. As it would be difficult to continue financing the budget deficits from reserves in the medium and long term, some consideration should be given to introducing either an income tax or a sales tax, particularly given the diversification of the economy.

Monetary developments had contributed to basic economic stability in Saudi Arabia, Mr. Nebbia considered. Moderate liquidity expansion and improved availability of goods had reduced inflation. The authorities' ability to moderate fiscal expenditure and maintain stable monetary conditions provided reassurance that economic development would continue, especially as the authorities intended to incorporate the private sector more fully into the economy. Credit policy had been an important instrument in achieving orderly growth of the banking system.

Saudi Arabia's exchange rate policy was generally appropriate, although it would be interesting to see whether it would encourage a greater diversification of the economy, Mr. Nebbia commented. A major objective of the Fourth Development Plan would be to reduce the country's reliance on crude oil exports by diversifying the economic base. The authorities were moving efficiently toward their goal of transforming and modernizing the economy, with increasing participation by the private sector. Success in achieving a modern economy would depend not only on the adoption of appropriate macroeconomic policies but also on appropriate microeconomic decisions. Therefore, the authorities should simplify the system of incentives in order to ensure efficient resource allocation. They should continue to avoid excessive protection and permanent subsidies, which tended to encourage unviable and unproductive enterprises. The shift in emphasis toward more active participation by the private sector in the economy was well timed, as the underlying infrastructure had been established. Finally, the authorities should be commended for their sound economic management, continued generous assistance to developing countries, and strong financial support for the Fund.

Mr. Pérez remarked that the authorities should be commended for their continued pursuit of cautious domestic and highly cooperative international policies. Saudi Arabia had successfully adjusted its external sector and its fiscal position to the abrupt decline in oil revenues caused by lower oil prices and a decline in the production of petroleum. Despite a decrease in export proceeds of 60 percent over the past three years, the country had maintained a positive rate of growth, enviable price stability, and moderate deficits in both the external current account and the budget. The policy mix adopted by the authorities in response to the sharp decline in oil exports and revenues over the past three years had been remarkable; they had reduced expenditure by more than 30 percent and diversified the revenue base, allowing for an increase of more than 100 percent in budgetary revenues other than oil and investment income. Furthermore, the reduction in government expenditures had caused the expansion of monetary aggregates to decline from 20 percent in 1982/83 to 4 percent in 1984/85.

However, those adjustments had not prevented Saudi Arabia from maintaining its crucial role in the international system, Mr. Pérez noted. Its cooperation was evident in the international oil market, the international financial system, and in the provision of substantial official development assistance. Saudi Arabia had contributed to the stability of the international oil market through its role as a swing oil producer. Before 1981, it had produced an adequate supply of oil to meet the requirements of consumer countries in order to prevent a major disruption in prices.

After 1981, Saudi Arabia had absorbed the bulk of the adjustment to the new oil situation by reducing its output, action that was especially commendable given its negative impact on the Saudi Arabian economy.

Much progress had been made toward transforming and modernizing the economy in the past 15 years, Mr. Pérez observed. The composition of output and the share of the private sector in the economy had changed considerably. The infrastructural base had been established; the future goals were to improve the efficiency of the economic system. To that end, the authorities had appropriately given high priority to manpower development and training and to the continued transfer of advanced technology.

The uncertainties surrounding the international oil market remained the main element of concern, Mr. Pérez remarked. Various factors cast doubts on the staff's oil revenue projections, including the problems facing OPEC, the slow pace of adjustment to the decline in oil revenues in most oil producing countries, the influence of new producers on the supply market, the pursuit of energy-saving policies in industrial countries, and the slower growth in the world economy projected for the medium term. Owing to those uncertainties, the authorities' goal of strengthening the role of the private sector in the economy was particularly appropriate and would help to diversify the economy, making it less dependent on oil production and broadening the revenue base of both the fiscal and external sectors. The efficiency of the non-oil sector should be fostered by minimizing the amount and number of subsidies and placing less emphasis on special incentives and administrative regulations. Finally, the authorities' success in managing the economy and their contribution to ODA, despite adverse economic circumstances, were welcome.

Mr. Joyce remarked that the authorities should be commended for their impressive economic management in the past few years. The fall in the price of oil had seriously limited the range of policy options open to the authorities. They would have to make difficult choices between consumption and investment in the short term and between alternative paths of economic development in the longer term. The challenge would be to maintain the necessary degree of fiscal restraint, while encouraging both an expansion in the private sector and the development of a more diversified productive base. A further step in that direction would be to increase privatization of publicly owned enterprises and shift investment expenditures toward sectors with larger domestic value added and lower import content. Expenditure cuts were inevitable given the continuing decline in oil revenues. While the maturity of the infrastructure and social services investment program made it easier for the authorities to implement those cuts, they should be selective with a view to ensuring that activities underpinning or complementing private sector investment were not cut back too sharply. A difficult task lay ahead: room must be created for private sector investment in the economy without encouraging dependence on public sector subsidies and without providing fiscal stimulus that would constitute a further drain on foreign reserves.

The staff questioned whether the planned stance of fiscal policy might be too restrictive and advocated a transitional approach that would accommodate at least a small budget deficit in the short term rather than seek a balanced budget immediately and at all costs, Mr. Joyce observed. That advice was sound for Saudi Arabia, especially given oil market prospects. The authorities were concerned about external reserves, which, in his view, were currently at a comfortable level. In any event, whether fiscal policy was overly tight or not would also depend on the adequacy of monetary and exchange rate policies.

The staff had proposed the introduction of a sales tax or an income tax to cushion the country's high dependence on the oil sector, Mr. Joyce noted. While those tax measures might have been ruled out by the authorities on social policy grounds, the growing maturity of the economy and the broadening of the economic base only served to strengthen the case in favor of such measures. He welcomed the measures recently announced to increase import tariffs and various fees and indirect taxes, which were projected to increase non-oil revenues by 30 percent in 1985. Those measures went in the direction of widening the tax base, although less distorted revenue measures would have been desirable.

The introduction of Bankers' Security Deposit Accounts (BSDA) in 1984 was encouraging, as it offered a viable alternative investment channel for domestic savings, Mr. Joyce commented. Those accounts should be used as an instrument of monetary policy, which should usefully complement fiscal policy in an effort to achieve the Government's overall financial management objectives. Exchange rate policy could also carry more of the burden of demand management. A more active use of exchange rate policy could improve the international competitiveness of the economy, particularly given the real appreciation of the riyal in line with the strengthening of the dollar. A more competitive exchange rate could also make a significant contribution to the diversification of the economy.

The medium-term economic outlook for Saudi Arabia was highly uncertain, especially in view of the recent developments in the oil markets and the difficulties experienced by OPEC, Mr. Joyce noted. If oil revenues were considerably less favorable than assumed in the staff's medium-term outlook, the authorities would face a hard choice between maintaining their foreign asset holdings and diversifying the economy. It would have been useful for the authorities if the staff had provided a medium-term outlook based on more pessimistic assumptions. Further progress by the authorities in providing data for the Fund on government finances and in improving the currentness of monetary and external trade data was called for. Saudi Arabia should be commended for its generous bilateral aid and its continued strong commitment to maintaining a sound international monetary system.

Mr. Grosche commended the authorities for their good economic performance. On the domestic side, by pursuing appropriate fiscal policies, the authorities had adapted the economy smoothly to declining oil revenues.

On the external side, they continued to demonstrate prudence and responsibility in the oil market, the management of foreign reserves, and the continued provision of generous foreign aid. Furthermore, Saudi Arabia had played a constructive role in many international organizations.

The targets established in the Fourth Development Plan provided an appropriate medium-term framework for fostering economic growth through diversification, Mr. Grosche observed. Construction activity had appropriately been scaled down following the completion of both the transportation system and the port facility. The Plan emphasized the manufacturing sector and the strengthening of the private sector, which already contributed 33 percent to GDP, an increase of 20 percentage points in only ten years.

The differences of view between the staff and the authorities regarding the scaling down of fiscal expenditures in response to the decline in oil revenues were spelled out clearly in the staff report and Mr. Nimatallah's opening statement, Mr. Grosche noted. Mr. Nimatallah's argument that expenditure restraint was necessary to avoid depleting the country's foreign reserves had many merits, particularly in view of the recent dramatic developments in the oil market. However, the arguments put forward by the staff could not be dismissed easily. The stimulus for non-oil private sector activity and the non-oil economy as a whole had been emanating for some time from government expenditure on goods and services. If that stimulus were withdrawn too abruptly, private sector activities might be hampered. On the whole, it appeared that the authorities had embarked on a middle solution, whereby the drawdown of reserves would be limited, while the private sector would be stimulated through relatively stable public sector demand. The recent revenue measures should alleviate the need for further expenditure restraint. A broadening of the tax base and an increase in the income elasticity of the tax system, while not having any immediate effects, deserved further consideration.

A more flexible approach to exchange rate management would not only improve the balance of payments position, but also foster export activity and help to diversify the economy, Mr. Grosche commented. Exchange rate policy should be used as a tool to encourage a shift of resources from the nontradable sector toward the tradable sector. Despite the recent increase in import duties, the authorities preserved an open foreign trade policy. They should be commended for maintaining an exchange and payments system free of restrictions.

Although the complicated system of direct and indirect subsidies, rules regulating government procurement, and unlisted prices was intended to support the private sector, it might also represent an obstacle to a more efficient allocation of resources, Mr. Grosche considered. Subsidies impaired international competitiveness. The authorities' announcement that the system of subsidies would be reviewed and rationalized was reassuring. Could the staff or Mr. Nimatallah indicate the scope and speed of implementation of those reforms? Finally, he encouraged the authorities to continue their efforts to provide statistical data in a timely and comprehensive fashion.

Mr. Fujino noted that the Saudi Arabian authorities had impressively adjusted the economy to the decline in oil revenues, primarily through the pursuit of a restrained fiscal policy, supported by a drawdown of official foreign assets. The budget deficits of the past two years had been financed by a partial withdrawal of public sector deposits from the SAMA. The external current account deficit, while registering a deficit of about $13 billion in each of the past two years, was not cause for concern at present, given the level of Saudi Arabia's official foreign assets. However, growth in the non-oil sector had slowed from the double-digit growth registered in the recent past as a result of the authorities' restrained fiscal stance.

Adjustments in the fiscal area had been impressive, Mr. Fujino observed. Expenditure had been reduced by almost 25 percent in nominal terms in the past three years. The composition of expenditure had changed dramatically; project expenditure had declined significantly reflecting the completion of major infrastructural projects and the postponement of some low-priority projects. Current expenditures had also been contained over the same period. The authorities' aim to balance the budget in 1985/86 through the continued pursuit of a restrictive fiscal policy was appropriate. But the staff suggested that there might be room for a temporary budget deficit, which would be consistent with the maintenance of a comfortable cushion of official foreign assets. It was understood that the authorities would be flexible in the management of fiscal policy as long as official foreign assets remained at a comfortable level, in which case the difference of view between the staff and the authorities would not seem so great.

The authorities' medium-term strategy of achieving sustainable economic growth based on a more diversified economy was appropriate, Mr. Fujino considered, although it was circumscribed by Saudi Arabia's oil production policy of adopting a role as a swing producer--a role that was highly respected by the international community. The performance of the private sector was key to achieving that goal. However, the task of promoting private sector growth would be challenging.

The domestic financial sector would have to be strengthened further with a view to promoting and mobilizing domestic savings, Mr. Fujino commented. While commercial bank credit to the private sector had increased rapidly, it was still of limited importance. The ratio of foreign assets to deposits of those banks exceeded 60 percent. Therefore, the courses of action suggested by the staff--the development of new debt instruments and a move toward term-lending operations--were appropriate.

The riyal had appreciated with the dollar, reflecting the close relationship between the currencies, leading to some real effective appreciation of the riyal, Mr. Fujino pointed out. Exchange rate policy could be used more actively as a tool to encourage production of tradable goods and import substitutes. Finally, the authorities should be commended for their generous assistance to developing countries and to multilateral institutions, including the Fund.

Mr. Kabbaj observed that Saudi Arabia's economic and financial performance in 1984 had continued to be affected by conditions in the world oil market. Further progress had been made in adapting government spending and the economic structure to declining income. Owing to the significant level of Saudi Arabia's international reserves, the completion of major infrastructural projects, and the authorities' cautious fiscal management, adjustment to the steep decline in oil revenues had continued in an orderly fashion.

Fiscal adjustment efforts had been particularly impressive even though the budget, which had been balanced in 1983/84, had recorded a deficit equal to about 12.6 percent of GDP in 1984/85, Mr. Kabbaj went on. Faced with the decline of oil revenue of about 64 percent over the past three years, the authorities had reversed the strong upward trend in public expenditures that had prevailed until 1981/82. In addition to reducing capital expenditure sharply through phasing down ongoing development projects and postponing or canceling some new ones, they had made efforts to curtail current outlays, increase domestic non-oil revenues, and cut subsidies. A sharp reduction in transfers to specialized credit institutions had also helped to contain the pressure on the budget. While fiscal restraint had enabled Saudi Arabia to sustain the sharp decline in oil revenues and to contain the drawdown of official reserves, it had also adversely affected the growth of the non-oil sector, which had decelerated from a rate of 12 percent in real terms in the three years ended 1981/82 to an estimated 3 percent in 1984.

Given the dependence of private sector expansion on demand generated by public expenditures, the staff seemed to favor a less rapid reduction in the role of the public sector and the maintenance of a larger budget deficit, as the impact on official reserves would be minor, Mr. Kabbaj observed. However, the authorities' approach was more cautious and was concerned not only with the need to limit the drawdown of official international reserves but also, and more important, with the need to achieve other objectives that had not been sufficiently addressed in the period of rising oil revenues. Those objectives included, in particular, a streamlining of government expenditures, a strengthening of budgetary controls, and a reduction in less essential outlays.

Bank supervision by the SAMA had been strengthened, Mr. Kabbaj noted. The commercial banks had been urged to increase reserves to cover bad loans and to improve their scrutiny of credit applications. The establishment of a credit information center should be helpful in that regard. The BSDA scheme also established by the SAMA in 1984 had been successful in reducing the share of foreign assets in commercial banks' portfolios and providing banks with an alternative to the Bahrain market.

With the expansion of infrastructure and the establishment of a relatively strong industrial base, the focus of development policies was appropriately shifting toward the promotion of the private sector, Mr. Kabbaj stated. The authorities' program should result in a gradual transfer of major public enterprises to the private sector and establish a new incentive for domestic private investment. Both the Fund and the World Bank group were collaborating on a study on promoting the private sector in Saudi Arabia. Assistance would be provided only to viable enterprises that were profitable without any permanent subsidies or protection.

Saudi Arabia's external performance would continue to be affected primarily by conditions in the world oil market, Mr. Kabbaj noted. While considerable uncertainties underlay the external projections made by the staff, the financing or sustainability of the projected deficits raised no concerns in view of the high level of foreign reserves accumulated in previous years and the authorities' cautious reserve management policy. Protectionist measures against Saudi Arabia's industrial products, particularly petrochemicals, might increase pressures on the external accounts. Such protectionist practices should be eliminated and should not be allowed to hinder the development of the industrial base in a country that maintained a liberal trade system. Finally, he commended the authorities for continuing to provide substantial ODA, despite a sharp drop in oil revenues and a reduction in foreign investment income.

Mr. Wijnholds observed that Saudi Arabia had gone through a remarkable adjustment in the past decade, from a highly expansionary economic phase, buoyed by sharply rising oil revenues, to a phase of strong economic contraction since 1982. That sharp turnaround indicated that, in fact, countries with truly chronic balance of payments surpluses and countries acting as "reserve sinks" were rare indeed. Saudi Arabia's adjustment to declining revenues had been cushioned by a considerable drawdown of official reserves. The authorities' pursuit of prudent policies and their continued active support of the international financial system were commendable.

A great deal of uncertainty underlay the immediate growth prospects for the Saudi Arabian economy, particularly given the present volatile situation in the oil market, Mr. Wijnholds noted. Mr. Nimatallah had alluded to the need to protect the national interests of his country in his opening statement. In the light of the present uncertainties regarding oil prices and production levels, the emphasis of the Fourth Development Plan on diversifying the economy, particularly by encouraging the growth of the private sector, was appropriate and timely. The Fund and the World Bank were conducting a study on that sector.

The staff had suggested that the authorities might pursue a different exchange rate policy aimed at promoting the private sector, particularly by fostering a shift of resources toward the tradable goods sector, Mr. Wijnholds observed. However, it was questionable whether a depreciation of the riyal would, in balance, be in Saudi Arabia's interest. Given the relatively high level of imports, a downward adjustment of the riyal could endanger Saudi Arabia's good record of price stability, whereas the benefits of such action on the non-oil tradable goods sector, the size of which was likely to remain modest for the time being, appeared limited.

Although expenditure had been curtailed sharply in recent years, government deficits had been considerable, rising to 13 percent of GDP in 1984/85, when revenues had been lower than expected, Mr. Wijnholds remarked. The revenue projections for 1985/86 were unlikely to be met, as they were based on crude oil production of 4.5 million barrels a day and on current oil prices. A strengthening of the government revenue base and the introduction of a general income or sales tax were, therefore, all the more important. He agreed with the staff that under present conditions Saudi Arabia should incur limited budget deficits and should draw down its reserves. The authorities' wish to maintain the current level of official foreign assets was understandable, in view of the volatile nature of Saudi Arabia's exports, but official financial assets had still stood at more than three years' imports in February 1985, and commercial banks held net foreign assets amounting to about $18 billion, which constituted a buffer for the financing of an overall balance of payments deficit.

While the staff report for the 1985 Article IV consultation with Saudi Arabia contained more statistical information than the previous year's report, some information was still lacking, Mr. Wijnholds observed. Non-oil GDP growth rates had been provided in the report, but the real rate of growth of GDP had not been mentioned--although it could be gleaned from information presented in the tables in the report on recent economic developments. He hoped that the authorities would be able to improve the timeliness and coverage of statistical information provided to the Fund. Finally, Saudi Arabia should be commended for continuing to provide considerable amounts of foreign aid despite the fall in oil income.

Mr. Ismael remarked that the economic policies followed by the Saudi Arabian authorities over the past year had continued to focus on adjusting the economy to a lower level of oil exports, while maintaining economic development and diversification. The authorities had introduced prudent and timely demand management policies, which had helped the economy to adjust to lower growth with relatively minor disruptions in economic activity.

In response to the decrease in oil revenues, the authorities had reduced government expenditure, particularly subsidies and capital outlays, and had tightened expenditure control, Mr. Ismael observed. They aimed to balance the budget in 1985/86 and, appropriately, to reduce subsidies further, especially those on water and electricity consumption; those measures would help to improve the allocation of resources. The projected increase in non-oil revenues was also encouraging. An improvement in the collection of taxes seemed to be more appropriate than the introduction of a general income tax, a course of action that would be premature in present circumstances. The increased emphasis being placed on the implementation of prudent expenditure policies and on improving project selection and execution was welcome.

Action taken by the monetary authorities to strengthen bank supervision, the requirement that banks build up their reserves, and the expansion of the BSDA scheme were all measures that would help to improve the authorities' control over monetary policy, Mr. Ismael noted. Emphasis was appropriately being placed on the diversification of the economy through an expansion of the productive base and increased participation by the private sector in the economy. The sale of 30 percent of the equity capital of the Saudi Arabian Basic Industries Corporation to the private sector was a step in the right direction. Any specialized incentive schemes, such as credit subsidies and other forms of protection, should be removed as soon as possible so as to reduce distortions in the allocation of resources. He commended the authorities for continuing to maintain their high level of development assistance despite the reduction in oil revenues.

Mr. Clark stated that he was impressed by the policies of the Saudi Arabian authorities, not only as a response to a large fall in external and, thence, fiscal revenues, but also insofar as they took into account international implications. In that latter respect, Saudi Arabia's role as the swing producer in OPEC, management of the SAMA portfolio, a generous aid program, and support for the Fund were particularly noteworthy. However, current developments in the oil market suggested that the fiscal and current account pressures of the past few years were likely to continue and, perhaps, even intensify. The new figures presented by the Director of the Asian Department at the beginning of the meeting appeared to be much more realistic than the medium-term projections in the staff report. The uncertainty surrounding oil market developments made an assessment of medium-term prospects even more important both as a way of indicating the possible areas and degree of pressures and as an aid in contingency planning.

While commendable progress had been made in reducing subsidies from their peaks of 1981/82, they still accounted for about 10 percent of current expenditure and should be cut further, Mr. Clark noted. The likely shortfall in budgetary revenue in 1985, based on recent figures for oil prices and production, reinforced the staff recommendation that the authorities should consider further measures to strengthen the domestic tax base. Could Mr. Nimatallah or the staff comment further on the reasons for the authorities' opposition to the introduction of an income tax or a general sales tax? The BDSA scheme had been broadly successful, although bankers had complained that the rates offered by SAMA had been inadequate. Did Mr. Nimatallah consider that the scheme could be made more flexible if an interbank market in BDSAs were set up?

The strong emphasis in the Fourth Development Plan on the growth of the private sector was appropriate, Mr. Clark considered; he sympathized with the view expressed by Mr. Abdallah on that issue. However, the experience in financial markets in cases where entrepreneurs had been given full and unsupervised rein had not always been very happy. The financial position of many private sector companies was difficult, and the authorities were experiencing difficulties in identifying profitable new industrial projects. What measures were the authorities considering to encourage development in priority areas? He looked forward to the joint Fund/Bank study on private sector development.

He agreed with the staff's recommendation that exchange rate policy should be used more actively and hoped that progress in that area would be assisted rather than constrained by consultations with the GCC, Mr. Clark commented. In sum, the authorities had followed sound policies in difficult circumstances, with considerable success. Continued and perhaps intensified fiscal restraint would be necessary if developments in the oil market continued to be unfavorable. In any event, whatever the immediate prospects for the oil market, Saudi Arabia possessed at least one fourth of the world's oil reserves, and there was, therefore, no reason for the authorities to be too despondent in the longer term.

Mr. Lundstrom stated that he was in broad agreement with the staff appraisal. The response of the Saudi Arabian economy to the sharp decline in oil revenues since 1981 had been impressive. Through careful planning and prudent policies, the authorities had managed to adjust the economy in an orderly fashion while taking account of the international implications of the domestic policy stance. They had consistently advocated an oil policy that would stabilize the international oil market and allow it to function smoothly. Moreover, Saudi Arabia's foreign assets continued to be managed in a balanced way with a view to avoiding disruptions in the currency markets. The authorities should be commended for their prominent role in development financing, which had remained high despite the substantial decline in external revenues.

The new emphasis of the development strategy on promoting the private sector was welcome, Mr. Lundstrom considered. It was reassuring that the authorities were fully aware of the danger that the private sector might become dependent on excessive protection and permanent subsidies.

The authorities had exercised considerable restraint in public spending in the wake of declining oil revenues, Mr. Lundstrom noted. Given Saudi Arabia's position as a swing producer and the uncertainty of the oil market, the strategy of maintaining a tight fiscal policy stance was understandable. However, the staff's suggestion that there might be scope for somewhat greater flexibility in budgetary policies was also valid, given the comfortable level of foreign exchange reserves and the need for diversification of the production and export base. Did the staff consider its suggestion to be valid even after the recent developments regarding oil production? Finally, the authorities should aim to improve the availability and timeliness of statistical data.

Mr. Arias joined previous speakers in commending the Saudi Arabian authorities for their efforts in adjusting the economy to unstable conditions in the world oil market. Faced with declining oil revenues, they had cut government expenditures, while diversifying the revenue base. The authorities' view that a balanced budget would be desirable to maintain a comfortable level of reserves was understandable. However, they should consider introducing an income or sales tax in the context of the increasing privatization of the economy.

The authorities had shown determination in developing an industrial base, in addition to the existing agricultural base, Mr. Arias observed. It was important that their efforts not be hindered by protectionist measures, including trade and exchange restrictions. Saudi Arabia had played an important role in the world economy, and Mr. Nimatallah's assurances that the authorities would continue to consider the well-being of the international community while pursuing their economic policies and to continue assisting developing countries were welcome.

Mr. Coumbis remarked that he was in broad agreement with the staff appraisal. The authorities should be congratulated for pursuing flexible policies to adjust the Saudi Arabian economy, maintaining aid to developing countries at such high levels, making efforts to stabilize the world oil market, and supporting the Fund. However, some areas of weakness remained. Further progress was needed in eliminating direct subsidies and tariff protection of some industries. Such arrangements were unproductive and distorted the efficient allocation of resources, as the authorities were well aware. As Saudi Arabia did not have the balance of payments and unemployment constraints that faced many other developing countries, the authorities should rationalize subsidies and tariffs as soon as possible.

The discretionary measures taken recently to increase import duties and indirect taxes had boosted non-oil domestic revenues by 29 percent, although they accounted for only 12 percent of total revenues, Mr. Coumbis observed. The staff had appropriately suggested that the tax base should be broadened and the income elasticity of the tax system increased. The authorities should explore the possibility of introducing an income or sales tax. If the tax base were not broadened, the brunt of adjustment in the fiscal sector would continue to be borne by government expenditure alone, potentially inhibiting the authorities' efforts to diversify the economy.

The SAMA's efforts to encourage commercial banks to build up reserves and to strengthen bank supervision were welcome, Mr. Coumbis stated. The recently introduced BSDA scheme had evolved into a useful new instrument of monetary policy.

There was some difference of view between the authorities and the staff regarding the policies that should be followed in the medium term, Mr. Coumbis noted. The authorities hoped to maintain a relatively high level of official foreign assets, diversify and privatize the economy, and reduce economic activity gradually to sustainable levels that would be consistent with the deteriorating prospects of the oil market. The Fourth Development Plan aimed at achieving an annual average growth rate of 4 percent in real terms, including 2.9 percent growth in real non-oil GDP. Annual government expenditure was projected to be maintained at SRl 200 billion each year, with the objective of achieving a balanced budget. However, the simulation exercises carried out by the staff indicated that, if the authorities were to maintain that level of expenditure and to balance the budget each year until 1989, the growth rate of non-oil GDP would fall significantly in 1986/87 and would recover only slightly in 1988/89. The staff considered that the authorities' strategy would lead to a further economic slowdown and would have an adverse impact on profitable domestic investment opportunities for the private sector, thereby inhibiting the diversification and privatization of the economy--the basic objectives of the authorities.

The differences of view between the authorities and the staff were due not only to differences in value judgments but also to differences in interpretation of facts, Mr. Coumbis went on. For example, the simulation exercises of the staff based on the authorities' objective of achieving a balanced budget had produced results different from those expected under the authorities' Five-Year Development Plan. Further analysis and research would clarify the facts and issues and reduce the differences between the authorities and the staff. Close cooperation between the Fund, the Bank, and the authorities would be useful in that respect. It was a refreshing change to hear the staff recommending the maintenance of a budget deficit and pursuit of expansionary policies, while the authorities insisted on a balanced budget and contractionary policies.

Mr. Jayawardena remarked that his authorities generally commended the Saudi Arabian authorities for their prudent and highly responsible management of domestic economic affairs. The authorities' efforts to stabilize the world oil market and to maintain a high level of ODA to developing countries, despite Saudi Arabia's economic difficulties, were greatly appreciated. Also deserving commendation was Saudi Arabia's role in supporting international organizations, including the Fund, reflecting an extraordinarily high commitment to international cooperation.

Self-sustaining economic growth and price stability in Saudi Arabia were important to the world economy and, in particular, to the developing world, Mr. Jayawardena remarked. Thus far, economic growth had stemmed from oil and oil-related industry and from heavy government investment in infrastructure. Yet that infrastructure alone might not promote a more diversified economy. Hence, the authorities' distinct shift in policy emphasis to private sector development was most welcome. It remained to be seen whether a dynamic private sector would emerge under a widespread system of subsidies. Negligible import tariffs provided little protection to nascent economic activities. In fact, there might be negative protection in many cases, because even trade and transport costs to Saudi Arabia were subsidized. Subsidies were the most inefficient way to create incentives and achieve economic objectives, as they distorted prices and negatively affected the allocation of resources. Saudi Arabia should seriously evaluate the costs and benefits of the subsidy program to determine whether the negative effects of subsidies could be mitigated either by straightforward income transfers or by granting subsidies to only those that really needed them. In its frequent consultations with the authorities, the staff might examine Saudi Arabia's subsidy policy.

The authorities needed to undertake substantial investment in manpower and human resources to support the development of the non-oil sector, Mr. Jayawardena considered. Given its limited non-oil resources and small population, Saudi Arabia must focus on high-technology industries, for which the country would need high-quality manpower. Furthermore, manpower development was crucial for the healthy development of the private sector.

Exchange rate policy should reflect the authorities' objective of developing a viable non-oil private sector, Mr. Jayawardena pointed out. It was questionable whether the close relationship between the riyal and the dollar would be the most appropriate policy for encouraging the development of a viable non-oil sector, despite the benefits of such a policy for the oil industry. In sum, the authorities should be commended for their prudent economic management under deteriorating economic circumstances and for their exemplary approach to international cooperation. The current thrust of policies aimed at diversifying the economy should be strengthened.

Ms. Bush commended the authorities for their success in adjusting to the sharp drop in oil revenues. Saudi Arabia was currently in an important transition period, evidenced by the completion of major infrastructural projects and by substantial progress toward establishing the country's basic industrial capacity.

The authorities' emphasis on expenditure reduction in the face of declining oil revenues had been prudent, Ms. Bush observed. The objectives of achieving a balanced budget and preserving the level of foreign reserves was indicative of the authorities' continued emphasis on prudence. She understood that policy stance and expected that the economy might be resilient enough to tolerate a balanced budget without seriously jeopardizing growth prospects for the private sector. Perhaps the stimulus to the private sector that had been provided by government spending in the past would be replaced by other efforts to promote private sector growth. Included among those efforts should be continued emphasis on establishing joint ventures with foreign investors, developing the petrochemical industry, and shifting activity from public enterprises to the private sector, which in turn would provide greater incentives for economic growth. The joint Fund/Bank/IFC study to promote private sector growth and the development of domestic financial instruments such as the BSDAs were welcome initiatives that should promote private sector growth. Steps should be taken to strengthen the banking system to ensure that an appropriate financial structure would be in place to finance private sector growth.

On the question of tax reform, there was some merit in formulating contingency plans that could be implemented if needed and that would be appropriate to a more diversified economy, but there did not seem to be an immediate plan for alternative revenue sources, Ms. Bush remarked. Hence, the authorities' caution regarding the actual introduction of new taxes seemed appropriate, given the transitional economic period and the key objective of developing the private sector. The authorities should continue to evaluate the need for tax reform based on conditions in the economy. She commended them for their internationally responsible policy approach in such areas as free trade and payments, management of international reserves, and stability of the world oil market.

Mr. de Groote pointed out that the Fund staff had also in the case of Hungary recommended that the authorities should allow the budget to move from surplus into deficit and should increase wages and retail prices more rapidly. The Hungarian authorities had, indeed, adjusted their policies to those recommendations.

Mr. Romuâldez noted that the staff had responded to his chair's request at the previous Article IV consultation with Saudi Arabia by including more detailed analysis of the country's medium-term prospects. The Fourth Development Plan was appropriately aimed at strengthening the financial sector and introducing a broader-based tax system. Fiscal policy should, in the short term, aim to improve tax collection, but the authorities should plan to introduce measures aimed at broadening the tax base when the private sector had grown stronger. Their intention to pursue cautious policies until the economy's dependence on oil revenues had been reduced sufficiently through the diversification of the economy was understandable, particularly given the recent figures on oil production presented by the staff. The authorities had indicated their ability to recognize the appropriate time when additional stimulus, and hence a small budget deficit, would be necessary.

Real growth in the non-oil sector had accelerated in 1984/85, Mr. Romuâldez remarked. The authorities were aware of the costs and rigidities of subsidies; given the peculiar structure of the economy, they were using subsidies to their best advantage, as a useful and temporary means for promoting private sector activity. The staff had rightly stressed the need to identify growth priorities clearly so that the costs of subsidies were minimized.

The authorities' intention to avoid providing excessive protection as a means for promoting the private sector was welcome, Mr. Romuâldez commented. While the staff had rightly drawn the authorities' attention to the possibility of using exchange rate policies to encourage a shift of resources from the nontradable sector to the tradable sector, he agreed that there was no urgency in changing exchange rate policy. Finally, he commended the authorities for their responsible economic management, for their continuation of a high level of ODA, and for their meaningful participation in the Fund and World Bank group.

The Director of the Middle Eastern Department remarked that the difference of view between the staff and the authorities was primarily a difference of emphasis. The staff was concerned about the authorities' aim to pursue a balanced budget, as private sector activity had been stimulated primarily by government expenditures. To subject private sector activity to sharp swings in government expenditure from year to year would hinder the achievement of the authorities' goal of promoting that sector. Expenditures would have to be cut sharply if oil prices or the volume of oil exports declined. However, the staff agreed with some of the measures that would be introduced to achieve the authorities' objective of balancing the budget, including stricter budgetary controls and expenditure reduction of inessential items.

The staff had no additional information on the recent meeting of the International Energy Agency (IEA), although press reports indicated that the IEA had agreed to continue consulting with oil-producing and oil-importing countries regarding ways to ensure that the additional volume of refined oil products and petrochemicals from Saudi Arabia and Kuwait could be absorbed into the world market without disrupting existing production in traditional producer countries, the Director commented. Those consultations should provide Saudi Arabia and other oil producing countries with greater assurance of access to markets in the OECD countries. The authorities projected that petrochemical exports would amount to about $3 billion by 1988.

Subsidies for wheat, other foods, and public sector services had been reduced in the past year, the Director indicated. One of the main objectives of the Fourth Development Plan was the rationalization of the subsidy and incentive program to assist the private sector. Only gradual progress in that area could be expected in the next few years. A major study, being undertaken by the Fund, with the assistance of the World Bank and IFC, on ways to promote the private sector would be discussed with the authorities before its final completion by the beginning of 1986.

Under the new procedures, all rather than only half of the zakat, a wealth tax levied at a rate of 2.5 percent annually, would be collected by the Government, the Director of the Middle Eastern Department concluded. The zakat receipts were administered by the zakat office and were used only for approved purposes, which were mainly charitable. The new procedures were part of a package of discretionary fiscal measures aimed at increasing revenues and improving tax administration. Individuals could continue to make charitable contributions that were greater than the zakat tax payment. Finally, information on GDP was included in Table 1 of the report on recent economic developments.

The staff representative from the Exchange and Trade Relations Department observed that Executive Directors had been divided in their views on the appropriate exchange rate policy for Saudi Arabia. The maintenance of a close relationship between the riyal and the dollar had injected some volatility into the exchange rate system vis-à-vis the European and other important currencies. The price impact of that exchange rate policy had to be traded off against the volatile profit situation and fluctuating incentives for the private sector. The staff had based its views regarding exchange rate policy on the authorities' objective of diversifying the economy and encouraging private sector activity. A downward adjustment of the exchange rate could have a negative effect on price developments, but the staff was confident that the authorities would continue to manage fiscal and monetary policies in a way that would limit any adverse impact. Exchange rate policy would be a useful tool to encourage private sector activity, thereby helping the authorities to reach their budgetary goals.

Mr. Nimatallah commented that the difference of view between the staff and the authorities was more a matter of emphasis than of substance. The Saudi Arabian authorities had generally followed the policy stance prescribed by the Fund. The medium-term objective of fiscal policy was to secure growth momentum at a lower level of economic activity. Expenditure had been reduced gradually in many areas. Outlays on subsidies and administrative expenses and transfers to the specialized credit institutions had been reduced. In the past, oil revenue and revenue from investments abroad had been sufficient to meet government expenditure plans. Given the decline in oil revenues, more revenue would have to be raised from domestic sources. The authorities were considering various tax measures that could be introduced in the future.

Because Saudi Arabia depended principally on the export of one product, it was not technically easy to identify the most appropriate exchange rate strategy, Mr. Nimatallah considered. It was difficult to use the exchange rate as a tool for enhancing exports; action on that front would depend on the authorities' success in diversifying the economy. He urged the international community to help Saudi Arabia to achieve a more broadly based economy by opening their markets to Saudi Arabian export products other than oil, particularly petrochemicals.

The Chairman made the following summing up:

> Executive Directors commended the authorities on their foresight and success in building a modern economy over the past 15 years and on the orderly adjustment to sharply reduced oil export earnings in recent years. They endorsed the shift to a development strategy that accorded a greater role to the private sector in the growth process. Directors commended the highly responsible policies pursued by the Saudi Arabian authorities during recent years aimed at maintaining orderly and stable conditions in the oil market despite difficulties associated with the lower levels of oil output and export receipts. They complimented the authorities for taking into account the international impact of their own policy actions in framing their policies, an essential aspect of Article IV surveillance.

In response to the decline in oil exports and the likely continuation of weak oil market conditions for some time, financial and economic policies of restraint had been implemented. The decline in public sector spending since 1982/83 had been facilitated by the completion of major infrastructural projects and substantial progress toward the establishment of basic industrial capacity, and it had been consistent with the desire to streamline expenditures. Moreover, as the adjustment to the substantial fall in oil revenues over the past three years had been effected partly through a drawdown of official foreign assets, the authorities had avoided the potentially damaging effects on the economy of a more abrupt reduction in government spending. While a number of Directors associated themselves with the authorities' fiscal objective of balancing the 1985/86 budget, some Directors noted the strength, in their view, of the staff's argument that such an objective might be unduly contractionary in present circumstances and might compound the problems confronting the private sector. It was generally observed, however, that as oil revenues were likely to decline substantially in the current fiscal year, the authorities would need to reduce expenditures further in order to limit both the size of the budget deficit and the drawdown of official foreign assets. The authorities were complimented on the steps already taken in the 1985/86 budget to curtail nonessential expenditures, rationalize the consumption of utilities, and reduce some subsidies, which still account for about 10 percent of current outlays. Some Directors urged that consideration also be given to measures aimed at further broadening the tax base and increasing the income elasticity of the tax system.

Directors observed that, given the high dependence of private sector activity on demand generated by government expenditures, the authorities would need to reconcile their twin objectives of promoting the private sector and avoiding a further drawdown of official foreign assets. They welcomed the rapid growth of the private sector, which amounted to one third of GDP compared with 13 percent a decade ago. They noted that the authorities were cognizant of the dangers of according excessive protection as a means of promoting the private sector and welcomed the authorities' determination to reduce subsidies in an orderly manner over a period of time. Directors observed that commercial banks would need to adjust to the changed economic conditions and applauded the steps being taken by the authorities to ensure a sound growth of the banking system. They generally endorsed the evolution of the Bankers' Security Deposit Account scheme into an instrument of monetary policy.

With respect to the external sector, Directors noted the revised balance of payments projections. They generally agreed with the desire of the authorities to maintain a comfortable level of international reserves. Considering their present level, the expected further drawdown in such assets was not seen by Executive Directors to be a matter for serious concern. However, Directors noted the tentative nature of the balance of payments projections, particularly in view of the uncertain outlook for the oil market. While Directors generally agreed with the authorities' approach to exchange rate policy and noted the contribution that it had made to maintaining relative price stability in recent years, several Directors felt that, given the need to promote private sector activity and to rationalize the existing system of subsidies, the authorities would be well advised to keep the appropriateness of the exchange rate under close review. A number of Directors also stressed Saudi Arabia's concern regarding the potentially damaging impact of possible restrictions in importing countries on Saudi Arabia's exports of petrochemicals and refined oil products and reaffirmed the need for a liberal global trading system. Saudi Arabia's objective under the Fourth Development Plan to strengthen economic and social ties among the members of the Cooperation Council for the Arab States of the Gulf (GCC) was noted.

Directors complimented Saudi Arabia for its continued generous program of providing concessional economic assistance to developing countries despite lower oil export receipts and a weaker balance of payments position. Directors noted that Saudi Arabia has continued to follow appropriate reserve management policies. They also expressed appreciation for Saudi Arabia's continued close cooperation with the Fund and the strong support exhibited by the provision of substantial resources to this institution.

The authorities were encouraged to continue improving their statistical data base and to enhance its complete and timely communication to the Fund.

The next Article IV consultation with Saudi Arabia is expected to be held 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/85/112 (7/24/85) and EBM/85/113 (7/26/85).

2. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 85/155 are approved. (EBD/85/185, 7/19/85)

Adopted July 25, 1985

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAP/85/190 (7/23/85) and by an Assistant to Executive Director as set forth in EBAP/85/191 (7/24/85) is approved.

APPROVED: April 28, 1986

JOSEPH W. LANG, JR.
Acting Secretary