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Minutes of Executive Board Meeting 85/163

10:00 a.m., November 12, 1985

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

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
C. H. Dallara	M. Lundsager, Temporary
J. de Groote	
	S. de Forges
M. Finaish	T. Alhaimus
	A. Mustafa, Temporary
	M. Sugita
G. Grosche	B. Goos
	Jaafar A.
A. Kafka	
	M. Foot
H. Lundstrom	
M. Massé	
	A. Abdallah
F. L. Nebbia	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Coumbis
	Jiang H.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

Administration Department: H. J. O. Struckmeyer, Deputy Director. African Department: A. D. Ouattara, Director; R. J. Bhatia, Deputy Director; J. Artus, M. Dairi, C. A. François, R. H. Nord. European Department: B. E. Rose, Deputy Director. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; J. T. Boorman, E. H. Brau, S. Kanesa-Thasan. External Relations Department: A. F. Mohammed, Director; H. O. Hartmann, N. K. Humphreys. IMF Institute: J. Hamza, Participant. Legal Department: F. P. Gianviti, Director Designate; J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, J. K. Oh, S. A. Silard. Research Department: R. R. Rhomberg, Deputy Director; A. D. Crockett, Deputy Director; M. Goldstein. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat, G. Djeddaoui. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer. Western Hemisphere Department: S. T. Beza, Associate Director. Bureau of Language Services: A. J. Beith, Director. Bureau of Statistics: J. B. McLenaghan. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, G. R. Castellanos, L. P. Ebrill, J. Hospedales, S. Ganjarerndee, G. Nguyen, P. Péterfalvy, G. W. K. Pickering, I. Puro, M. Z. M. Qureshi, A. Steinberg, E. M. Taha, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, I. Angeloni, M. B. Chatah, J. de la Herrân, J. J. Dreizzen, G. Ercel, R. Fox, S. Geadah, V. Govindarajan, N. Haque, L. Hubloue, A. R. Ismael, Z. b. Ismail, H. Kobayashi, R. Msadek, J. A. K. Munthali, K. Murakami, M. Rasyid, J. Reddy, J. E. Rodríguez, A. Bertuch-Samuels, S. Simonsen, A. J. Tregilgas, H. van der Burg, E. L. Walker, B. D. White.

1. EXECUTIVE DIRECTOR

The Chairman welcomed to the Executive Board Mr. Michael Foot, Alternate Executive Director for the United Kingdom.

2. TUNISIA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Tunisia (SM/85/261, 9/19/85). They also had before them a report on recent economic developments in Tunisia (SM/85/281, 10/24/85).

The Deputy Director of the African Department recalled that a staff team had visited Tunisia during the final week of October to discuss the authorities' objectives and policies for 1986 included in their draft Budget Economique. Based on information that had become available from that team after the issuance of the staff reports, the projections for real GDP growth for 1985 had been revised upward to 4.5 percent, on account of the better than expected performance in agriculture and tourism. Moreover, the latest projection for the external current account deficit was 7.5 percent of GNP in 1985, in contrast to the 7.9 percent figure mentioned in the staff report. The projection had been revised downward, despite a larger than expected deterioration in the terms of trade and in workers' remittances. With exports likely to decline by 1 percent, the projected improvement in the external current account deficit stemmed from a larger than expected reduction in imports, most of which was concentrated in raw materials and semifinished products.

As part of the effort to redress the balance of payments disequilibria, the authorities had recently demonstrated a greater flexibility in the conduct of exchange rate policy, the Deputy Director continued. According to them, between July and October 1985, the dinar had depreciated by 5.5 percent in nominal terms against the Central Bank's basket of currencies. Moreover, while budgetary policies for 1986 had yet to be finalized, the authorities had indicated to the staff that the aim of their policies was to reduce the budget deficit by 1.5 percentage points in relation to GNP, mainly through expenditure restraint. The staff considered that those various policy initiatives were properly directed.

Mr. Salehkhou made the following statement:

Economic performance

The economic recovery that started in 1983, after the adverse climatic conditions of the previous year, continued during 1984. GDP growth showed a healthy performance of 5.4 percent and agricultural output reached 11.6 percent, the highest in many years. An important aspect of the development process in 1984 was its broad base, touching almost all sectors of the economy. This progress was achieved at a time when world economic conditions were least favorable as the U.S. dollar reached unprecedented high levels and interest rates became excessive, while raw material and commodity prices were low and protectionist measures reduced the flow of international trade. Within the same world context and during the first half of 1985 the signs of economic progress in the Tunisian economy were characterized by record performance of the agricultural sector, which registered a rate of growth of 15.0 percent in constant prices over and above the exceptional rate in 1984 as well as an improvement in tourism and textiles that indicated a slight turnaround in European economic recession. The authorities estimate the growth rate for 1985 to be about 4.5 percent, due mainly to the poorer performance of the hydrocarbon and chemical sectors on the international market. The manufacturing sector also showed reduced growth on account of a smaller production of olive oil. While the energy sector is Tunisia's most important economic sector, representing 10 percent of GDP and 40 percent of exports, the authorities are giving high priority to the diversification of the economy in view of the limited prospect for future high production in the petroleum sector as estimated output seems to have reached its peak in 1983 and is increasingly on the decline.

This will not be without consequence on Tunisia's investment capability, as the high level of investment maintained up to 1984 must now be adjusted on account of reduced petroleum receipts because of both diminishing production and deteriorating world prices.

Investment and plan objectives

Tunisia's Sixth Development Plan will be completed at the end of 1986. During the period 1982-84 investment remained high, at 30.5 percent of GNP. Several factors accounted for this level of investment. In the first place the Plan's objective is to promote growth and employment and sizable capital outlays have been expended in projects development. The second reason is, although the level of investment was intended to be lower in 1984, the surge in the U.S. dollar and other major currencies forced a re-evaluation of a number of projects, with the effect of pushing up the rate of investment in terms of GNP. The unexpected surge in housing construction during the same year also contributed to the higher investment level.

However, despite the high level of investment, the impact on employment fell just short of covering new demands for 1984. The reason for this deficiency is inherent in the structure of investment projects, which tended to be largely capital intensive. A major correction is under way for 1985 and will be a fundamental consideration in the new Development Plan, 1987-91. The estimated cover for new job demands in 1985 is over 70 percent, compared with 66 percent in 1984. The surge in investment during 1984 was not matched by the growth of resources, which tended to slow down on acount of lower receipts from the petroleum sector and the moderate evolution of fiscal revenues.

The effects of high investment and high consumption led to an increase in the resource gap rather than the decrease envisaged by the Plan. For this reason and to reduce pressure on the balance of payments the economic budget for 1985 incorporated measures to stem the growth of consumption and reduce the level of investment. Thus, the level of investment in 1985 is estimated to fall within 27 percent of GNP mainly because of a reduction in public investment. The public sector in Tunisia plays an important role in terms of production and employment. It also covers the majority of the export sector and three fourths of export receipts.

Transfers to public enterprises including new capital injections, loans, and equity participation reached 4.1 percent of GNP in 1984. In order to trim the investment budget and to rationalize investment, a thorough examination of public investment priorities is under way. First, the authorities aim at a better distribution of investment favoring those sectors that can accommodate projects with shorter maturity and are more labor intensive. In this context the share of agriculture has been upgraded from 15.3 percent in 1984 to 18.1 percent in 1985, and similarly tourism and mechanical industries will be reinforced with special emphasis on maintenance and a better utilization of existing capacity. Second, investment in projects related to exports will henceforth have a greater priority in view of the impact of these projects on the external current account.

Finally, public enterprises directly tied to government control will be reduced to those in which the Government retains 34 percent ownership or more. For all other public companies a rehabilitation program is under way in order to improve their managerial and financial conditions so that they become eligible for development bank financing. The World Bank has been cooperating in this respect with the Tunisian authorities and a mission is expected to visit Tunis next fall.

Fiscal policy

The economic momentum maintained for several years in the face of strong adversities in the international environment, coupled with some slippages in expenditures in pursuit of growth and employment, has caused pressure on the fiscal situation of the country. Thus, total expenditures of the state increased by 24 percent in 1984. The authorities are aware that in view of limited perspectives for future high petroleum revenues, restrictions must be placed on the growth of consumption so that it remains below the growth of GDP. In this context a moderate wage policy is being followed, which has resulted in a stabilization of prices and a relative regression of demand. Furthermore, the authorities' policy on wages is linked to productivity and the profitability of enterprises--which will have a beneficial effect on employment, will improve Tunisia's competitiveness in the export sector, and will help to reduce inflation. So far in 1985 a slowdown in global expenditures is being witnessed and consumption is being maintained below the growth of GDP. On the revenue side, the authorities are adjusting upward energy and food prices and are raising interest rates. They are determined to reduce the intervention role of the Subsidy Fund for essential staple products so that it could attain equilibrium in the coming years.

Furthermore, a review of the tax system is under way in cooperation with the Fund and the introduction of a value-added tax is being considered. The measures implemented in 1984 led to a reduction in the fiscal deficit from 8.0 percent in 1983 to 7.4 percent in 1984. Further measures have been implemented in 1985, including a reduction in capital investment and transfers and tighter control on government expenditures while temporarily reducing certain nonessential imports with the aim of lowering the budget deficit. It is expected that the deficit in 1985 will remain close to the previous year at 7.5 percent. This is due partly to the fact that import taxes are growing less than the increase in imports reflecting a greater share of imports of raw material and semifinished goods usually taxed at a lower rate. In line with their policy of containing external debt, the authorities plan to maintain the share of foreign resources in the financing of the fiscal deficit to its 1984 level of 40 percent, which was brought down from 63 percent in 1983. A slight increase of credit from the domestic banking system is, however, expected, whereas nonbank domestic financing will be lower than in 1984.

Monetary and credit policies

Monetary and credit policies in 1984 and, in a more marked way, in 1985 were geared to the economic needs of the country for the purpose of sustaining growth while at the same time reducing the pressure on imports and prices. The policies also strived to foster savings through improvements in the remunerative interest rates while keeping a check on excess liquidity to reduce consumption. Thus, deposit rates are more positive in real terms. The composition and orientation of credit play an important role in Tunisia and are governed by central bank intervention in order to ensure the availability of credit to certain priority sectors. However, greater flexibility is being experienced in 1985 to give commercial banks the required latitude in credit allocation mainly to encourage exports and agriculture.

Interest rates for sizable investments in decentralized areas have been reduced by 1.5 percentage points in order to encourage regional development. A plan to incorporate offshore banks into the local credit system is under review, this will allow offshore banks to grant credit to resident enterprises and stimulate competition in export sector financing.

During 1984 and in line with the objective of reducing demand pressure, credit decelerated to 11.7 percent, against 18.9 percent in 1983. Likewise, demand deposits of households show a net slowdown from 27.3 percent in 1983 to 14.3 percent in 1984 as a result of wage restraint. In the distribution of credit, tourism and manufacturing registered the highest rate of increase, followed by chemical and mechanical industries in the expectation of better performance for these sectors in the international market. The tight credit policy maintained by the authorities continued in 1985, as reflected in the decrease in the money supply by 2.1 percent in the first quarter of 1985, against an increase of 1.4 percent in the same period of 1983. The pressure experienced on the balance of payments at end-1984 and in the course of 1985 has had a direct bearing on the orientation and level of credit. A net increase in credit allocation to agriculture is under way to meet the financing requirement of the exceptional harvest registered this year, whereas credit expansion for import financing has been moderately in line with the objective of reducing the pressure on the external accounts. Credit to the Government, however, will be higher than in 1984, partly to replace the shortfall in earnings from import tariffs.

External performance

The effects of the deterioration in Tunisia's international trade environment appeared in the merchandise account, which registered an increase in the deficit equivalent to 15 percent of GNP from 13.1 percent in 1983. The weak performance of phosphate and derivatives stems from a decrease in world demand along with a soaring of the price of sulphur input and a worldwide surge in new processing capacity. World prices for petroleum products have been on the decline, which explains the reduction in earnings from the hydrocarbon sector. Likewise textiles and mechanical industries have met with marketing difficulties and continued protectionist tendencies. While exports have stagnated, imports rose by 6.4 percent to accommodate the needs for raw materials and semifinished products.

On the service side, tourism has registered a strong decline due to the recession in Europe and workers' remittances have fallen substantially. The surge of the dollar has increased the burden of the external debt, at the same time it has brought about a sizable increase in the price of food products particularly corn and soybean. The rise in the current account deficit has also been precipitated by the increase in public expenditures, which grew faster than revenues leading to further foreign borrowing. As a consequence, debt service in 1984 amounted to 19.5 percent of exports of goods and services from 18.5 percent in 1983. Finally, in the capital account a scaling-down of foreign direct investment took place in the petroleum sector leading to further pressure on the balance of payments. For 1985 the preliminary figures indicate an improvement in exports and a slowdown in imports, while tourism is showing a definite rebound. As a consequence the trade deficit is expected to improve in 1985 from 15 percent of GNP to 12 percent and, with the estimated rise in tourist receipts, the current account will decrease to 7.9 percent of GNP from 10.7 percent in 1984.

A large-scale effort has been undertaken by the authorities to promote exports both institutionally and financially. Besides the creation of export companies and export insurance coverage, measures have been taken to alleviate the administrative procedures by abolishing the system of export licensing, while an export promotion fund has been established within the center for exports.

Thus, export of manufactured goods as well as agricultural products are the basis for the strategy adopted by the authorities in order to diversify the economy in the face of declining petroleum revenues and to restore equilibrium within the external sector.

However, while some results are already seen within the current year, the momentum for exports will need time to build up. Meanwhile, the need for the financing of the current account deficit and the debt will have to come from further borrowing and the debt service is expected to increase to 20 percent in 1985 from 19.5 percent in 1984. At the same time, reserves will temporarily fall both for seasonal reasons and for being drawn down to finance the balance of payments deficit.

Medium-term prospects

To briefly summarize Tunisia's economic development in 1984 and 1985, it is necessary to point out the considerable effort it exerted in reversing the performance of 1982 when no growth was registered and its ability to accomplish important rates of growth for 1984 and 1985 in the face of unfavorable world environment characterized by a strong deterioration in Tunisia's terms of trade particularly for oil and phosphate derivatives.

Slippages in government expenditures in pursuit of growth and employment, coupled with a high rate of investment, has spurred demand, which has led to higher imports and consequently has called for the need for more foreign borrowing to finance the deficit in its current account. To redress the situation the authorities have called for and have taken specific measures in the 1985 economic budget summarized as follows:

(a) Rationalization of investment priorities both public and private with an emphasis on labor-intensive investment.

(b) Moderation in wage increases.

(c) Gradual increase of prices of energy and subsidized foods.

(d) Restraint on credit with increase in interest rates.

(e) Strong measures for the promotion of exports.

(f) Control of nonessential imports to adapt imports to changing economic circumstances.

The prospects for end-1985 show a sizable improvement in exports and services and, added to the excellent performance of the agricultural sector and economy measures applied since the beginning of the year, the current account deficit will be reduced substantially.

The forecast for 1986 will be the subject of the economic budget program durig the last quarter of 1985. 1986 is the last year of the Sixth Development Plan, which will carry additioanl measures for the restoration of the internal and external accounts and a further strengthening of the export momentum as the economy is prepared for the posthydrocarbon era. With regard to the medium-term prospects, the authorities have drawn up a short- and a medium-term plan aimed at stabilizing the economy.

In the fiscal area, the authorities are exerting every effort to contain the budget deficit for 1986 and bring it down to 6.3 percent of GDP from 7.5 percent in 1985. This will be achieved by a reduction of 20 percent in the budgetary transfer to the Subsidy Fund and a 10 percent cut in the capital budget in nominal terms, as well as an increase in energy prices to reach international levels.

Concerning investment policy, the authorities intend in 1986 to maintain the level of global invesment equal to that of 1985 in nominal terms, which will mean a sizable reduction in real terms.

This will concern mainly government investment and public enterprise. They intend to reinforce private investment and grant it the necessary support, particularly in the fields of integration, export, employment, and regional development.

With regard to the exchange rate, since the beginning of 1984, the Tunisian authorities have adopted a flexible system of determination of the rate, which has allowed in part the absorption of the appreciation of the dinar vis-à-vis currencies of the competing countries. They intend to maintain this system in order to re-establish quickly during the coming months the competitive position of the Tunisian economy.

Finally, regarding the medium-term prospects, the authorities will await the macroeconomic outcome of the first half of 1986 to be able to draw up the precise program for the next Plan, 1987-91, which will focus on the need to restore external equilibrium through greater efficiency of investment, tight demand management policies, and strong encouragement of exports.

Mr. Nimatallah remarked that the Tunisian economy, which had performed fairly well in 1984, had begun to show signs of strain in 1985, reflected mainly in slower growth, high unemployment, and a general deterioration in the external position. Those difficulties were attributable in part to factors beyond the authorities' control, but were also due to inadequate domestic policies.

Among the positive and commendable steps taken by the authorities to arrest the deteriorating economic situation were a reordering of investment priorities, firmer control over wages, reduced subsidies, and the adoption of measures to improve the external position, Mr. Nimatallah continued. The authorities were also aware that the restoration of domestic and external equilibrium was a prerequisite for a healthy and balanced growth over the medium term.

The authorities recognized that the size of future investment programs in Tunisia should be consistent with a more realistic assessment of resource availability, Mr. Nimatallah said. However, investment policy had an important role to play in reducing unemployment and accelerating growth. The focus should be on productive activities, preferably those that generated additional employment. It was particularly important that Tunisia's new development plan, scheduled to commence in 1987, should focus on productive investment--for example, in agriculture and manufacturing--to expand exports and employment. Assistance from the Fund and World Bank in that area would be helpful, and he encouraged the authorities to utilize, in particular, the Bank's technical and financial assistance to ensure that the plan was appropriately directed. In that respect, staff comment on the overall orientation of the Seventh Development Plan would be helpful, particularly since little had been said in the staff paper about Tunisia's high unemployment problem and how it could be reduced over time.

The authorities were also making good progress in the area of the public sector enterprises, Mr. Nimatallah remarked. They planned to reduce the number of those enterprises substantially, and in view of the current large budgetary transfers to the enterprises, such a reduction was welcome; it would contribute positively to strengthening Tunisia's public finances. World Bank involvement in the rehabilitation of public sector enterprises in Tunisia was appropriate and should continue. He would appreciate any information that might be available on the timetable for completing the reform of the public sector enterprises; also, it would be helpful to know the corresponding reduction in budgetary transfers, which at present were equivalent to 4 percent of GNP. On the budget, the authorities were making good progress to reform the tax system and improve Tunisia's revenue-generating capability. And their intention to accelerate the reform effort was welcome.

On the demand side, given Tunisia's uncertain balance of payments prospects for the period ahead, Mr. Nimatallah considered that it would be prudent for the authorities to strengthen finances, continue wage restraint, improve export competitiveness, and adopt a cautious debt management policy. The overall annual budget deficit of 7.5 percent of GDP realized over the past one or two years was unsustainable; and he was thus heartened by the latest indication of the staff that the deficit would be reduced to about 6 percent in 1986 by reductions in budgetary transfers to and subsidies for prices of petroleum and other product prices, and cuts in other outlays. The strengthening of public finances in 1986 should reduce the authorities' reliance on domestic bank financing of government operations. However, that effort should be complemented by a reduction in the access of public enterprises to bank credit. On wage policy, he welcomed the authorities' intention to maintain a cautious stance. He agreed with the staff that wage increases should be linked more closely to productivity gains and to the profitability of enterprises.

In the external sector, the authorities recognized the need to reverse the deterioration in the balance of payments and improve the medium-term prospects for Tunisia's external position, Mr. Nimatallah commented. The task was a challenging one, particularly since Tunisia was expected to be a net importer of energy by the early 1990s. Reliance on import controls could only be temporary; the authorities should strengthen their effort to expand Tunisia's nonenergy and export capabilities, an effort that could be aided by Tunisia's trading partners acting to keep their markets open for Tunisia's exports. In conclusion, the Tunisian authorities were in the process of reorienting their economic policies to attain sustainable growth with domestic and external stability, an objective requiring the maintenance of adjustment effort and an expansion of exports.

Mr. de Forges observed that the Tunisian authorities and the staff were apparently in agreement on the analysis of the current situation, on the short- and medium-term objectives to be pursued, and on the nature of the policy needed to meet those objectives. However, the authorities were not as yet prepared to unveil their concrete plan for action, something they had indicated they would do only at the time of the forthcoming budget discussion, presumably sometime later in the month. As such, his observations and comments would be limited.

On the domestic side, the problem with policies in Tunisia was not so much their nature as their lack of effectiveness, Mr. de Forges continued. For example, wage policy was aimed in the right direction, but the current wage drift remained far too strong. Similarly, while liberalization measures had been introduced for price subsidies, the consumer subsidy bill as a percentage of GDP had continued to rise in 1984. Taxes on income and profits other than those of the oil companies and banks had decreased in 1984 from 4.5 percent of GDP to 4 percent of GDP, in spite of the commitment by the authorities to an ambitious tax reform. It was debatable whether a process whereby the proper policies were announced but were thereafter pursued only halfway might not in the end be more politically dangerous than the more energetic approach of matching strong policies with an equally strong effort to implement them.

The current inward orientation of the economy was probably the most important obstacle facing the authorities in their effort to achieve external balance and domestic growth, Mr. de Forges remarked. In order to compensate for the shortfalls of internal policies, the authorities had developed a formidable system of protective measures that effectively insulated the economy from outside competition. Unfortunately, implementing protective measures was the most effective way to make the economy uncompetitive. He was not impressed by high rates of investment achieved within a closed economy. The experience was that an important part of such investment was misdirected.

It was noted on page 16 of the staff report that the Tunisian authorities agreed with the staff that an exchange rate adjustment, within the context of a comprehensive policy package, could be entertained, Mr. de Forges commented. He welcomed the recent indication of the authorities that they would carefully study the staff's projections and recommendations with a view to discussing them later in 1985. He looked forward to the results of those discussions, since the prosperity of the Tunisian economy was of interest to all Mediterranean countries, including his own. He trusted that the right decisions would be implemented by the authorities.

Mr. Goos observed that the Tunisian authorities had been successful over the past two to three years in achieving impressive positive real growth rates in an unfavorable external environment. That achievement unfortunately had not prevented unemployment from increasing; indeed, it had given rise to sizable domestic and external imbalances that clearly seemed unsustainable in the medium term. He was particularly concerned about the rapid increase in foreign indebtedness and the concomitant rise in the debt service ratio. Against that background, and notwithstanding the more recent encouraging developments, he echoed the staff's warning that, on the basis of past and present policies, the authorities' scope for absorbing further large deficits and dealing with additional external developments of an adverse nature was becoming increasingly limited. Accordingly, there was clear need for a reorientation of policies toward increasing domestic savings supported by appropriate measures to secure the economy's external competitiveness.

That the authorities had become aware of the need for corrective action was welcome, Mr. Goos continued. He was pleased that, in fact, they had already taken several corrective measures within the 1985 budget. However, while most of those measures were appropriately aimed at rationalizing the investment program, moderating wage increases, and adjusting administered prices, more needed to be done to bring about a tangible improvement in the external accounts. Among the staff's recommendations toward that end, he particularly welcomed the emphasis on the need to reduce the continued reliance on widespread price and import controls in order to improve overall efficiency and assist in reducing the budget deficit.

The authorities' task of liberalizing imports would certainly be greatly facilitated if supported by sufficiently flexible exchange rate policies, which would also help the authorities' export promotion efforts, Mr. Goos remarked. In that context, he welcomed the indication that the authorities had recently demonstrated a greater degree of flexibility in exchange rate policies. Finally, he could support the staff's views on monetary policy, including the concern that domestic credit growth might be too expansionary and the suggestion that a more market-oriented approach to monetary policy should be introduced.

Mr. Wijnholds remarked that, in a number of areas, Tunisia's recent economic performance had been satisfactory: GDP had grown substantially, with a particularly heartening performance in agriculture; inflation had fallen; and the buildup of external debt had slowed. Furthermore, real wages had declined from too high levels, and the authorities had allowed the exchange rate to depreciate. In that connection, he would appreciate more detailed comment on the greater exchange rate flexibility that had recently occurred; in particular, it would be interesting to know whether press reports about a further substantial depreciation of the dinar in recent weeks were correct.

Among the weaknesses in the Tunisian economy noted by the staff, the external position was clearly a matter of immediate concern, Mr. Wijnholds continued. Reserves had fallen to a dangerously low level, the initial reaction to which had been a tightening of policies, including additional import restrictions. The authorities' willingness to take corrective action was to be commended, although he agreed with the staff that the measures taken thus far were not sufficient. Import restrictions could serve as only a temporary expedient, and the recent intensification of such restrictions should be reduced as soon as possible, before serious distortions set in.

The authorities' recent move toward a more flexible exchange rate policy was welcome, Mr. Wijnholds said. In an economy heavily dependent on tourism and workers' remittances--items particularly sensitive to exchange rate changes--a more flexible policy was essential to maintain competitiveness. Given certain structural changes that were bound to affect Tunisia's external position--particularly the shift to net imports of energy and the imminent enlargement of the European Community--the maintenance of competitiveness was all the more important.

He agreed with the staff that the debt service ratio should not be allowed to increase from its present level, Mr. Wijnholds remarked. Consistent with that advice was the authorities' decision not to take up further loans in the international financial markets in 1985 after using the remainder of bank credit contracted in 1984. Continued moderation in taking up foreign credits, as projected for the remainder of the current decade in the medium-term scenario, was necessary to prevent Tunisia's future entanglement in debt servicing problems. In that regard, he noted that the stable debt service ratio postulated in the medium-term scenario in Table 2 of the staff paper implied that exports in 1986 would increase by 9 percent from the current year's level, after having stagnated since 1982. Also, proceeds from tourism and services were projected to increase substantially in the future. To achieve such an outcome would require, in addition to a flexible exchange rate policy, tight demand management policies so as to make room for exports, and a policy of wage moderation. The authorities seemed willing to follow such policies and were increasing the efficiency of investment. An important step in that respect was the shift toward improvements in existing investment projects, which should benefit expansion in the tourist sector. Finally, the challenges facing the Tunisian economy in future suggested that the Fund should remain in close contact with the Tunisian authorities with a view to providing assistance where warranted. He was thus pleased to have learned from the staff that there had been a meeting between the Managing Director and the President of Tunisia earlier in the year.

Ms. Lundsager considered that economic and financial developments in Tunisia during the past year had been decidedly mixed. While real growth had exceeded 5 percent in 1984 and consumer price increases had moderated somewhat, the fiscal and current account deficits had remained high at 7.4 percent of GDP and 10.7 percent of GDP, respectively. For 1985, the current account deficit was projected to fall by 3 percentage points in relation to GDP; yet, gross international reserves were declining rapidly, having fallen already to the equivalent of only 2 1/2 weeks' imports during the summer of 1985. Furthermore, the decline in the current account deficit seemed to be mainly attributable to a depreciation of the dinar and a strengthening of import controls. Tables 1 and 2 of the staff report showed little tightening of fiscal and monetary policy in general, while exports remained unchanged and imports had been falling. She would be interested in hearing staff views on the sharp decline in imports in 1985 with some focus on whether that decline was attributable to a depreciation of the dinar or to import controls.

The medium-term scenario presented in the staff paper was a normative one, with the goal of no increase in the debt service ratio mandating firm adjustments in imports, since exports were heavily dependent on external market conditions, Ms. Lundsager continued. It would have been useful if the staff had included in the scenario some indication of the policy mix that would facilitate attaining the stated goals, especially since mention had been made of the somewhat optimistic export assumptions. Mr. Salehkhou had indicated that the authorities planned to reduce the fiscal deficit to 6.3 percent of GDP in 1986 by means of measures that included reductions in subsidies and further rationalization of the capital budget, as well as continued wage restraint and limited credit expansion. Those measures were welcome, and she would be interested in hearing what additional steps were being contemplated or might be required in future to achieve the medium-term scenario presented in Table 2.

The recognition by the staff and the authorities of the need to reorient the investment plan to increase the productive capacity of the economy, especially in the more labor-intensive sectors, was a welcome evolution in thinking, Ms. Lundsager stated. Agriculture still appeared to be a natural sector for development, both for production of domestic consumables and for exports. The authorities were making an effort to promote exports, and she would be interested in staff comment on prospects for exports of agricultural and manufactured goods, especially in light of the conditions in Europe. One important element in that regard was the maintenance of adequate producer prices, and recent price increases--along with favorable weather conditions--seemed to be having a positive effect on production and export. Appropriate consumer goods prices, especially for imports, would also maintain incentives for consumption of domestically produced foodstuffs, while at the same time reducing the strains on the government budget. In her view, a more general move toward price decontrol would be helpful.

On a related matter, the recent real depreciation of the dinar was welcome, and she urged the authorities to continue with a flexible exchange rate policy, given the developments in those countries with which Tunisia competed for export markets, Ms. Lundsager remarked. With world phosphate capacity at a high level and oil prices rather weak, growth in exports would have to depend on agriculture, manufacturing, and tourism, areas in which foreign competition was not lacking and where additional exchange rate adjustments could thus strengthen the profitability of local production while increasing competitiveness abroad. Also, a more flexible exchange rate policy, combined with continued moderation in wage adjustments, could increase the attractiveness of Tunisia for foreign investment in those sectors. Table 2 of the staff paper did not seem to indicate strong prospects for growth in foreign investment and grants in comparison with earlier years when investment in oil-related sectors had been high;

however, a more liberal trade and exchange regime might improve the prospects for such inflows. Clearly, the recent tightening of import and exchange restrictions, together with the system of price controls, did not generate investor confidence in the Tunisian economy.

Given Tunisia's rapidly growing labor force, employment generation was a high priority matter for the authorities, Ms. Lundsager considered. A large government sector might be the easiest short-run solution to the employment problem; but in the long run, a large civil service could be difficult to sustain. In fact, with the emphasis on the productive sectors, the authorities should be aiming at a reduction in the overall size of the fiscal sector, which currently consumed more than 40 percent of GDP. They had already implemented a policy of wage restraint, and it might be appropriate if they were also to consider reductions in the size of the civil service. Subsidies and transfers to public enterprises remained high at 8 percent of GDP and were obvious areas for additional economizing. For that reason, she urged the authorities to continue their efforts to generate a social consensus on the need for economic reforms in the hope that cooperation could facilitate policy implementation in the effort to strengthen Tunisia's productive base while improving its financial situation. In conclusion, she welcomed the steps that the authorities had taken to improve the process of adjustment, and she urged speedy implementation of several additional important steps, including tax reform and the rehabilitation of the public enterprises. Fund and Bank assistance to the Tunisian authorities in that effort would be welcome. A strengthening of the pace of adjustment in the context of a liberalized trade and payments system was necesary if the medium-term scenario was to be attained.

Mr. Mustafa observed that the strong economic performance enjoyed by Tunisia during the 1970s had been significantly weakened in the early 1980s, mainly because of falling oil export receipts and adverse weather conditions. The slowdown in economic activity, coupled with the authorities' pursuit of expansionary, growth-oriented financial policies, had given rise to excessive demand pressures and a deterioration in the external payments position. Economic performance had shown a significant improvement in terms of output growth and price stability since 1983, but that improvement had fallen short of preventing the unemployment rate from rising in 1984. The economy had also continued to confront potentially serious financial difficulties in both the fiscal and external areas. The persistence of a large deficit in the consolidated budget and the sharp rise of the current account deficit in 1984 were of particular concern. The social implications of the recent tendency for the unemployment rate to rise and for real wages to decline had added to the existing difficulties.

The policy response of the authorities to the mounting financial problems seemed to be intensifying and, as the staff had indicated, the policies adopted were generally aimed in the right direction, Mr. Mustafa remarked. Overall economic strategy seemed to be adapting to the new imperatives in such key areas as the structure and pace of public sector investment activity, export promotion, and the role of public enterprises. Particularly welcome was the shift toward less capital-intensive projects, bringing public investment activity to a more realistic level and directing more investment toward agriculture and export-oriented sectors. The reorientation of public sector plans was more consistent with the authorities' objective of achieving better external balance and creating more employment opportunities. Moreover, the planned rehabilitation of the public enterprises was expected to improve efficiency and reduce costs to the budget. The favorable impact of the change in policies would of course be felt only gradually.

The intensification of import restrictions through administrative measures as an immediate response to external payments difficulties might be justified on a temporary basis, Mr. Mustafa said. However, such measures and the encouragement they gave to financing imports from abroad were likely to prove costly and counterproductive if maintained over an extended period. Alternative policy actions were needed--particularly in the areas of demand restraint and the exchange rate--to limit imports and promote exports. The Tunisian authorities had already taken several steps to improve export growth by various export promotion measures as well as by a more competitive exchange rate. As noted by the staff, Tunisia had gone beyond the recommendations of the 1984 Article IV consultation by reversing the previous appreciation of the dinar. While further depreciations might be needed, given the economy's external payments position, the effectiveness of a more competitive exchange rate would be limited somewhat by the barriers erected against Tunisian export access to some European Community countries. He would welcome staff comment on that matter and on the authorities' concern regarding future access to the markets of the European Community.

On the fiscal side, various measures had been taken by the authorities and further action was contemplated to improve the budget balance, Mr. Mustafa observed. However, no immediate improvement was foreseen for 1985, and the budget deficit was expected to remain relatively unchanged in terms of GDP for the year. While the ongoing tax reform was expected to improve fiscal management and raise the tax elasticity, some progress was also envisaged in reducing the fiscal deficit in terms of GDP in 1986 through expenditure cuts. Capital expenditure would be reduced, and the increase in current expenditure would be limited by wage moderation, curtailment of recruitment, and further reductions in consumer subsidies. The approval of a wide-ranging reform bill covering the public enterprises would reduce transfers to those enterprises; however, the fiscal deficit was expected to remain fairly high, and further action to reduce it should therefore be contemplated.

On the monetary side, the recent tendency for interest rates to rise--in some cases to positive levels--would be maintained through a more active role by the monetary authorities, Mr. Mustafa commented. The rate of credit growth, on the other hand, should be carefully assessed, as projected rates remained high. Their impact on prices and the external balance should be kept in mind in that regard. He took note of the useful remarks in the staff paper on the World Bank's recommendation to adopt a system of global ceilings on bank credit to limit credit expansion. However, the authorities' concern over the need to provide adequate credit to priority sectors such as agriculture was understandable. Finally, the problems of the external sector appeared to be still manageable through strengthened economic adjustment. Consequently, like others, he welcomed the recent encouraging measures and developments reported by the staff representative in his opening statement.

Mr. de Groote considered that any review of economic developments in Tunisia must take account of the fact that, since the early 1980s, Tunisia had been able to achieve high growth rates and a strong balance of payments position, despite a narrow array of natural resources limited mainly to petroleum and phosphates. The information provided by the staff at the beginning of the discussion showed the most recent improvements in Tunisia and a strengthening of policies in the right direction. The maintenance of appropriate policies was a precondition for achieving the medium-term objectives mentioned by Mr. Salehkhou in his opening statement.

From the early years of the current decade, a series of exogenous factors--the decline in oil prices, a drought, and weak external demand--had impeded Tunisia's progress, Mr. de Groote commented. The efforts of the authorities to correct the deep-rooted imbalances in the economy had been partially successful: growth rates had been satisfactory in 1983 and 1984; inflation had been relatively low; and structural changes had been initiated. However, areas of concern still remained. Both the current account and the consolidated budget deficits were unacceptably high, and the gap between gross capital formation and domestic savings remained wide, indicating that further adjustment, including structural changes, was needed. The main problem for the authorities was how to achieve high growth rates and to reduce unemployment in the medium term while making adjustments to cut the budget and current account deficits to reasonable levels. He agreed with the staff that several avenues were open to the authorities for correcting the imbalances. Most important among those was the need to restrain government spending, which had grown from 34 percent of GNP in 1981 to 43 percent of GNP in 1984. Because tax rates and the ratio of total revenue to GNP were already quite high, the focus must be on spending and subsidy cuts and on improvements in the financial position of the public enterprises. The authorities' moves toward renewed tax reform and toward curbing increases in current and capital expenditures were most welcome. A recently approved bill to reform the public enterprises could relieve some of the pressure on the budget and make a contribution to the external sector if the envisaged measures were correctly applied, perhaps with some strengthening. Any contribution the World Bank could make to the success of the reform effort would be most helpful.

Another trouble spot in the Tunisian economy was the rapid growth of credit, which put pressure on prices and the balance of payments, Mr. de Groote observed. The positive real interest rates that had finally been achieved after several years of effort by the authorities seemed to be an appropriate tool for easing the effect of high domestic credit growth. Present interest rate policy should be maintained, and the structure of interest rates should be simplified. At the same time, competition should be encouraged within the banking sector to help generate resources for development and for productive purposes generally. However, it would be unrealistic to expect that internal policies alone would suffice to bring forward the savings required to maintain the projected rate of growth. Tunisia was typical among the countries that could benefit from the development-oriented strategy that the Fund was currently advocating; private external sources of finances should be generated in connection with Tunisia's efforts to develop its export capacity.

Exchange rate policy should continue to be aimed at keeping the Tunisian economy competitive by a realistic margin, Mr. de Groote considered. The staff had noted that the real appreciation of the dinar during the period 1981-83 had been reversed through the authorities' policies; however, the role of exchange rate policy in pursuing the authorities' medium-term objectives was a separate issue. He agreed with the staff on the need for a more flexible exchange rate policy in achieving those objectives but would appreciate some elaboration on the staff's judgment that "a more flexible exchange rate policy would...ease the social cost of adjustment policies." It was doubtful that exchange rate adjustments alone could provide Tunisia with the full advantage it should derive from its participation in foreign trade; the dismantling of Tunisia's restrictive trade regime and price controls was also urgently needed. The Research Department's recent studies of exchange rate policy in developing countries demonstrated that, unless supported by appropriate trade and price policies, exchange rate policies generally failed to achieve a lasting improvement in the current account. In sum, further improvement in the fiscal, external, and structural situation of Tunisia was necessary. The policies embarked upon by the authorities were appropriate but required a more vigorous and timely implementation.

The Deputy Director of the African Department remarked that, until nearly the beginning of 1985, the authorities in Tunisia had tended to believe more in financing--coupled with a greater reliance on import restrictions--than in adjustment. The Sixth Development Plan, scheduled to be completed in 1986, had placed emphasis on employment and growth and had given only secondary importance to matters like the balance of payments or external indebtedness. Near the end of 1984, the authorities had begun to sense that Tunisia's external indebtedness and the external current account deficit required special attention, even if that meant some compromise on the primary objectives. However, official policies for 1985 had continued to be based upon a hope that improvements would occur and that, with a minimum of adjustment, the authorities could continue to pursue the main objectives of the development plan. Sometime toward the middle of 1985, the authorities had recognized that their hopes for improvement would not be realized and that, in fact, the economic situation had been deteriorating. At that point, on the basis of a more general agreement throughout the Government that adjustment policies must be assessed, a number of ad hoc measures had been adopted to correct the deteriorating situation. At the same time, the authorities had begun to see that their policies would need to be placed in a comprehensive medium-term framework. In that respect, although they had been reluctant, even through mid-1985, to adopt an active exchange rate policy--recognizing that such a policy was unlikely to be helpful unless accompanied by appropriate monetary and fiscal policies--they now seemed more willing to move on the exchange rate because budget policies and, to some extent, pricing policies had moved in the right direction.

Until the end of 1984, the real effective exchange rate in Tunisia had been allowed to appreciate, a trend that had been completely reversed since the beginning of 1985, the Deputy Director continued. There were two separate elements to the depreciation that had occurred in 1985. During the first six months of the year, the depreciation had been due to the fact that domestic prices had not risen as fast as prices in competitor countries, partly as a result of price controls and partly because of the general climate relating to prices in Tunisia. After July 1985, the greater movement in the nominal effective exchange rate of the dinar reflected the deliberate policy of the authorities to allow the dinar to depreciate.

The staff had referred in its report to the exchange rate flexibility as easing the social costs of adjustment, the Deputy Director recalled. During the course of the consultation with Tunisia, the staff had prepared for the authorities two different scenarios for 1986, one including and one excluding exchange rate adjustment. The aim had been to demonstrate that an exchange rate adjustment could, to some extent, prevent a decline in investment, help to maintain the level of employment, or even achieve some increase in general wages. Those were the social costs of adjustment to which the staff had been referring.

Another element of the exchange rate adjustment was related to the public sector enterprises, the Deputy Director commented. Several speakers had recalled that those enterprises accounted for some 4.5 percent of GDP in budgetary transfers. Aware of the problem, the authorities had recently passed a law aimed at a substantial reform of the state enterprises. The intention was to establish a list of those enterprises that, by end-1986, would remain under government control; and the staff had noted that the authorities would consider retaining control of only those enterprises in which they had at least 34 percent equity. During 1987, the aim was to restructure the equity capital of those enterprises, with a view ultimately to making them eligible for development bank financing and moving them away from dependence on budgetary transfers. The precise timetable for those changes had yet to be established. A World Bank mission on the reform of public sector enterprises would be visiting Tunisia sometime in 1986, and it was his understanding that the Bank might provide both technical and financial assistance in the reform process.

In supporting the staff's view that import restrictions were not the appropriate way of tackling the economy's fiscal problems, some Directors had asked the staff to assess whether the recent decline in imports had been due to exchange rate adjustments or to import controls, the Deputy Director said. To the extent that the exchange rate adjustments had only begun to take place, the decline in imports in 1985 was in his view related mainly to the import controls, particularly controls on consumer goods. On the export side, it was clear that Tunisia's access to the European Community market was limited. As for Tunisia's two major exports of manufactured goods--namely, olive oil and textiles--the authorities were discussing with the European Community the possibility of a guaranteed purchase of some 50,000 tons of olive oil, which was equivalent to 50 percent of Tunisia's total annual production. Those discussions had not yet been concluded. The matter of import restrictions on textiles had been discussed in the paper on recent economic developments. It was clear from the tables in that paper that the quota for textiles in the European Community had been increasing in volume from year to year; however, Tunisia had been unable to meet its quota in 1983 and 1984, a fact that probably reflected the noncompetitiveness of Tunisian exports referred to earlier. It was his understanding that in 1985 exports of textiles from Tunisia to the European market had increased substantially, and that the quota for the year might well be reached.

The staff had not discussed in great detail how the various objectives in the medium-term scenario could be realized, the Deputy Director noted. That was because the authorities were not yet in a position to discuss their policies and objectives for the medium term beyond some general agreement that the focus would be on reducing or maintaining the current ratio of external indebtedness and the debt service. Even the staff's medium-term scenario was not so much a description of the basic objectives as a means of prompting the authorities to look closely at the possible effects of certain adjustment policies, including an exchange rate adjustment, so as to determine basic objectives and to agree on a comprehensive package of policies, a process still going on in Tunisia.

The staff representative from the Exchange and Trade Relations Department considered that a change was required in paragraph 2 of the proposed decision to reflect more correctly developments in Tunisia. During the course of the year, restrictions had been tightened only in regard to certain imports, and had been eased in respect of some transactions in invisibles. To reflect that difference, he proposed the following change in the first sentence of paragraph 2 of the draft decision: "Tunisia's system of exchange restrictions has been tightened since the previous consultation in regard to certain imports. While there has been an easing of restrictions in respect of some invisible transactions, the Fund urges the authorities to ease the remaining restrictions on payments and transfers for current international transactions."

Mr. Nimatallah observed that the unemployment problem in many countries had been exacerbated lately by the addition of returning workers who had found a decline in the demand for their services outside their home countries. The problem of unemployment was particularly acute in Tunisia and, although it had been emphasized in earlier economic strategies, the results had not been particularly satisfying. He would appreciate hearing comment from the staff on how the problem would be dealt with in future, perhaps with help from the World Bank.

The Deputy Director of the African Department replied that the unemployment problem in Tunisia was to a certain extent related to the investment pattern. Investment in Tunisia had tended to be very capital intensive. One way of tackling the unemployment problem was to shift the composition of investment, and the World Bank was looking into the potential for such a shift in Tunisia. Certainly, the matter had been focused upon in the initial papers prepared by the World Bank for discussion with the authorities. He was certain that the issue would be raised and discussed at later meetings, but it was up to the authorities to decide whether the matter would be focused upon in the next development plan.

Mr. Salehkhou observed that the staff and the Tunisian authorities seemed to agree that relatively satisfactory GDP growth rates had been achieved during 1983 and 1984 and both were hopeful that the performance would continue into 1985. Differences arose with respect to the external situation, which had been deteriorating rather steadily since 1983, mainly because of the severe world recession and the worsening of Tunisia's terms of trade. The staff believed that the measures implemented in 1984 and 1985 were not sufficient to create a viable external position in the medium term, while the Tunisian authorities felt that they had been following prudent policies but that social constraints had made it impossible to contain the deterioration of Tunisia's external position and so move the economy toward external equilibrium. The relatively satisfactory performance observed in 1984 and expected in 1985 could in his view be attributable to the many corrective measures implemented by the authorities in those years. With a view to stabilizing domestic demand, Tunisia had pursued a moderate wage policy and had made all wage increases contingent on productivity gains, an approach that had created some uneasiness among the labor unions and had narrowed the authorities' room for maneuver. In addition, Tunisia had adjusted the price of certain subsidized products in 1984 and 1985 and had eliminated certain other products from coverage by the subsidy fund. In the budgetary area, significant efforts had been made to contain the growth of public expenditure.

The rate of expansion of claims on the economy had slowed considerably but was still above the GDP growth rate, in line with the authorities' desire not to bring production to a halt, Mr. Salehkhou continued. In addition, a far-reaching interest rate reform had been introduced to encourage savings and rationalize credit use. The efforts of the authorities had thus far brought the rate of growth of consumption in constant terms to 0.6 percentage points below the GDP growth rate.

Significant exchange rate flexibility had been introduced in 1984 and strengthened in 1985, making it possible for the authorities to offset much of the depreciation of the dinar in 1982 and 1983, Mr. Salehkhou observed. The exchange rate flexibility had been accompanied by the introduction of a more rational import policy with tighter quantitative controls for products deemed nonessential and fewer restrictions for products and sectors deemed vital for exports, such as the importation of raw materials and intermediate goods used in manufactures. In that respect, the authorities had reoriented import policy by relying on liberalization measures rather than on additional restrictions.

For 1986, the persistent pressure on Tunisia's external position had strengthened the determination of the authorities to pursue the adjustment policy begun in 1984 and 1985, Mr. Salehkhou remarked. The emphasis was on curbing domestic demand, strengthening export incentives, limiting recourse to external borrowing, and preventing a further reduction of imports. The plan envisaged a reduction in the current account deficit from D 510 million in 1985 to D 450 million in 1986, a limitation on the growth of overall consumption to 1.8 percent in constant prices, and lower investment volume aimed at holding overall domestic demand to the level in 1985. Toward those ends, the authorities were aiming at keeping the budget deficit at or below the level registered in 1985, continuing wage and price policies, and maintaining the effort to slow credit expansion. Their strategy, directed at avoiding recourse to external borrowing and the need for emergency administrative measures, would be supported by the more flexible exchange rate policy designed to improve the competitiveness of Tunisia's economy.

On the proposed modification of the draft decision, Mr. Salehkhou observed that the Tunisian authorities were determined to take all measures necessary to re-establish a viable external payments position in the medium term and to pursue a policy of liberalizing payments so as to facilitate the efficient performance of the economy's productive system. Moreover, the authorities were conscious of the fact that emergency administrative measures could be resorted to only on a temporary basis, as stipulated in Article XIV of the Articles of Agreement. In that context, the authorities felt that the original language of the draft decision, which stated that "Tunisia's system of exchange restrictions has been tightened since the last consultation," was in conflict with the facts. In reality, despite the magnitude of its external difficulties, Tunisia had continued to work toward liberalizing its exchange and trade system. The authorities' decision to suspend certain goods temporarily from the benefits of the import regime had been taken in the context of the investment rationalization policy rather than as part of any effort to tighten imports. No ceiling had been set for the amount of imports of any type of investment goods, and new products had since been brought under the import licensing procedures in the context of the authorities' efforts to determine the advisability of investments. Those controls were applied with speed and discretion. The request to modify the draft decision had originally been put forward by his Tunisian authorities; however, the staff's recommended modification did not, in his view, reflect the current situation in Tunisia. The reference to an easing of restrictions on some invisible transactions was appropriate, but he had difficulty with the staff's intention to maintain a reference to tightening the system of exchange restrictions with regard to certain imports;

as he saw it, the action of the authorities amounted to a rationalization of investment. As he had noted earlier, unemployment in Tunisia was high and industrial capacity utilization was quite low. The typical capital-intensive investment in Tunisia had aggravated the unemployment problem, and the authorities had recently adopted a decision to reallocate or redirect investment--whether labor intensive or more export oriented--to be more beneficial; but there was no effort to reduce the extent of investment activity in the country. In that respect, he would prefer that the reference to tightening the exchange system be deleted from the decision.

The Chairman wondered whether the use of the word "tightened" was typical in such decisions and whether the measures adopted by the Tunisian authorities, whatever their purpose, could be translated into more restrictions than would otherwise have existed.

The staff representative from the Exchange and Trade Relations Department replied that, when appropriate, the staff had used the word "tightened" in other similar decisions.

The Deputy Director of the African Department, replying to the Chairman's second question, noted that the Tunisian authorities each year published a list of commodities that could be imported freely. In 1985, that list was considerably shorter than in 1984. Also, the estimates for imports for 1985 showed that imports in virtually every category would be lower than in 1984; indeed, even the July 1985 estimates had had to be revised downward. In his judgment, the controls on imports that had been instituted had produced a greater reduction in imports than would otherwise have occurred. The demand existed but was not being satisfied.

Mr. Salehkhou said that his Tunisian authorities maintained that the issue was not what implications the measures might have had on the amount of imports. The suggestion that import controls had been tightened was more a reflection of the intention of the authorities than of the impact of the measures they had adopted; and, in that respect, the intention of the authorities had been to rationalize investment rather than merely to reduce imports. In countries like Tunisia, the desired impact of policies might not be felt immediately. It would take time for the public and the manufacturers to understand that the Government was serious in not allowing useless equipment into the country. While the controls might well have had an immediate impact on the reduction of imports, that would be offset in time as investment was reoriented toward other more useful machinery and equipment. Until that reorientation occurred, it was, in his view, unfair to judge the measures implemented by the authorities on the basis of only a few months of statistics and to conclude that the authorities had been tightening import controls. Besides, the same situation had occurred in Tunisia in 1983, and in its decision the staff had not at that time made any reference to the tightening of restrictions.

The staff representative from the Exchange and Trade Relations Department agreed that the staff had not taken note in 1983 of the similar reduction in the number of items on the list of freely imported goods. That failure had been an error on the part of the staff and should not be repeated. It was clear from the report that a certain category of imports had for the first time been brought into the system of import and exchange restrictions and, in a substantive sense, that action had had the effect of reducing the flow of such imports. The situation could only be described as a tightening of the restrictions. If the reorientation of investment had been accomplished by any machinery other than the exchange system, the issue at hand would never have arisen.

Following a further brief discussion, Executive Directors agreed that the language of the draft decision would be revised to include a reference to Tunisia's efforts to rationalize investment and to relate that effort to action by the authorities to shorten the list of freely imported goods.

The Chairman made the following summing up:

Directors cited the continued relatively high rate of economic growth in Tunisia in 1984 and 1985 and the moderation of the inflation rate as positive developments that, while not preventing the unemployment rate from rising, had permitted a continued growth in real GDP per capita. On the negative side, they expressed serious concern about the sharp deterioration in the financial sectors, both domestic and external. While taking note of the prospects for a significant reduction in the current account deficit in 1985, Directors also observed with concern that a large part of the reduction would be the result of further cuts in imports and some additional restrictions on imports. Recognizing that imbalances in the Tunisian economy were due in part to several adverse conditions, including a reduction in the net oil export receipts, a deterioration in the terms of trade, and a reduction in the number of Tunisian workers employed abroad, they felt that the external disequilibrium was also a result of sizable fiscal deficits and of an expansionary monetary and credit policy.

Directors welcomed the authorities' growing awareness of and readiness to address their financial problems in a comprehensive manner and noted the authorities' intended policies for 1986, which are aimed at a significant reduction in the fiscal deficit and an application of a flexible exchange rate policy. While noting that the authorities are putting greater emphasis on external adjustment and stabilization of the debt service ratio in the context of their medium-term objectives, Directors stressed that greater urgency and firmness in policy implementation than at present contemplated were, in their view, required to deal with the unsustainable imbalances, and they urged the authorities to devise and implement without delay a comprehensive adjustment program.

In the fiscal area, Directors welcomed the increased emphasis put on the reduction of the budget deficit, mainly through expenditure restraint. They urged continued strong wage and salary restraint as well as restraint in new public sector employment. They welcomed the increased flexibility in the price system, as reflected by more frequent increases in prices of subsidized food products, agricultural inputs, and energy. However, they felt that further rationalization should be introduced in the subsidy system. Directors stressed the need to scale down investment from the high levels of recent years and to relate it more closely to resource availability. They also emphasized that more attention should be paid to productivity in investment decisions and to increased flexibility in management and pricing policies in the public enterprise sector. In that regard, Directors welcomed the ongoing reform aimed at limiting the size of the public enterprise sector and at its financial rehabilitation. They also felt that in order to help reduce the heavy dependence on imports and petroleum as a source of government revenue, an effort should be made to speed up the ongoing tax reform, aiming at a broadening of the tax base.

Regarding monetary and credit policy, Directors noted with satisfaction the recently introduced flexibility in interest rates and liberalization in credit distribution. They urged the authorities to further simplify the interest rate structure and to limit the scope of preferential interest rates. It was observed that a positive pattern for interest rates in real terms should help in the ongoing process of rationalizing investment decisions in the private sector.

Directors recognized that significant efforts have been made recently by the authorities to encourage exports, mainly by exchange rate flexibility and the improvement of export financing. However, they felt that the authorities' export-oriented objectives were in danger of being hindered as a result of the recent further increase in tariff and nontariff protection of domestic activities. In particular, they considered that an easing of import restrictions as part of the adjustment effort was most desirable in order to enhance incentives for exports and increase overall productivity in the Tunisian economy. Several Directors also noted the protectionist actions taken against the Tunisian exports.

Directors observed that the real appreciation of the dinar that had taken place in 1982 had been fully reversed by mid-1985, and that a further small depreciation had been achieved since then. They welcomed the announced continuation in exchange rate flexibility, which they believed would ensure a better environment for attaining the demand management and export performance objectives of the authorities. In view of the rapid increase in external indebtedness in recent years, a number of Directors urged the authorities to fulfill their intention of following cautious policies with regard to borrowing abroad.

It is expected that the next Article IV consultation with Tunisia will be held on the normal 12-month cycle.

The Executive Board then adopted the following decision:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Tunisia, in the light of the 1985 Article IV consultation with Tunisia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. In the framework of its policy of rationalizing domestic investment, Tunisia has modified, since the previous consultation, its system of exchange restrictions by shortening the list of freely importable products; at the same time, there has been an easing of restrictions in respect of some invisible transactions. The Fund urges the authorities to ease the remaining restrictions on payments and transfers for current international transactions.

Decision No. 8127-(85/163), adopted
November 12, 1985

3. WORK PROGRAM

The Managing Director made the following statement on the work program of the Executive Board until the April 1986 meetings of the Interim and Development Committees:

With the Annual Meetings in Seoul behind us, we should as usual have an exchange of views on our work program, taking into account the guidance provided by Governors and by the Interim and Development Committees. In this statement, I intend to cover our work program for the period up to the next meetings of the Interim and Development Committees in April 1986 and to provide some indications where necessary of tasks to be undertaken or followed up in the period thereafter.

1. <u>G-10 and G-24 reports on international monetary system</u>

As you know, the Interim Committee had a preliminary exchange of views on the two above-mentioned reports and it was agreed "to request the Executive Board to study the issues raised in these reports with a view to facilitating a substantive consideration by the Committee at its next meeting." In carrying out this mandate, it seems best to organize our work around the same main topics as in the two reports, especially as they are similarly structured. Both reports cover the following four subjects, namely:

(a) exchange rate system;
(b) surveillance;
(c) international liquidity and the SDR;
(d) role of the Fund; and
(e) debt problem.

In addition, the G-24 report also addresses itself to the debt problem and to the subject of transfer of resources to the developing countries.

Each of these main topics is dealt with in turn below. The Chairman of the Interim Committee has urged that the material for the Committee's substantive consideration of the G-10 and G-24 reports become available to members of the Committee by the end of February 1986. While we will have to decide later on the way in which we will report to the Interim Committee, the staff will see to it that its studies on the various subjects will include introductory and concluding sections that would be useful to members of the Committee and, in addition, there will, as usual, be my summing up of each of the Board discussions.

(a) <u>Exchange rate system</u>

Drawing on the analysis in the G-10 and G-24 reports, as well as on their own earlier work on the subject, the staff will prepare a paper entitled, "Review and Assessment of the System of Floating Exchange Rates." The paper will discuss issues and proposals for improvement in the functioning of the exchange rate system.

The main specific idea in the G-10 and G-24 reports with respect to the exchange rate system as such concerns the possible usefulness of target zones. The G-24 report generally endorses the proposal and calls for further study. While the majority of the G-10 did not consider the proposal practical, the G-10 report notes that some Deputies suggested that the technical aspects of a target zone approach should be further explored at an appropriate time. The staff plans to prepare a paper examining the various concepts of target zones, ranging from those designed to supplement the present surveillance procedures to ones that would represent a fundamental change in the present exchange rate regime.

The two above-mentioned papers on the exchange rate system, which would aim at discussing the broad issues involved, would be issued in time for discussion in the Executive Board on February 10. Depending on further guidance from the Interim Committee in April, there may be need for subsequent staff work to give further study to certain aspects of the concept or perhaps to examine specific proposals with a view to possible implementation.

(b) Surveillance

As provided under the initial Board decision regarding surveillance (Decision No. 5392-(77/63)), this year's annual review of surveillance will encompass the general implementation of the Fund's surveillance over members' exchange rate policies and also the biennial review of the document entitled "Surveillance over Exchange Rate Policies." The staff material for the biennial review would examine the background against which the "Principles of Surveillance" were drafted in 1976-77 and consider the extent to which subsequent developments may have altered their applicability and usefulness. The Board would then be invited to discuss the advantages and drawbacks of possible changes in the principles of surveillance and the basic issues on which it would be necessary to reach agreement before considering specific changes in the principles. The annual review of surveillance will, in the usual fashion, cover recent experience in the implementation of surveillance. Proposals to enhance the effectiveness of surveillance that have been put forward by the G-10 and the G-24 will be examined against the background of the review and possible changes in principles. Following Executive Board consideration of the staff material on surveillance which has been scheduled for February 19, 1986, and discussions in the Interim Committee in April 1986, the staff would be ready to undertake further work, particularly toward possible amendments of the principles of surveillance and related improvements in the implementation of surveillance.

(c) International liquidity and the SDR

Concerning the management of international liquidity, the G-10 report proposes measures to improve the operation of financial markets in the provision of international liquidity. As regards the SDR, it recognizes that the SDR may well have a useful role in meeting the long-term global need for reserves and, in that context, in providing a safety net for future contingencies. A number of specific proposals concerning the SDR are also described and discussed but they do not reflect a consensus among the drafters of the G-10 report. The G-24 report, on the other hand, has less confidence in the capacity of the international financial markets to maintain appropriate conditions for the supply, and especially the distribution, of international liquidity. It emphasizes the objective under the Articles of Agreement of making the SDR the principal reserve asset and for that, among other reasons, favors allocations.

With regard to this subject, Directors will recall our informal discussion last June of a program of studies on the SDR and also that the Interim Committee in its recent communiqué has urged us "to pursue [the] planned review of the role of the SDR, in all its aspects, in the international monetary system as a matter of priority, and to submit to the Committee a progress report for consideration by the Committee at its next meeting." There are at present in preparation, as the first stage of the in-depth review of the role of the SDR, papers dealing with the following topics:

(i) implications of changes in the international monetary system for the role of the SDR;

(ii) the potential role of the SDR in contributing to the stability of the system; and

(iii) a comparative analysis of the functioning of the SDR and the ECU.

Executive Board discussion of these papers is planned for February 24. The progress report to the Interim Committee at its April meeting would reflect the outcome of that Executive Board discussion and future work on this subject would be charted in light of the guidance provided by the Interim Committee.

Finally, as the Interim Committee "agreed to consider the matter [of an SDR allocation in the current basic period] again at its next meeting in the light of developments," the staff will prepare a paper in time for discussion in the Board on March 17.

Other papers concerning SDR-related topics are referred to in Section 6 below entitled "Other SDR matters."

(d) <u>Role of the Fund</u>

Under this heading, the G-10 and G-24 reports discuss various aspects of the Fund's work, which include, among other matters, access limits and conditionality for the use of Fund resources, creation of a new facility to provide financing for interest rate increases, prolonged use of Fund resources, overdue financial obligations to the Fund, Fund-Bank collaboration, quotas, and decision making. While some of these matters are covered below in the appropriate sections, we cannot study all these subjects before April; any guidance that the Board can provide regarding priorities would be most helpful.

As regards quotas, I may note that preliminary work bearing on the Ninth General Review of Quotas should normally start during the latter part of 1986. (In accordance with Rule D-3, the Executive Board must appoint, not later than March 31, 1987, a Committee of the Whole to prepare a report on the matter.)

(e) Debt problem

Directors have already received a staff report entitled "International Capital Markets - Developments and Prospects, 1985" (SM/85/267). Board consideration of this paper has been scheduled tentatively for November 6; it is intended that this meeting would also provide an opportunity for the Board to exchange views on the U.S. initiative on capital flows to developing countries.

A report is being prepared on the recent staff discussions with the export credit authorities of the ten major industrial countries. It will analyze recent trends in export credit flows to developing countries, and examine the main developments in policies and practices in the export credit field that have a direct bearing on the outlook for these financing flows. The focus of the paper will be on the role of export credits in enhancing the adjustment efforts of debtor countries and in contributing to their return to normal access to commercial credits. This paper is expected to be ready for issuance by end-January.

Further, it is planned to prepare a paper tentatively entitled "The Debt Situation: Recent Developments and Longer-Term Considerations" in conjunction with the next World Economic Outlook exercise and drawing on the projections and analysis carried out in that connection. This paper would attempt an assessment of the progress made toward resolution of the debt problem and of the prospects and conditions for further progress in the light of the staff's medium-term scenarios. The paper would examine some of the systemic links between the way in which international financial arrangements have functioned and the vulnerability of countries and groups of countries to debt difficulties. Executive Board consideration has been scheduled on March 24, immediately following our discussion of the World Economic Outlook on March 21.

2. World Economic Outlook

A comprehensive World Economic Outlook exercise will be carried out in advance of the Interim Committee Meeting and for consideration by the Executive Board on March 21. As before, the staff report will present a medium-term scenario for the world economy and analyze the sensitivity of the scenario to alternative prospective developments. While it is not feasible to anticipate at this stage all the specific topics that will be given special attention, they can be expected to include commodity prices, macroeconomic policies of major countries, protectionism, and exchange and interest rates.

It is planned to publish the World Economic Outlook studies soon after the meetings of the Interim and Development Committees. Executive Directors will be informed about publication plans, including procedures and timetable for prepublication clearance by the Executive Board.

3. Use of Fund resources and review of Fund liquidity

In light of the agreement reached in the Interim Committee on the question of the Fund's policy on enlarged access and limits on access under that policy in 1986, we have been requested by the Committee to complete, before the end of this year, the necessary implementing actions. Accordingly, it is planned to issue a paper on that subject incorporating proposed decisions that would be brought to the Board's agenda on December 9.

The annual review of experience with upper credit tranche arrangements and of the guidelines on conditionality needs to be completed before the end of 1985. This year's review will concentrate on the issue of program design, and consider the matter of prolonged use of Fund resources. The report will be supplemented by a background paper reviewing the experience with program design in the 1980s, based on a detailed review of balance of payments adjustment in the countries that entered into upper tranche arrangements in 1982. Executive Directors will also have available a staff study on the design of adjustment programs in planned economies (see Section 9 below). Executive Board discussion has been scheduled for December 30.

As Directors are aware, the Interim Committee arrived at a number of key conclusions, which are spelled out in its communiqué, concerning the use of resources that will become available over the period 1985-91, from reflows related to loans made by the Trust Fund. The Committee has "urged the Executive Board to complete its work on this matter before the Committee's next meeting, in the light of the guidance provided by the Committee." To this end, the staff plans to issue a paper that has been placed on the Executive Board agenda for January 22, with a view to taking a decision before the Interim Committee meeting next April. The staff paper will spell out proposed modalities of the use of the resources, addressing the key issues of the framework for disbursement, eligibility, conditionality, collaboration with the World Bank, and terms.

A staff paper on the next semiannual review of the Fund's liquidity and financing needs for the remainder of 1986 and 1987 is planned to be issued in early March and Board discussion has been tentatively scheduled for March 26.

4. Area departments' work program

On the basis of the area departments' projections, which take into account discussions with delegations in Seoul at the time of the Annual Meetings, we can expect that about 60 staff reports for consultations under Article IV will be brought to the Board's agenda during the period up to the end of April 1986. Under the upper credit tranche arrangements and programs that are at present in effect, some 24 reviews should be completed in the same period. Discussions are expected to be held with about 25 members concerning adjustment programs and possibly concerning the use of Fund resources with upper credit tranche arrangements. This number includes members who currently are implementing a Fund-supported program and anticipate that Fund financial assistance will continue to be needed after the conclusion of the present arrangement. In the case of some members, it will be necessary for overdue financial obligations to the Fund to be cleared, before negotiations on the use of Fund resources become feasible. It is anticipated that the actual number of requests for new arrangements in the period under consideration would be less than 25.

On current indications, some 7-8 members have expressed an interest in drawings under the compensatory financing facility during our work program period. However, considering the continuing weakness of commodity prices and markets, more members may become eligible in the coming months.

5. Operational matters

A midyear review of the Fund's income position has been scheduled for Executive Board consideration on December 11. The annual review, to be held shortly after the end of the financial year, would take place in the first part of May 1986. For that purpose, a paper reviewing the Fund's income position for financial years 1986 and 1987 will be issued in the first half of April; it will deal with the disposition of the Fund's income, the rate of charge on the use of ordinary resources, and also review the SDR interest rate and the rate of remuneration.

As regards the subject of overdue financial obligations to the Fund, following our preliminary discussion last June on the subject of special charges applicable to overdue financial obligations to the Fund, a further staff paper, prepared in the light of Directors' comments and suggestions, has recently been issued and it is proposed to place it on the agenda for December 2, following Board discussion on the six-month report on overdue financial obligations to the Fund that is about to be issued and has been scheduled for discussion on November 25. A further six-month report on overdue financial obligations will need to be issued during the current work program period toward the end of March 1986.

The designation plans and the operational budgets for the December 1985-February 1986 and March-May 1986 quarters are tentatively scheduled for consideration on December 11 and March 12, respectively.

Papers dealing with the quota calculations for new members would be issued during the work program period, as the need arises.

6. Other SDR matters

It will be recalled that at the time of our discussion last July of a staff paper on the valuation of the SDR, Directors had broadly endorsed the conclusions of the paper regarding the revised weighting to be attributed to the five currencies in the basket, in the revision to be effective January 1, 1986. A paper dealing with the technical issues associated with the implementation of the new weights for the basket and entitled "SDR Valuation Basket--Rounding Procedures and Trial Calculations" will be issued toward the end of November and has been scheduled for Board discussion on December 16. In order to bring the review of the SDR valuation basket to completion, a paper on "SDR Valuation Basket--Revised Currency Amounts" will be issued on December 31, 1985 for lapse of time approval on the same day.

When the Executive Board last reviewed the level of the Fund's SDR holdings, it was agreed that a reduction of SDR holdings to a target level of SDR 2.5 billion by May 31, 1986 was appropriate for the Fund's liquidity and operational needs and that another review of the subject would be held prior to April 30, 1986. It is planned to issue the necessary paper for this review in time for it to be brought to the Board's agenda for April 18, when the staff report for the annual review of the Fund's income position mentioned above will be available to Executive Directors.

Executive Directors will receive shortly a paper concerning arrangements for investment in SDRs of funds held in the Supplementary Financing Facility Subsidy Account and the payment of subsidies from that Account.

7. Administrative and related matters

The annual midyear review by the Executive Board of the budget is scheduled on December 13. Executive Directors have already received a paper on the subject of accounting for capital assets (SM/85/246). Its discussion in the Executive Board is tentatively planned for January-February 1986, in conjunction with a parallel paper concerning the impact of capital budgeting on the administrative budget that is being prepared.

The Administrative Budget for fiscal year 1987 will, as usual, be circulated to Executive Directors at the end of March 1986 and Board discussion has been scheduled on April 16, in the week following the meetings of the Ministerial Committees. A staff paper on the Fund's income position will be available at the time of the discussion of the Administrative Budget.

A paper incorporating options and associated cost estimates for building a Fund computer center is planned to be issued to the Board for consideration before the end of the year. Also, a proposal concerning leasing of office space at International Square may have to be submitted for Executive Board consideration before the end of the year.

In connection with the job evaluation exercise, a paper incorporating proposals for a new grade structure and an interim salary structure will be issued for consideration by the Executive Board in early December. In accordance with the usual procedure, it is planned to schedule Board discussion of the 1986 Compensation Review in April-May 1986. I understand that the report of the Joint Bank-Fund Committee of Executive Directors on Staff Compensation, chaired by Mr. de Maulde, can be expected to become available to the two Executive Boards in March 1986.

8. Other matters

In response to comments received from some Executive Directors on this year's Annual Report, the staff has initiated a review of the content, format, and procedures for the consideration of next year's draft report in the Executive Board. Proposals emerging from this review will be submitted to the Board in February 1986 in the form of a detailed and explanatory outline of next year's Annual Report; Board discussion has been tentatively scheduled to take place on March 7.

As requested by the Executive Board at the time of the review last March of the Fund's statistics, the staff will prepare an annual report on developments in statistics published in IFS in 1985, including the reporting performance of members, and its effects on the coverage and currentness of published statistics in Fund statistical publications. The paper will also report on developments in procedures implemented last year to review statistical issues in Article IV consultation reports, and will describe the latest developments in the Fund's statistical work with other agencies (the United Nations Statistical Office, the World Bank, the BIS, and the OECD) including the work of the International Compilers' Working Group of External Debt Statistics. This subject has been tentatively scheduled for Board discussion on March 14.

When the Board discussed last January a paper concerning a request for additional appropriations for mainframe computing services, the staff was requested to prepare a report on various aspects of collaboration between the Fund and the Bank in the field of statistical data collection, storage, and processing. The initial focus of the staff's effort on this subject has been on the technical aspects of cooperation in electronic data processing and it is planned to issue a progress report in time for consideration by the Executive Board on April 25.

It is expected that an interim report from the working group on the global discrepancy in world current account balances would become available for circulation to Executive Directors early in 1986.

9. Special Staff Studies

Executive Directors are aware of the following studies that have been included and described earlier in the work program:

(i) inflation and fiscal deficits (to be issued before end-1985);

(ii) social expenditures of the G-7 countries (to be issued before end-1985);

(iii) the design of adjustment programs in planned economies (to be issued in the second half of December); 1/ and

(iv) theoretical aspects of the design of Fund-supported adjustment programs (to be issued by March 1986). 1/

1/ The issuance dates of these studies have had to be put back owing to the press of work.

Two more studies are planned for issuance in the current work program period. One of them will review the theoretical basis of Islamic banking and describe its implementation in the banking systems in the Islamic Republic of Iran and in Pakistan. It will attempt to identify potential difficulties that might be encountered by a country adopting an Islamic banking system and to suggest steps to overcome such difficulties. This paper will be issued early in February 1986. In the second paper, it is planned to review experience since 1982 with exchange rate flexibility in certain developing countries and, in particular, the technical aspects of the various exchange arrangements. This study is expected to be completed in time for issuance in March 1986.

Following the issuance of the papers mentioned above and after Executive Directors have had an opportunity to examine them, they are invited to indicate whether, and in what format (for instance, Board or seminar discussions) they may wish to consider these papers. Discussions could then be scheduled accordingly.

Mr. Nebbia made the following statement:

Our discussion on the work program for the coming months is of a particular importance for the international community in general. This time I would dare to say more than ever before, in view of the trying conditions that are framing the global financial and commercial environment and the expectations generated during the last meetings in Seoul.

The work program before us is, as expected, strongly influenced by the mandate given by the Interim Committee. The result is that this Board will be faced once again with a heavy work schedule ahead, but neither the Executive Board nor the staff could be absolved of the task of doing their utmost to conclude it.

My authorities agree with the general outline presented in the Managing Director's statement, but they would like to make a number of suggestions on the manner in which certain topics have been presented and their content. This is a contribution toward what we believe will be a more efficient use of the short time available and a more fruitful discussion in the light of the developments of the October meetings. I will touch upon the work to be done with regard to the G-10 and G-24 reports on the international monetary system, since we generally agree on the rest of the work program.

Both documents present in a comprehensive manner the views endorsed by their respective Ministers on the functioning of the international monetary system and contain a number of proposals or suggestions aimed at improving the system. They are the result of many months of detailed work, and a large number of meetings were held to reach agreement.

The Interim Committee at its Seoul Meeting made a preliminary consideration of them and agreed, as the Managing Director rightly pointed out, "to request the Executive Board to study the issues raised in the reports with a view to facilitating a substantive consideration by the Committee at its next meeting."

It seems reasonable to follow the proposal of studying separately each of the main subjects contained therein, since both reports are structured in a similar way; but keeping in mind that each of them constitutes a part of a whole that will have to be reassembled at the end of the exercise, since this is the spirit of paragraph 10 of the Interim Committee's press communiqué of October 7, 1985.

In order to carry out this work and taking into consideration, as I said before, that

(a) there is a time restriction, and

(b) that the Ministers of the G-24 and/or the Ministers of the G-10 have made a number of proposals and suggestions, my authorities believe that it will be proper for the staff to concentrate on them and we would like to propose the following.

First: A paper will be prepared on each subject to be analyzed separately, but to give due regard to their interactions within the functioning of the international monetary system. In doing so the staff, as a general rule under each of the headings, will have to use the following methodology:

(i) As a first step, a presentation of all the proposals and suggestions presented in both reports, including the logic behind each of them.

(ii) As a second step, an evaluation of the feasibility, desirability, or modification that will have to be introduced if they are to be implemented. If, in their view, any of the modifications are not adequate they can be candid and say so.

(iii) If more time is needed for the analysis of any of the Ministerial proposals a preliminary analysis will be submitted and an outline of the work to be done will have to be agreed on.

Second: A global paper should be prepared by the staff in order to have a comprehensive vision of the interrelationship among the proposals made in view of the discussions held on each and every subject. This paper, while useful in seeking the consistency of the conclusions reached separately, will also serve to facilitate the substantive consideration that the Interim Committee will give to the functioning and improvement of the international monetary system at its next meeting.

Directors might consider having this global paper submitted at the outset of the Board discussions prior to the treatment of the specific subjects. This may help to clarify the various issues raised in both reports to be considered at a later stage, and to determine their interaction.

If this approach proves to be acceptable, a revised version of it will have to be prepared in the light of the discussions held on each and every subject for its final presentation at the coming Interim Committee meeting.

With this general scheme in mind, I would like to offer some comments on the specific topics.

(a) Exchange rate system

Both reports, although with different degrees of emphasis, recognize that the functioning of the system of floating exchange rates has not fulfilled all the expectations of the international community. Vast amounts of literature from different sources have been produced, reviewing and assessing the system. I would disagree with the advantage of having a new paper, particularly due to the time constraint that we are faced with, and, rather, I would suggest involving ourselves in a more straightforward manner with the proposal of the report.

In the view of my authorities, the present floating exchange rate system allows the separation of the monetary and fiscal policies from the external sector in those countries where currencies are the base of the international payments system and, therefore the system is responsible for not generating the pressures needed to coordinate their policies, which have been provided to them with the space to develop a set of mutually international policy inconsistencies and have allowed them to postpone the necessary domestic adjustment.

The proposed study on target zones is therefore a most welcome one, since both the G-24 and a number of members of the G-10 considered the usefulness of this concept as a means to promote greater international policy consistency. But in an environment where the exchange rates of major currencies are characterized by a high degree of short-term volatility, as well as a persistent misalignment, which brought about uncertainty regarding future exchange rates, a mechanism needs to be devised to enforce policy coordination among the major industrial countries. A general outline for this purpose is offered in the G-24 report, and the staff could elaborate more on it.

(b) Surveillance

It has been recognized by the Ministers of the G-24 and G-10 that the IMF plays a central role in surveillance, and its function is essential for an orderly international monetary and financial system, as well as the fact that it has so far been ineffective. The main objectives of Fund surveillance should be to bring about symmetry in international adjustment, and it should be able to effectively influence the policies of industrial countries in a manner that would be supportive of growth, particularly in developing countries. First, the staff should analyze all the firm proposals to enhance the effectiveness of surveillance that have been put forward and, second, the staff should provide an analysis of the changes in the principles that are necessary for their implementation.

(c) International liquidity and the SDR

On international liquidity the views of both reports differ in substance in the opinion of my authorities. Specifically, we should ask ourselves whether there is or not an international liquidity policy in place, and whether the present system provides or not adequate instruments for the management of that liquidity. As for the experience of most developing countries, we think the answer to both questions remains negative.

The present inadequacy as well as unevenness in international liquidity cannot be corrected or even controlled through the market process. It is often held that access to commercial banks would depend on "creditworthiness," which is dependent upon adjustment. But despite vigorous adjustment policies pursued by developing countries leading to a sizable improvement in their current account position, "creditworthiness" was not improved concomitantly, now was there a reversal of the decline in bank lending. On the latter, the staff paper on international capital markets, which would be discussed shortly, depicts this negative trend.

An important argument of the G-10 report for opposing an SDR allocation is that international financial markets are able to provide an adequate supply of liquidity in order to satisfy the present world liquidity needs. On the other hand, the G-24 does not share this confidence in the role of international financial markets with regard to the provision and distribution of international liquidity. Therefore, I believe that the staff papers should also answer the following questions:

- Are the international financial markets able to maintain the appropriate conditions for the supply and distribution of international liquidity for both developed and developing countries?

- What is the distribution of international liquidity geared by a supply system based on international financial markets?

- What are the problems of a system that relies heavily on borrowed reserves?

These issues should be included in our discussion on the role of SDRs, and the papers prepared by the staff should deal with them.

(d) Role of the Fund

With reference to the role of the Fund, I suggest that we focus our attention on the following subjects: first, on conditionality for the use of Fund resources. With reference to this point, the G-24 report makes some proposals about changing some aspects of conditionality. We think that this is a key area that deserves crucial attention by the staff. Second, regarding the creation of a new facility to provide financing for interest rate increases, my authorities believe that a paper from the staff on this subject is needed. It should focus on analyzing several possible structures that this facility could have. Also, it should include legal, technical, and financial implications for the creation of this facility. Finally, further attention should also be paid to aspects regarding quotas and access limits, as well as to the decision-making process.

In view of recent developments in relation to the debt problem, I would like to propose that the staff produce a paper on the role of the Fund in relation to a set of macroeconomic and structural policies necessary to encourage growth and balance of payments adjustment in developing countries.

(e) Debt problem

With regard to the debt problem and taking into consideration the proposals made by the G-24 report and the developments in this area since the last Interim Committee meeting held in Seoul: first, it would be extremely important to have a paper from the staff dealing with the subject of growth in developing countries and new strategies to make improvements in the external sector compatible with growth in these countries. This concurs with the G-24 report, which advocates the need to move toward a "positive" type of adjustment. The study should identify areas and policies that are relevant in order to encourage growth in those countries.

What is needed is a coherent explanation of why we are facing this situation today, and what were the causes that led us to this level of indebtness and the difficulties faced by developing countries to reverse it. Therefore, my second proposal under this heading will be to have a paper on the debt situation, its causes and present status: policies in industrial countries that will improve its prospects.

(f) Transfer of resources

I note with concern that the subject of transfer of resources has not been included in our work program.

The Interim Committee had a preliminary exchange of views on the reports by the Group of Ten and the Group of Twenty-Four and it was agreed to ask the Executive Board to study all the issues raised in these reports.

In the view of my authorities, to analyze the problem of transfer of resources in the context of the functioning of the international monetary system is only appropriate since it is deeply interrelated with many of the issues dealt with before. Therefore, I suggest that we discuss a paper on transfer of resources to be based on the section contained in the G-24 report.

Finally, my authorities would like to suggest a change in the order of the discussions and, particulary, in early February to bring to the attention of the Board those discussions referring to the debt problem and transfer of resources, because of the latest developments and new proposals in this area. This change will allow us to have a second round of discussions before the April meeting if they are deemed necessary. Priority should also be given to the discussion of the role of the Fund and surveillance.

Mr. Polak said that he could endorse the thrust of the work program as outlined by the Managing Director and would limit his remarks to only a few areas. On the exchange rate system, he was looking forward to reviewing the paper and assessing the system of floating exchange rates, and was intellectually interested in reviewing the proposed paper on target zones, although he would be quite willing to postpone discussion on the latter paper until after the next meeting of the Interim Committee.

With regard to the heavy agenda of work relating to the SDR, Mr. Polak said that he was sorry that the issues of private holdings of SDRs and the use of the SDR as an instrument of intervention were not among those items scheduled for consideration. As to the role of the Fund, he agreed with those who felt it was impossible to study all the topics that had been mentioned under that heading; the Board should perhaps be guided in its approach by the various issues that came up naturally in the context of the Board's work. Directors should be similarly guided with respect to issues relating to the debt problem. It was to be hoped that the forthcoming discussion on international capital markets would focus on the recent U.S. initiative for dealing with the debt problem. A great deal of work would have to be done in connection with that initiative and, in that regard, he himself would give priority to that practical work over the new study entitled "The Debt Situation: Recent Developments and Longer-Term Considerations." In the context of struggling with the U.S. initiative, the Board might well be more productive by attempting to deal with the problem itself than by discussing another staff paper that was as yet only broadly defined.

He was pleased that a discussion on the use of reflows of Trust Fund loans had been placed on the Board's agenda for January 1986, Mr. Polak said. It was his understanding that the U.S. authorities were again promoting the fully integrated approach to helping the poorest developing countries, an approach that Mr. Dallara had presented to the Executive Board in September but which, according to Secretary Baker at the Seoul meetings, had provoked concerns among many other countries. He hoped that the staff paper being prepared on the Trust Fund would deal with that facility by itself, along the guidelines recommended by the Interim Committee in Seoul. Close collaboration with the World Bank on the matter was implied, and the very difficult question of integration could be considered once it had become clear that the Bank and member governments would be able to mobilize the additional resources necessary to make integration a meaningful proposition.

Mr. Kafka stated that he, too, was in general agreement with the work program outlined by the Managing Director. In an effort to meet the demands of the Interim Committee, the coverage of the work program would have to be comprehensive and might demand more than the Executive Board or the staff could deliver and still maintain high standards. He could endorse Mr. Nebbia's helpful suggestion that, where more time was needed to complete the work than was available before the next meeting of the Interim Committee, the staff should add to that part of the work completed an outline of the work still to be done. He hoped that issues in the reports of the G-10 and the G-24 on the international monetary system could be meaningfully covered before the next Interim Committee meeting, even if only in a preliminary fashion.

It was not easy to assign priority to any of the subjects covered in the G-10 and G-24 reports, Mr. Kafka continued. However, if forced to make a choice, he would give priority to the role of the Fund, the exchange system, and the problem of debt and the transfer of resources. Of course, both the staff and the Executive Board would be operating under time constraints, although much of the material needed for papers on the subjects he had mentioned were already in the staff's files. He wondered in that regard, however, whether it might not be helpful in some cases--for example, in studies on the exchange rate system--to contract out to reputable specialists the preparation of some parts of the necessary studies. Such an approach would save time while providing Directors with a somewhat different perspective on certain issues.

Remarking on specific elements of the work program, Mr. Kafka agreed with Mr. Nebbia's recommended approach to the proposed studies on the topics in the G-10 and G-24 reports on the international monetary system. In particular, he agreed with the recommended analytical approach and with the call for a global paper at an appropriate stage. Under the subheading "Exchange rate system," he hoped that the staff would not limit its discussion to target zones in any narrow sense of the concept. He himself would like to see thought given to various forms of moving pegs as different from the target zone approach. Under the subheading "Surveillance," he hoped that equal emphasis would be given to the surveillance of members with and without Fund programs. More particularly, attention should be paid to ways of improving the effectiveness of surveillance over those countries that did not require the Fund's resources or the Fund's approval of their policies.

Among the subjects under the heading "Role of the Fund," priority should be given to conditionality and the problems of program design, Mr. Kafka considered. Attention should also be paid to the question of prolonged use of Fund resources and to overdue obligations, as well as to the proposal for a compensatory facility for interest rate increases. With regard to the debt problem, he could support the proposed study on export credits, which he hoped would include the issue of maturities, a matter likely to become important if, in future, guaranteed export credits had to be substituted for commercial bank credit. He also joined Mr. Nebbia in regretting the absence in the work program of any proposal for a study on the transfer of resources.

In general, the Group of Ten and the Group of Twenty-Four should be commended for having taken the initiative to bring the international monetary system and its problems once again to the world's attention. The Group of Five, in his view, also deserved commendation for having begun to apply a kind of target zone system even before studies on such a system had been circulated. It was to be hoped that the initiative of the Group of Five would be successful in the short run before any changes had been made in the U.S. fiscal deficit.

Under the heading "Use of Fund Resources," he noted that the review of experience with upper credit tranche arrangements and of conditionality guidelines had been scheduled for December 30, Mr. Kafka said. It would be preferable to postpone that discussion to a date sometime in January.

On other matters, Mr. Kafka remarked that he was troubled by the prospect of discussing an interim salary structure in December, given that the report of the joint Bank-Fund Committee of Executive Directors on Staff Compensation might be ready as early as March 1986. An interim salary structure would be naturally disturbing to the staff and perhaps more burdensome than a definitive structure, which would also correct any inappropriate relationships to the external market.

He had for some time been looking forward to the study on theoretical aspects of Fund programs, and it was disappointing to note that that study would not be ready before March 1986, Mr. Kafka commented. His hope had been that, with the assistance of the Research Department, the study would have been ready in time to endow the next annual review of upper credit tranche programs and guidelines on conditionality with a special gloss. It was also unfortunate that the paper entitled "Experience with Exchange Rate Flexibility in Certain Developing Countries," would be ready only in March 1986.

Mr. Nimatallah, endorsing the work program, said that he doubted that the Executive Board would be able to cover in depth all the points raised in the G-10 and G-24 reports on the international monetary system before the April meetings of the Interim and Development Committees. It would thus be prudent if the Board, recognizing that possibility, could agree on a scenario showing what could be covered in full before April and what could be looked at partly before and partly after April.

On the exchange rate system, Mr. Nimatallah remarked that the New York meetings of the G-5 Ministers and Governors in September 1985 had convinced him that exchange rates could not be left totally to the private market. As he saw it, the system was made up of the private market, official financial and monetary authorities, and the International Monetary Fund. Members of the Fund had been talking about strengthening Fund surveillance for the purpose of enhancing coordination, particularly on exchange rate policies, among governments, and between governments and the Fund. What was missing was a link to facilitate coordination between the authorities and the market. Following the New York meetings of the Group of Five, intervention by monetary authorities had begun to create part of that link by sending messages to the private market. However, as intervention could not be an ongoing activity, there should be another means of strengthening the link, perhaps some form of target zone approach. As he saw it, the system could benefit from development of certain flexible target zones aimed at completing the circle of coordination among the major parties concerned with the achievement of stable exchange rates. In his statement on the work program, the Managing Director had observed that "depending on further guidance from the Interim Committee in April, there may be need for subsequent staff work to give further study to certain aspects of the concept [of target zones] or perhaps to examine specific proposals with a view to possible implementation." Mr. Polak had suggested that such further study or examination could perhaps be postponed until after the April meetings. His own view was that the matter should at least be touched upon before April, with a view to gaining further guidance from the Interim Committee.

On the role of the Fund, Mr. Nimatallah considered that the examination of a new facility for compensating for interest rate increases, together with the issues of quotas and of decision making, needed to be coordinated and carefully prepared before those issues were brought to the Board. For all practical purposes, any rush to examine those issues before April might prevent them from receiving the attention they deserved. All other issues under the subheading "Role of the Fund," had appropriately been assigned discussion dates in the period until the April meetings.

The idea to combine a staff paper on the debt problem with the World Economic Outlook exercise was a good one, Mr. Nimatallah considered. At the time of the World Economic Outlook discussion, it would be easier to assess the progress made on the debt problem. On the use of Fund resources, he was happy to note that the Board would be focusing on the design of Fund programs; however, in light of recent developments, he wondered whether December 30, 1985 was an appropriate time for discussing what he considered was an important issue. He was pleased to see that efforts were under way to improve the quality of the Fund's Annual Report, about which in the past he had had some misgivings. Finally, all the special staff studies mentioned in the program could, in his view, be most usefully discussed in seminar session.

Mr. Dallara stated that, like others, he could support the thrust of the program outlined by the Managing Director. On specific aspects of the program, he welcomed the proposed follow-up of the G-10 and G-24 reports on the monetary system, and he agreed that it would be appropriate to organize the Board discussions around the four main topics covered in the two main reports. However, he did not feel that the emphasis given to the subject of target zones in studying the exchange rate system was fully warranted. Target zones had been cited in the G-24 report as means of promoting "exchange rate stability and a sustainable pattern of payments imbalances." The G-10 report also clearly referred to target zones but did not give the topic much prominence. Moreover, the majority of the Deputies of the Group of Ten had agreed that the adoption of target zones was undesirable and, in any event, impractical at present. Some Deputies had suggested that technical aspects of a target zone approach might be explored further at an appropriate time, but the main conclusion of the report regarding improvements in the exchange system was that greater exchange rate stability required close and continuing cooperation among countries and a strengthening of international surveillance to improve the compatibility of policies among countries and the convergence of economic performance around sustainable noninflationary growth. It was toward that conclusion that he felt the Executive Board's discussion should be aimed.

One possible problem with the G-10 report was that it did not contain many specific ideas regarding the exchange rate system per se, Mr. Dallara continued. However, there were some points that warranted further analysis, including the role of liberalization of capital markets and the removal of restrictions on structural rigidities that hampered adjustment. Both of those ideas had been cited in the G-10 report as having some potential for promoting greater exchange rate stability. Of course, the issue of exchange rates was only one of a number of variables that could assist in the evaluation of a country's performance and policies; in the circumstances, therefore, an analysis of target zones might usefully be combined with an analysis of the issues he had mentioned, together with an examination of other factors in addition to exchange rate developments that could be taken into account in assessing national policies and the need for consultation and policy discussion. The importance of that somewhat broader approach had been recognized in paragraph 30 of the G-10 report, where it was observed that, in addition to those factors highlighted in the International Monetary Fund's principles of surveillance, account should be taken of the structural rigidities, the openness of economies, and developments and performance in the areas of fiscal and monetary policies. In that regard, he would welcome an analysis by the staff of how such factors, together with exchange rate developments, could be used to evaluate performance and policies and to promote sound and convergent policies.

He had been struck by a comment in Mr. Nebbia's statement that the current exchange rate system allowed for the separation of monetary and fiscal policies from external sector policies in reserve currency countries, Mr. Dallara commented. While unable to agree with that statement, he found that it had particularly interesting implications for the ongoing debate regarding U.S. fiscal policy, exchange rate developments, and the external imbalances; the implication of the statement was that there had been a separation among those developments.

Surveillance was an area in which there existed considerable scope for improving the functioning of the international monetary system, Mr. Dallara said, and he looked forward to a Board discussion of proposals for strengthening the effectiveness of surveillance that had been suggested in the G-10 and G-24 reports. His own views on a number of surveillance issues had been outlined in a statement (4/11/85) that he had delivered at EBM/85/48 (3/22/85). He hoped that the staff would find points in that statement and in statements of other Directors delivered at the March meeting on surveillance that were deserving of further consideration. In reviewing the work program on surveillance, he attached particular importance to two aspects: the review of specific proposals in the G-10 and G-24 reports to increase the effectiveness of surveillance; and the examination of the principles as well as the procedures for surveillance. He looked forward to Board discussions that might lead to a consensus on some concrete recommendations to improve the surveillance process, improvements he believed were expected of the Board based on the attention given to surveillance measures in both the G-10 and G-24 reports.

Regarding the program of studies on the SDR, Mr. Dallara observed that the timing and order of discussions should be arranged to produce the most effective analysis. The G-10 report prefaced its recognition that the SDR might have a useful role to play in the system with an indication that the monetary system had changed considerably since the creation of the SDR and that that change had affected the rationale for the asset. That view suggested that it might be best to begin the program of studies with a consideration of the implications of changes in the monetary system for the role of the SDR. To ensure that that issue received adequate attention and that the necessary analytical foundation was established for discussions of the potential role of the SDR in contributing to the stability of the system, he recommended that consideration be given to two separate discussions on the SDR. The first would focus on the implications of changes in the system for the role of the SDR and would look at the role of the asset under the changed and current circumstances. Directors' comments in that discussion could then be taken into account in the preparation of a paper on the potential role of the SDR in contributing to the stability of the system--a paper that could be discussed at a later date. He was not suggesting any delay in the Board's consideration of SDR matters; indeed, he would be happy to consider an earlier date for the first item if other Directors felt his recommended approach was a useful one.

Considering the topics he had already mentioned, it was unclear how much further the Board could go in addressing other issues, including those under the heading entitled "Role of the Fund," Mr. Dallara said. Still, the role of the institution had been considered important by both the Group of Ten and the Group of Twenty-Four. In the circumstances, he proposed that the Board's attention be focused on three areas: overdue payments to the Fund; prolonged use of Fund resources and the effort to preserve the Fund's role as a temporary source of balance of payments financing; and BankFund collaboration. On the subject of overdue payments to the Fund, he hoped that the forthcoming papers on the institution's income and liquidity position would examine the impact that overdue charges could have on the Fund's income position and possibly on the rate of charge. Consideration should also be given to the provisions relating to the Fund's treatment of arrears. On Fund-Bank collaboration, it would be helpful if a paper could be prepared reviewing some of the recent steps that had been taken to strengthen that collaboration and analyzing a few case studies of Fund-Bank collaboration to give national authorities an idea of the extent to which policy was being translated into the implementation of specific measures or arrangements for different countries and what progress had been achieved under those arrangements. Moreover, consistent with the request in the G-10 report that operational proposals should be considered by the Fund and World Bank Executive Boards, he would welcome an analysis of, inter alia, the possibility of joint missions or an assessment of other means by which an economic program might be supported by the resources of both the Fund and the Bank. More generally, it would be helpful if an effort could be made to develop a broad, internally consistent policy framework for guiding the two institutions in discussions with individual members.

On the debt problem, Mr. Dallara agreed with the Managing Director that the forthcoming discussion of the staff paper entitled "International Capital Markets--Developments and Prospects, 1985" (SM/85/267) should provide an opportunity for Directors to exchange views on Secretary Baker's initiative for dealing with the debt problem. He also looked forward to further discussion of the evolution of Secretary Baker's proposal in the broader paper on the debt situation being prepared in connection with the World Economic Outlook exercise. Like Mr. Polak, he felt that the forthcoming discussion on international capital markets would also generate a number of issues that could be incorporated into the debt paper, which he hoped would cover not only the financing aspects of Secretary Baker's proposal but also the essential efforts to develop and implement comprehensive economic programs in debtor countries. In passing, he expressed the hope that the staff, in preparing material for the next World Economic Outlook discussion, would focus on inflation and budgetary problems in developing countries and on developments in, and prospects for, structural reform in both industrial and developing countries.

He was looking forward to the annual review of upper credit tranche arrangements and guidelines on conditionality, Mr. Dallara said. That review should provide an opportunity for Directors to discuss another aspect of Secretary Baker's Seoul initiative, namely, the role of the Fund in encouraging comprehensive growth-oriented economic programs. It was Secretary Baker's conviction that the Fund should play an important role in encouraging the development of such programs, without which the needed financing could not and, indeed, should not materialize. In that regard, he had noted Mr. Nebbia's reference to the need for the Fund to analyze the types of policies that could best be pursued by debtor countries in an effort to establish sustainable growth. He hoped that the paper being prepared for the upcoming conditionality review would include an analysis of the ways in which the Fund could give relatively greater emphasis in Fund-supported programs to the structural and institutional policy changes that might be necessary for sustainable growth. It went without saying, of course, that sound macroeconomic policies must form the center of any Fund-supported programs; at the same time, it was necessary to place additional emphasis on such elements as pricing, trade liberalization, and the operation and ownership of public sector enterprises.

The staff paper on the use of Trust Fund reflows, scheduled for discussion in January 1986, should perhaps include a brief section on the "bolder approach" to utilization of Trust Fund reflows outlined by Secretary Baker during the Interim Committee meeting in Seoul, Mr. Dallara noted. That bolder approach was, in his view, fully consistent with the Interim Committee communiqué, and the U.S. authorities remained prepared to seek additional financing in support of such an approach.

On the forthcoming administrative budget discussion, Mr. Dallara recalled that his chair had remarked on several occasions in the past that it would be desirable to improve coordination between the compensation review and the budget process. Such an approach might well be particularly complicated in 1985/86, given the possibility of a variety of changes in the compensation system and uncertainties about the timing of those changes. Still, he would appreciate Board consideration of his proposal in connection with the midyear budget review.

Finally, Mr. Dallara said that he was looking forward to a seminar discussion of staff papers on the design of adjustment programs in planned economies and the theoretical aspects of the design of Fund-supported adjustment programs. Like Mr. Kafka, he believed that the latter paper would have been particularly useful as background for the forthcoming review of upper credit tranche programs. While recognizing the many demands placed on the staff at present, he wondered whether there was any possibility of circulating at least parts of the paper on the theoretical aspects of Fund-supported programs in advance of the review.

Mr. Massé remarked that he too was in broad agreement with the work program and he welcomed the serious and comprehensive attention that the management was proposing that the staff should pay to the G-10 and G-24 reports on the international monetary system. On the exchange rate system, he hoped that the staff would look at the recommendations in the two reports and assess the implications of changes in the floating system that might have arisen as a result of the G-5 meeting in late September. He welcomed the envisaged comprehensive review of Fund surveillance, with particular emphasis on the proposals in the G-10 and G-24 reports for enhancing the effectiveness of surveillance. Again, the implications of the recent G-5 meeting for surveillance needed to be carefully reviewed.

He could endorse the commitments of the Fund to the basic study of the role of the SDR, a study that he hoped would clarify the analytical foundations of the SDR and generate suggestions for enhancing the use of the asset, Mr. Massé continued. On the role of the Fund, he attached special priority to monitoring and assessing the evolving collaboration between the Fund and the World Bank, a matter that would need to be addressed in particular in conjunction with the scheduled discussion on the use of Trust Fund reflows. The recent U.S. initiative for dealing with debt had highlighted the issue of Fund-Bank collaboration, and it would be useful to have a staff paper in which the implications of the U.S. proposal could be fully discussed. He realized that the Executive Board had undertaken a full study of Fund-Bank cooperation in March 1985 and that another broad examination at present might be premature. However, over the next few months, the Board would be looking at proposals for the use of Trust Fund reflows and at the U.S. initiative on debt, and the institution must be prepared to respond to those proposals by clarifying its role in the resolution of the longer-term aspects of the debt situation. Perhaps it would be helpful if a review of recent proposals for strengthening Fund-Bank cooperation were included in the forthcoming paper on the debt situation.

On the use of Fund resources, recent developments relating to the debt problems of developing countries had heightened interest in the annual review of the guidelines on conditionality in Fund programs, Mr. Massé remarked. That review would include the issue of program design and should touch on the matter of Fund/Bank cooperation. Indeed, it would be helpful if the staff would suggest ways in which Fund programs could facilitate and enhance the World Bank's development role.

The proposed papers on overdue financial obligations to the Fund were timely, Mr. Massé said. A review of Fund experience in responding to those obligations over the past 12-18 months should help Directors to consider whether any changes in that response might be needed. Moreover, discussion of the papers on overdue obligations would give the Executive Board an opportunity to consider the extent to which Fund policy on arrears to the institution could be expected to bring about a satisfactory solution to the problem and whether any complementary action by others might be called for.

Finally, Mr. Massé wondered whether it would not be preferable if the paper entitled "The Debt Situation: Recent Developments and Longer-Term Considerations" were discussed in advance of the World Economic Outlook exercise rather than immediately afterward, as envisaged at present. Alternatively, arrangements might be made to have the Board's views on the paper taken into account before relevant sections of the World Economic Outlook paper were finalized.

Mr. Finaish noted that the agenda of work that the Interim Committee had asked the Executive Board to undertake in studying the issues raised in the G-10 and G-24 reports on the international monetary system was a heavy one, and the time available for its completion was limited. He shared Mr. Nebbia's concern in particular for ensuring efficient use of the time available and for directing discussions toward reaching useful and practical conclusions on the subjects under study. In that regard, the suggestion was appropriate to focus discussions on the particular proposals contained in the two reports under each of the main topics to be studied.

On the subject of the exchange rate system, due attention should be given in the proposed study of the functioning of floating exchange rates to the implications for the developing countries of the volatility and misalignment in the exchange rates of major currencies, Mr. Finaish remarked. On the subject of surveillance, both the G-10 and G-24 reports had emphasized the importance of enhancing the effectiveness of Fund surveillance over the policies of major industrial countries; staff papers for the next review of surveillance should examine thoroughly the proposals made in that regard with a view to drawing up final and practical measures.

The proposed paper on the implications of changes in the international monetary system for the role of the SDR was welcome, especially given the view of some G-10 countries that the evolution of a multireserve currency system might have significantly altered the role of, or the need for, a reserve asset such as the SDR from that envisaged at the time of its creation, Mr. Finaish continued. In examining the role of the SDR in the light of changes in the international monetary system, the approach should not be to assign the SDR a passive or residual role of adjusting to growth in the other elements of the system; rather the role should be defined on the basis of the SDR's merit in relation to other reserve assets. The paper on the potential role of the SDR in contributing to the stability of the international monetary system should aim at assessing the role of that asset--as an element in the system as constituted at present--in contributing to the stability of the system, raising the quality of reserve assets, and generally improving the management of international liquidity. Taking that line of inquiry a step further, the paper could also examine how a system featuring the SDR as a principal reserve asset as envisaged in the Articles of Agreement would qualitatively compare with the current system.

The study proposed by Mr. Nebbia on the role of the Fund in promoting more growth-oriented adjustment strategies could be a useful one, Mr. Finaish said. The study could be discussed simultaneously with the paper entitled "Theoretical Aspects of the Design of Fund-Supported Adjustment Programs," the date of issuance of which had been postponed too many times. In the proposed paper on the debt problem, due attention should also be given to the developments in, policies of, and prospects for the relatively small debtor countries facing difficult debt problems.

A decision on whether and in what form the special staff studies should be discussed by the Board could be taken when those papers had been issued and members of the Board had had a chance to examine them, Mr. Finaish remarked. He welcomed the addition of two staff studies to the program, particularly that on Islamic banking, a subject of interest to many Fund member countries, some of which in recent years had attempted to adapt their financial systems in accordance with Islamic principles. In some countries, measures had also been taken to adapt the fiscal system. Research by the Fund on the application of Islamic principles to banking and other relevant spheres of economic activity would serve to increase the Fund's understanding of the technical and policy issues and operational questions involved in the process and should help the Fund in performing its functions vis-à-vis the countries concerned. Given the relatively rudimentary familiarity that the Fund had with the subject at present, the expectation should be for more Fund research papers on it in the future. Both the Research Department and the relevant area department could contribute to the continuation of that research. Such papers would not necessarily need to be targeted for Board discussion and could be circulated in the "DM" series. A recent paper on Islamic banking by a staff member in the Research Department represented an example that could usefully be followed by others. Finally, he noted that there had recently been an increase in the number of cases in which Board discussions had been scheduled on quite short notice. He understood that such scheduling was sometimes unavoidable, but he hoped that it would be kept to a minimum. Even where the relevant staff paper had been available for a reasonable period of time, adequate advance notice should be given of the date of the discussion.

Mr. Doe remarked that, while he generally was in agreement with the priorities suggested for the various topics to be examined by the Executive Board, he wondered like some others whether it would not be preferable to prepare a single paper covering all the subjects raised in the G-10 and G-24 reports rather than separate papers on the topics covered by those reports. Following discussion by the Board of the "global" paper, Directors might request more detailed examination of individual subjects for discussion by the Board at a later date. As for the approach to be followed in developing the global paper, his chair would favor an orientation that highlighted for each of the topics covered the similarities of views or positions as between the Group of Ten and the Group of Twenty-Four, the differences, and what might be called "gray areas." Where similarities existed, the staff might consider putting forward proposals to give substance to those views. Proposals might also facilitate a meeting of minds where differences of view existed; an approach that gave emphasis to practical solutions to problems would enable the Executive Board to examine those solutions and make operational proposals to the policymakers on the Interim Committee.

Turning to certain of the specific topics for discussion, Mr. Doe considered that it was important to stress the debt problem and the transfer of resources, even though those items had not been addressed in the G-10 report. The presentation on the debt problem should not be limited to the debt situation of large debtor countries but should encompass the predicament of small debtors as well, in particular, the low-income debtor countries. The precariousness of the economic and financial situations of such low-income countries could hardly be overstated; many of them had been implementing adjustment programs in trying circumstances, and it was the view of the members represented by his chair that the large outflow of scanty financial resources from those countries to meet external payments obligations was rapidly approaching crisis proportions and constituted a major obstacle to the growth of the economies of those countries. On a related matter, while there might be merit in examining the debt situation in tandem with the World Economic Outlook exercise, his chair was concerned that such an approach might cloud the importance of the need for urgent and effective steps to deal with the debt problem.

Under the heading of "International liquidity and the SDR," it was recognized that the SDR "may well have a useful role" to play in meeting the long-term global need for reserves, Mr. Doe continued. The use of the words "may well have" gave the impression that there was some doubt about the effective role of the SDR as an international reserve asset, the function of which was clearly recognized in the Articles of Agreement. The view of his chair on the program of studies on the SDR had not changed since the June 26, 1985 meeting on that topic. He continued to feel that the program of studies should aim at strengthening the role of the SDR as an international reserve asset and an instrument for improving the stability of the international monetary system.

Under the subheading "Role of the Fund," Mr. Doe said that his chair would favor giving priority to the following topics: overdue financial obligations to the Fund, Fund-Bank collaboration, quotas, decision making, the creation of a new facility to provide financing for interest rate increases, prolonged use of Fund resources, and access limits and conditionality for the use of Fund resources. On the subject of quotas, given the prospective needs of member countries and likely requests for Fund financial assistance, his chair would favor advancing the preliminary work on the Ninth General Review of Quotas so as to allow early action by members on possible quota increases.

In his statement on the work program, the Managing Director had observed that the report for the annual review of experience with upper credit tranche arrangements and guidelines on conditionality "will be supplemented by a background paper reviewing the experience with program design in the 1980s, based on a detailed review of balance of payments adjustment in the countries that entered into upper tranche arrangements in 1982," Mr. Doe noted. He was certain that the choice of 1982 as the reference year had been guided by important considerations; he would be grateful if a few of those could be elaborated upon by the staff, and he would welcome comment on the sensitivity of the conclusions to be reported in the supplementary paper to the choice of the base year.

With regard to the area departments' work program and, more generally, the schedule of meetings of the Executive Board, Mr. Doe considered that care should be exercised to avoid a bunching of country matters in multi-country constituencies. Increased efforts should be made to spread country missions more evenly in order to limit the risk of crowding the Board's schedule; alternatively, the rule governing the timing of Executive Board discussions might be applied more flexibly. On special staff studies, he noted that the circulation of the paper entitled "Theoretical Aspects of Design of Fund-Supported Adjustment Programs" had been postponed. While he could understand the considerations leading to that decision, he could not but feel somewhat disappointed, in light of the considerable importance of the subject matter. Finally, his chair could support Mr. Nebbia's suggestion for a paper on external adjustment and economic growth.

The Executive Directors agreed to resume their consideration of the work program at 3:00 p.m.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/162 (11/8/85) and EBM/85/163 (11/12/85).

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/271 (11/7/85) is approved.

APPROVED: July 1, 1986

JOSEPH W. LANG, JR.
Acting Secretary