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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/18

3:00 p.m., January 24, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
J. Anson	C. Taylor
	E. M. Ainley, Temporary
J. de Groote	L. E. J. Coene, Temporary
	A. Le Lorier
	M. Teijeiro
	C. Dallara
	J. C. Williams, Temporary
	S. R. Abiad, Temporary
	Jaafar A.
	T. Yamashita
	D. I. S. Shaw, Temporary
A. Kafka	
	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	
	J. E. Suraisry
	T. de Vries
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
	M. Camara, Temporary
M. A. Senior	
J. Tvedt	
	Wang E.

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

Also Present

B. Legarda, Consultant. Administration Department: M. Russo, Deputy Director. Asian Department: B. Banerjee, R. G. Di Calogero, W. G. L. Evers, K. Saito. European Department: P. L. Hedfors. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; K. B. Dillon, H. W. Gerhard, M. Guitian, J. R. Marquez-Ruarte. External Relations Department: H. P. Puentes. Fiscal Affairs Department: R. R. Schneider. IMF Institute: M. G. Martin, G. Oliveros, C.-H. Wong. Legal Department: W. E. Holder, S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director; N. M. Kaibni, E. A. Milne. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; C. E. Sansón, Deputy Director; H. Arbulu-Neira, M. E. Bonangelino, C. Brachet, J. M. F. Braz, M. Caiola, J. Ferrán, J. E. Gonzalez, E. S. Kreis, J. S. Lizondo, C. L. Ramirez-Rojas, B. C. Stuart. Advisors to Executive Directors: J. R. N. Almeida, S. E. Conrado, J. Delgadillo, S. El-Khouri, P. Kohnert, H.-S. Lee, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: H. Arias, R. Bernardo, T. A. Connors, R. J. J. Costa, G. Ercel, C. Flamant, I. Fridriksson, G. Gomel, M. Hull, V. K. S. Nair, Y. Okubo, J. Reddy, J. Schuijer, H. Suzuki, P. Verly, A. A. Yousef, Zhang X.

1. ARGENTINA - 1982 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors continued from the previous meeting (EBM/83/17, 1/24/83) their consideration of the staff report for the 1982 Article IV consultation with Argentina, together with a request by Argentina for a stand-by arrangement equivalent to SDR 1.5 billion (EBS/83/8, 1/10/83; and Cor. 1, 1/21/83). In addition, they took up a request by Argentina for a purchase equivalent to SDR 520.1 million under the compensatory financing facility (EBS/83/11, 1/11/83; and Sup. 1, 1/21/83). They also had before them a report on recent economic developments in Argentina (SM/83/12, 1/17/83; Cor. 1, 1/20/83; and Cor. 2, 1/21/83).

The staff representative from the Research Department, responding to questions on the requested purchase under the compensatory financing facility, recalled that several Directors had asked whether the effects of the disturbances in the South Atlantic in the second quarter of 1982 should be regarded as factors within or outside the control of the member. In its assessment, the staff had been guided by past practice and by the April 1982 Executive Board discussion on the compensatory financing facility. The paper for that discussion (EBS/82/42) indicated that, with the exception of a possible reduction in the amount of compensation on account of stock accumulation, "the entire amount of the calculated shortfall has been regarded as compensable, once it has been established that the shortfall is largely attributable to factors beyond the control of the member." It was clear that the shortfall did not have to be entirely beyond the member's control. Besides, it was not the practice to examine segments of the shortfall--either by commodity or sector--and quantify which segments of the shortfall were related to factors beyond the control of the member and which were within its control. Rather, the staff looked at the situation as a whole in making its appraisal.

On page 11 of EBS/82/42, it was noted that "the question whether a political disturbance could have been avoided is one that the Fund does not address in its relations with members, and consequently, the practice has been to regard shortfalls resulting from such disturbances as being outside the control of the member," the staff representative continued. It was appropriate for the Fund to discuss the economic consequences of such a disturbance, and the paper went on to state that "two types of economic considerations have guided the staff in dealing with CF [compensatory financing] requests involving political disturbances: (i) the feasibility of making the required export projections for the two post-shortfall years, and (ii) an appraisal of the economic situation in which the member finds itself at the time of the request, the country's economic policy stance, and a judgment regarding its ability to implement economic policies." In their discussion of the matter, Executive Directors had generally agreed that there seemed to be no way of avoiding treating shortfalls attributable to political disturbances as beyond the control of the member.

In the specific case of Argentina, a number of factors had led to the staff judgment that the shortfall in total earnings was largely attributable to factors beyond the member's control, the staff representative said. The first was the time element involved. Argentina's policies had begun to move in the "right" direction with the unification of the exchange rate in the latter part of 1981. The favorable effects of that change had been felt through the first quarter of 1982, which covered roughly half the shortfall year. The hostilities in the South Atlantic had lasted for approximately three months--from early April to mid-June 1982--but the indirect effects may have spanned a longer period. In that regard, it was important to stress that the consequences of the hostilities had not been limited to dislocations in shipping; economic sanctions imposed upon Argentina had also had important effects, which had lasted into the middle of July. Policies following the hostilities also appeared to have hindered a smooth recovery in exports during the closing months of the shortfall year, particularly in August and September. However, during the first ten months of the shortfall year--from October 1981 until July 1982--factors affecting exports were presumed to be beyond the control of the authorities.

Another element entering into the staff's judgment was the input of external developments on Argentina's exports, the staff representative commented. As could be seen from Table 4 of EBS/83/11, the aggregate volume of major exports, accounting for 60 per cent of Argentina's total exports, had declined by 9 per cent, while prices for the same commodities over the same period had declined by about 11 per cent. The decline in prices--which was clearly beyond the control of the member--appeared to carry a large measure of responsibility for the shortfall in earnings. Taking the elements he had mentioned into account, the staff had reached a judgment that the shortfall for the 12 months ended September 1982 could be regarded as largely attributable to factors beyond the control of the member.

A question had been raised by Mr. Prowse about whether projected sugar prices for Argentina were consistent with projections contained in the paper on Brazil, the staff representative recalled. There was no real inconsistency in the projections; the unit price for Argentina's exports in the shortfall year was higher than the unit price for Brazil's exports and, while the projections in terms of absolute amounts were roughly the same, the projections for Brazil appeared to be much higher in index terms. The differences noted by Mr. Prowse were related to the fact that the periods covered were somewhat different and they reflected the relative weight of exports to various markets at different prices.

Regarding the exchange rate used to derive Table 3 in the paper, the staff representative noted that customs data for Argentina were compiled in U.S. dollar terms and, as was the practice, the staff had used the SDR/dollar exchange rates applicable to the period. For the postshortfall period, the average rate for October-November 1982 had been used to convert from U.S. dollars to SDRs.

With respect to Mr. Suraisry's concern that the request had been based in part on estimated data for the shortfall year, the staff representative observed that, originally, a full 3 months of the data had been estimated; however, as time had passed, the staff had been able to update the information and to present actual data for 11 of the 12 months. More recently, the authorities had provided provisional data for the entire shortfall year, which indicated that exports were substantially less than had been suggested by the figures in the staff paper. The implication was that the shortfall based on actual data that would eventually be submitted to the staff was likely to be much larger than the one projected in the paper. Generally speaking, he would argue that the staff's projections were more likely to be conservative than optimistic. For example, the staff had originally projected a wheat crop for 1982/83 of the order of 10 million tons; on the basis of more complete harvesting records, the latest estimate was for a crop of close to 15 million tons, implying that the original figures for exports of wheat might prove to be on the low side.

Some Directors had suggested that the projected 15 per cent increase in "other exports" might be high, the staff representative from the Research Department recalled. The staff had carefully analyzed the data and had determined that, of the projected value of other exports, approximately SDR 500 million a year represented firm contracts for sales of such items as cars, offshore oil drilling rigs, ships, and petrochemicals to new markets. If the figure of SDR 500 million were to be excluded and the price effect were to be offset, the data would show an increase in real terms of roughly 2.5 per cent a year which, in the staff view, represented a conservative estimate.

Mr. de Vries reiterated his support for Argentina's request for a purchase under the compensatory financing facility and his belief that the staff had applied existing Board policy on the facility quite logically. However, he was worried that a positive decision in Argentina's case might lead Directors in future to forget that there were in fact two options for dealing with compensatory financing facility requests when political hostilities led to export shortfalls. The Fund's Articles of Agreement clearly assumed peace among members and, if members became involved in hostilities and destroyed one another's export crops, it was difficult to say that the resulting shortfall was completely beyond the control of the authorities. The Fund could not, of course, choose to finance the export shortfall of one member and not the other; but it did have the option of not financing shortfalls that were clearly the result of government actions, including a decision to engage in hostilities.

Mr. Dallara asked for further clarification on the extent to which Argentina's exports might have been diverted into unrecorded trade. He was not so much concerned about whether such a diversion was within or outside the control of the member as about whether the development might have led to some distortion in the calculation of the shortfall.

The staff representative from the Research Department replied that the staff had not found hard evidence about the existence of unrecorded trade. Even if such evidence were available, it would be difficult to quantify in any meaningful way the effect of such an activity on the shortfall.

The staff representative from the Western Hemisphere Department, commenting first on a number of technical questions raised by Directors, noted that some of the apparent inconsistencies pointed out by Mr. de Groote had in fact been different presentations of similar indicators. The rate of increase of the wholesale price index presented in Table 2 of EBS/83/8 was the increase during the 12-month period to the end of March 1984. In mentioning a rate of increase in prices of 85 per cent as the target of the first quarter of 1984, the staff had been referring to the rise in prices at an annual rate during the period. Mr. de Groote had also inquired about the apparent discrepancy between GDP in the macroeconomic flow table and that in the balance of payments flow table (Tables 3 and 5, respectively, of EBS/83/8). Average exchange rates in Argentina had not moved in line with the GDP deflator. Actual rates had been used--the same rates for both the domestic and foreign flows--in the macroeconomic flow table, while, in the balance of payments flow table, the staff had attempted to apply what it felt was an equilibrium exchange rate in order to make the ratios of external flows to GDP more meaningful through time and across countries.

Regarding Mr. Casey's question on how the increase in external debt had been distributed, the staff representative noted that much of the increase had gone toward consumption spending, which had in turn spilled over into imports and an increase in the current account deficit. The remainder--particularly since the beginning of the banking crisis in March-June 1980--had financed private capital outflows. A reconciliation of the capital accounts and debt data--also requested by Mr. Casey--was not an easy matter on either a net or a gross basis because, for many categories of transactions, the data from Argentina did not include a record of disbursements and repayments. However, Table 3 of SM/83/12 showed quarterly developments in the balance of payments and, together with the more detailed tables included in the Statistical Appendix, should help to answer Mr. Casey's question.

In response to questions on the reliability of the debt data, the staff representative considered that the numbers referring to the debt of the public sector were reasonably solid. The staff itself had some doubts about the credibility of debt data for the private sector; indeed, while there was strong evidence that the capital flight that had taken place since 1980 had in part been used to repay foreign obligations of the private sector, those repayments had not been registered with the Central Bank. In other words, the private sector debts registered in the Central Bank had not appeared as canceled. Also, there was a reference in SM/83/12 to the fact that the exchange guarantees granted in 1981 might have applied to foreign loans to the domestic private sector which, in certain circumstances, might have been back-to-back loans. The Argentine authorities believed that about 20 per cent of total loans benefiting from an exchange guarantee came in that category.

Turning to the issue of whether Argentina might have done better to have requested a three-year extended arrangement, the staff representative noted that the magnitude of the imbalances at present would certainly justify a medium-term approach to the resolution of Argentina's difficulties; however, the authorities had felt unable to undertake policy commitments for the period beyond the March 1984 election. They had indicated in paragraph 2 of the letter of intent that they were mindful of the importance of ensuring continuity both in Argentina's stabilization efforts and in its relations with the Fund, and they had indicated their willingness to facilitate contacts between the Fund and the incoming government once the elections had taken place.

As to why the staff had not agreed on a test for March but had taken advantage of the May review to set targets for the remainder of the program, the staff representative observed that, while the practice was not common in Fund programs, it was particularly important in the Argentine case that targets should be set for the full period of the arrangement in order to give a sense of steadiness in policies and continuity in the implementation of the adjustment program.

Several Directors had wondered whether the program's objectives were perhaps too ambitious, the staff representative recalled. If the conditions of the program were met, it would in the staff view be possible to reactivate the economy. When the Argentine authorities had first called on the Managing Director in Toronto, inflation had been running at an annual rate of almost 900 per cent; the country had accumulated some $2 billion in arrears; and the decline in real GDP at an annual rate during the first half of 1982 had been extremely pronounced. The program under discussion had been designed to bring about a deceleration in the rate of growth of nominal domestic expenditure, and the question was how such a decelerating rate would be distributed among the current account of the balance of payments, prices, and real income growth.

A measure of protection in the program was provided by an exchange rate policy designed to compensate for domestic inflation and by an interest rate policy that should bring about the retention of financial savings in Argentina, the staff representative continued. The program's strength was in the balance of payments area, and, as the staff representative from the Research Department had noted, the export projections for 1983 and beyond might be on the low side. It was unclear how the remaining domestic expenditure would be distributed as between prices and GDP. The authorities had felt that, for political reasons, it would be important to indicate that the program was aiming at a mild recovery of economic activity, which was certainly desirable, given idle capacity in the products sector. The pace of recovery would, however, depend upon the impact of inflationary expectations on the resumption of normal import and production levels. Of course, the productive base needed resources--capital and labor--in order to operate, and labor would be in ample supply if the current wage policy was continued. The availability of capital, on the other hand, had been reduced by the large outflows of recent years; while the amounts could not be known with great precision, they were estimated at about $12 billion. There were also indications that Argentine assets abroad could be in excess of $20 billion.

Regarding Mr. de Maulde's point that many distortions had arisen in the economy in recent years as a result of inconsistencies between exchange rate, interest rate, and tariff policies, the staff representative observed that the importance of aligning such policies with the projected rate of inflation had been at the very center of the discussions between the staff and the authorities. It was important to ensure that, in future, there would not be abrupt changes in relative prices of the sort that had occurred in 1979 and early 1981 because of exchange rate policy, and again in the third quarter of 1982 because of the extremely complex exchange rate system that had been adopted. That did not mean, of course, that the set of relative prices that had been thought to be acceptable in the program was necessarily the optimum one. For instance, even though there had been a substantial increase in tariffs and prices of fuels, at the end of the program period those prices would still be only at 60 per cent of international levels. The accent of the program, instead, was on a reduction of existing distortions in relative prices with a view to giving the authorities a reasonable chance to meet the program's main objectives.

On Mr. de Maulde's observations about the complexity of the formulation of the net domestic asset test and the test on the net borrowing requirements of the public sector, the staff representative observed that the distinction between the deficit and the net borrowing requirements of the public sector was artificial and did no more than take into account the definition of the deficit that Argentina was using domestically, a definition that treated interest payments corresponding to inflation as being below the line. Viewed exclusively from the standpoint of the public sector, it was conceptually true that interest payments that corresponded to inflation were in fact an amortization because there was a discounting of the stock of debt; but from a macroeconomic standpoint, the more standard presentation of the deficit--which equated the deficit with the net borrowing requirements--was the appropriate one. What needed to be measured was the pressure of the public sector on resources, including the cost of interest payments, which the public sector had to finance in one way or another. Such a measurement was particularly relevant to a situation like that in Argentina where real domestic financial savings had fallen precipitously and where access to foreign sources of finance had virtually dried up. Accordingly, the target had been designed in such a way that most of the financing flows that could be identified on a cash basis would be picked up; those included net foreign financing, net financing from the domestic financial system, and net placements of bonds and bills with the nonbank private sector. However, changes in domestic suppliers' credits or domestic arrears were excluded, partly because such information would not be available in time to determine Argentina's eligibility to purchase under the arrangement, and partly because net changes in those items a priori had to be small.

The net domestic asset test also appeared to be complex in its formulation, the staff representative said; however, de facto it served simply to keep the components of central bank credit within the balance of payments and inflation targets. In other words, the net domestic asset test--which was a net concept--was the mirror image of the balance of payments target.

Regarding the general concern expressed about the authorities' ability to carry out the program, the staff representative agreed that implementation would be difficult. However, the staff had been encouraged by a number of developments. For example, the Minister of Finance had been able to marshal a large measure of consensus among all parties in Argentina--both within and outside the Government--on the course of policies. Also, a number of measures had been taken in recent months that went in the appropriate direction: the exchange rate had been unified and the rate of depreciation of the peso had been accelerated; interest rates had been adjusted, despite considerable opposition by domestic industries; and strong action had been taken by the authorities in the area of public sector prices. To a great extent, the success of the program would depend on the ability of the authorities to hold the line on wages. As indicated in the staff papers, there had not been any wage increase for government workers in January, and the wage adjustment formula was based on the future rate of inflation; the practice of indexing wages to past inflation--together with the risks associated with such an approach--had been eliminated.

The role of the oil sector in reactivation was related not so much to the added value expected in that sector as to the investment to be carried out in gas pipelines, the fertilizer industry, refineries, thermal plants, and so on, the staff representative continued. In general, less emphasis had to be placed on the very modest increment in the level of public sector investments than on the intended modification in the composition of the public investment program toward more labor-intensive, small projects with prospects of paying off rapidly.

In discussing wage policy, a number of Directors had commented on the apparent inconsistency between the profile of the adjustment and the intended improvement in the real remuneration of government employees, the staff representative recalled. The authorities were operating under certain political constraints, and they had had to announce that their policies would be geared to achieving a certain measure of improvement in real labor remuneration. The program, however, was formulated in such a way that the improvement de facto could be brought about only by a deceleration of inflation. As noted in the staff papers, the cumulative nominal increases in government wages were essentially limited under the program to the compounded rate of inflation plus the projected real growth for the economy; hence, to the extent that inflation did not decelerate as programmed, the authorities would be unable to produce the desired average improvement in real government wages.

The staff agreed that there was a need to develop incomes policies, although it would be difficult for the present Administration to launch such an ambitious scheme, the staff representative remarked; such an approach might best be looked at by the incoming Administration. Yet, there was a measure of incomes policy built into the program, in the sense that the authorities had indicated that they would no longer interfere with the process of wage determination in the private sector and that the guidance they would give to the private sector regarding wage adjustments in effect would be the pace of wage increases in the government sector. The authorities would endeavor not to decree adjustments in government remuneration that would trigger wage increases in the private sector at a rate higher than would otherwise result from the free play of supply and demand in the labor market.

In response to a question by Mr. Kafka, the staff representative observed that tax liabilities were indexed to inflation to a significant extent. Taxable income for individuals and net wealth taxes were adjusted on the basis of changes in the consumer price index, while tax liabilities for noncompliance were in principle based on changes in the wholesale price index. The problem was not so much the buoyancy of the tax system as the widespread incentives for noncompliance that were in existence. In that connection, the staff felt that it would be difficult in the short run to quantify the impact of a steady drive against tax evasion; however, the staff had taken into account the fact that revenues under the system of indexing necessarily lagged at a time of accelerating inflation and tended to lead at a time of decelerating inflation. Since the program was geared to a deceleration of inflation, tax collections should automatically rise somewhat in relation to GDP.

The authorities' reliance on export taxes tended to create distortions, the staff representative said; the problem had been a difficult one in Argentina over the years. All efforts at taxing income had essentially failed, with income tax receipts--both from individuals and from the corporate sector--never exceeding 1.5-2 per cent of GDP. Hence, given the state of emergency in which Argentina had found itself, export taxes had been seen as the only way of capturing for the Government part of the windfall income arising from the exchange rate adjustments. In terms of exchange rate policy, of course, the implication was that the peso at the official market rate had to be kept somewhat undervalued, so that the "gain" exchange rate would be more or less at the historical equilibrium rate for the peso.

A number of Directors had pointed to a certain lack of precision with respect to the nature and magnitude of the expenditure cuts that the authorities might be undertaking, the staff representative noted. The general view in Argentina was that, because the public sector had grown considerably in recent years, there was a substantial margin for reducing both current and capital expenditures, particularly on ventures that had not proved very productive. There also was room for reducing the operating costs of the public enterprises. The staff, in discussing with the authorities the scope for reductions, had mainly been guided by past experience; it had noted that drastic cuts in spending had been made in both 1976 and 1977 and that, in those two years, the public sector deficit had dropped from 12.5 per cent of GDP to less than 5 per cent of GDP, largely thanks to expenditure cuts.

Commenting on monetary policy, several Directors had pointed to the short-term nature of the financial instruments in Argentina, the staff representative observed. That feature of Argentina's financial system was certainly not a desirable one; however, the need for short-term instruments was associated with the very high rates of inflation and should therefore be reduced or eliminated over time as inflation rates moved closer to international levels. It should be borne in mind that there had been considerable political resistance in Argentina to any adjustment in the level of interest rates, so that the adjustment that had taken place on January 1 could be regarded as a courageous and radical move. There were indications of strong intermediation in the first 20 days of January, far beyond any potential increase in prices during the month, which suggested that the market had reacted positively to the interest rate adjustment.

In response to a question by Mr. de Maulde, the staff representative remarked that most, if not all, of the credit accommodation to the private sector provided for by the program would be channeled through existing credit schemes. Another Director had wondered about the justification for using seven different types of adjustment indices on the lending side for loans funded by cost-of-living-index deposits. The mechanism was certainly complex, but de facto it was not being used, because there was very scant demand for indexed credits. The justification for the system, as he understood it, was that it allowed the borrower to choose, from among a variety of indices, the index that reflected most closely changes in the borrower's costs.

As to why the changes in the wholesale price index had been adopted as a base for the formula to adjust interest rates, the staff representative commented that the formula applied to the lending rates, which bore a close relationship to producer prices. The producer prices in turn were better reflected in the wholesale price index than in the cost of living index, which was not as broad based and did not incorporate as many tradables.

Regarding questions by Directors on the measure of adjustment in the current account, the staff representative considered that, despite the strong movements in the ratio of the current account to GDP, the adjustment was not particularly drastic. As the staff representative from the Research Department had noted, there had been a bumper crop in 1982/83, and the adjustment in the current account was predicated exclusively on the rebound in exports and the slight decline in international interest rates. Actually, imports were projected to increase by 18 per cent in nominal terms, so that the bulk of the adjustment would be in the capital account. The assumptions about that adjustment were based on past experience, which showed that private capital flows in Argentina had proved very sensitive to interest and exchange rate changes. The program itself conservatively assumed that there would be no net inflows from the international banking system other than the bridge loan and the requested stand-by purchase which, for the purposes of the program, would be treated as reserve liabilities.

The pace of the liberalization of the exchange system over the program period would depend on the extent to which existing arrears could be eliminated, the staff representative commented. The staff had not sought earlier action on the simplification and liberalization of the exchange system, mainly because arrears at end-December 1982 had been at the high level of $2.7 billion.

Replying to questions on the potential implications for credit expansion of the unwinding of the new exchange guarantees and swaps, the staff representative noted that the staff had been guided by the decision of the authorities with regard to the 1981 exchange guarantees, although it hoped that any takeover of private sector loans benefiting from those guarantees would be handled by negotiations with creditors when the private sector loans came due in one year.

One speaker had questioned the usefulness of the $2 billion limit on net new external borrowing, the staff representative recalled. The limit was only an indicative one; the program did not anticipate any net new money from the market, even from foreign suppliers. The limit would apply only in the event that banks once again became willing to lend substantial amounts to Argentina over and above the bridge loan and the requested $1.5 billion medium-term loan. As for suppliers of credit, the staff had assumed no net new money except that implied in the normal functioning of Argentina's legal minimum financing scheme for imports.

The program did not assume any repatriation of private capital, the staff representative from the Western Hemisphere Department observed, and it would be some time before the private sector decided to finance itself or to repatriate capital on any significant scale. The program assumed only that the combination of interest rate policy and exchange rate policy would prevent further capital flight and, perhaps in future, would trigger a small measure of repatriation of capital. Finally, the limits on external debt did not cover the debt of the private sector because, unlike other countries, Argentina had no approval system for private sector debt.

Mr. Coene remarked that, by using two different methods of calculating the current account deficit, the staff seemed to be suggesting that the present exchange rate was out of line with an equilibrium exchange rate; while the formulation in the staff appraisal was somewhat vague about the need for the exchange rate to move, the staff representative from the Western Hemisphere Department had implied that the staff expected the rate to move toward the kind of equilibrium rate that had been employed in the tables.

The staff representative from the Western Hemisphere Department observed that there was a measure of arbitrariness employed in choosing a so-called equilibrium rate. For the purposes of the table, the staff had defined an equilibrium rate by referring to a year in which the external position of Argentina had been reasonably strong--1969. The staff was not passing judgment regarding the level of the exchange rate. The important point to bear in mind was that an appropriate measurement of GDP in U.S. dollar terms had to ignore the peaks and troughs resulting from the violent swings in the peso/dollar relationship that had occurred in 1976-82. The test of exchange rate policy obviously was the behavior of the balance of payments, and the Argentine authorities would need to demonstrate flexibility in the management of interest rate and exchange rate policies in order to produce the desired balance of payments results. The arbitrarily chosen constant exchange rate used in the table to derive GDP in dollar terms had been intended only to facilitate comparison between Argentina's situation and that of other countries, and to ensure consistency over time in the analysis of the behavior of external flows in relation to GDP.

The staff representative from the Exchange and Trade Relations Department, recalling a question by Mr. Dallara, noted that the external debt ceiling included short-term debt. In any case in which the maturity structure of the debt was unfavorable, emphasis on the control of borrowing at all types of maturity--including shorter-term debt--was desirable. The practice on other occasions had been not to include in the ceilings debts with a maturity of less than one year; however, more recently, the coverage had become more comprehensive because members had tended to get into difficulty primarily with shorter-term debt. The entire matter would be discussed in greater detail in the context of a forthcoming general paper on debt issues. It should perhaps be noted that private debt was not normally included in debt ceilings. In principle, as long as the basic policies of a country--including exchange rate, interest rate, and pricing policies--were appropriate, there was no reason to expect difficulties to emerge in the area of private capital flows. That was not to deny that, at times, such problems could arise, and it was possible to conceive of circumstances in which it might be useful to establish guidelines to monitor private capital flows. Some members of the Fund had themselves chosen to monitor both public and private foreign borrowing and, in those cases, the ceilings were formulated to reflect their approach; in general, however, the staff did not include private debt in the ceilings.

On the features of the arrangement, the staff representative continued, in cases of particular uncertainty the guidelines on conditionality allowed for formulation of performance criteria for a relatively short period, supplemented by the establishment of a review clause under which criteria for the remainder of the period of the arrangement would be set. In the case of Argentina, there was indeed uncertainty, but there was also a need for steadiness of policy as well as a need to influence future events by stating in advance what the policy instruments and objectives would be. On balance, therefore, it had been felt more appropriate in the Argentine case to formulate performance criteria for the full period of the arrangement. On another matter, some Directors had referred to statements by the Managing Director in his summing up of the 1982 Article IV consultation regarding the advantages and disadvantages of a shock approach and a gradual approach to adjustment. The choice between a shock approach and a gradual approach was not unlimited; to some extent, it depended upon the availability of financing. The gradualism that was imbedded in the Argentine program at present was related to the amount of resources that seemed likely to be available; if those resources did not materialize, the adjustment would have to be even stronger; to that extent, the actions that would have to be undertaken would represent more of a shock approach. Finally, with respect to the concerns and misgivings expressed by some about the complexity of Argentina's exchange system--particularly its discriminatory features--the staff had been as reassured as other Directors by Mr. Teijeiro's statement at the outset of the discussion (EBM/83/17).

Mr. Teijeiro, remarking first on matters concerning the compensatory financing facility request, assured Executive Directors that his Argentine authorities had paid special attention to the potential risk of overcompensation and were convinced that no such overcompensation would occur. The projections of export value for the two postshortfall years had been set at conservative levels during the discussions with the staff, and there was at present clear evidence that the agricultural output would be far larger than that originally foreseen. The authorities were even considering a request for a larger purchase. It might be possible to shift the shortfall period to cover the end of 1982, which would eliminate the effects that the multiple exchange rates during the third quarter of 1982 might have had on the volume of exports. Any enlargement of the purchase that might eventually be agreed would be directed only toward the elimination of arrears before June 1983, a matter to which his authorities were strongly committed as a way of normalizing relations with the international banking community.

He could not share the pessimism expressed by some Directors about the potential for a successful implementation of the program, Mr. Teijeiro said. The Argentine authorities were fully committed to the implementation of the program and to continuous consultation with the Fund. It was possibile that a request for a purchase under the extended Fund facility would be put forward when the new government took office; at that time, discussions could cover more structural aspects of the economy and could, for example, take account of the useful suggestions by Mr. de Groote on the hydorcarbon sector.

With regard to the appropriateness of interest rate policy, Mr. Teijeiro noted that the rule of the three-month moving average would imply a positive real interest rate if inflation continued its recent downward trend from an average of 21 per cent a month in the third quarter of 1982 to an average of 11.3 per cent a month in the fourth quarter of 1982. Several factors led his authorities to feel that the equilibrium interest rate would be no higher than the rate of inflation. First, the equilibrium rate was dependent upon the level of the real exchange rate, which was unlikely to attain the record levels of the past; hence, the equilibrium level of the real interest rate should be lower than usual. Moreover, the adjustment that had occurred during 1981/82 had caused a deterioration in real wages and, consequently, an increase in capital income. Such a redistribution must lead to an increase in the rate of private savings in the economy. Given the increase in savings in the public sector and the sluggishness of private investment, the equilibrium interest rate should decline significantly. In any event, as noted in the policy memorandum, the Argentine authorities considered that interest rate and exchange rate policies should be properly coordinated; and his authorities were prepared to manage both with sufficient flexibility to achieve the targets of the program.

Regarding Mr. de Maulde's question on the possible need for drastic financial reform, Mr. Teijeiro observed that the authorities had inherited the current financial system just at the point at which it had begun to be implemented. The complexities involved in the transition had led the authorities to the conclusion that the costs to the banking system would make it impossible to carry out another reform in such a short period of time. In any event, they held the view that a fractional reserve system would be preferable, and they had begun to move toward such a system by reducing reserve requirements below 100 per cent from January 1, 1983.

With respect to efforts to assign responsibility for the current situation in Argentina, Mr. Teijeiro considered that, particularly on the matter of the growth of foreign debt, the responsibility should clearly be shared by Argentina and by the international banking system, although it would be difficult, if not impossible, to determine which of the two sides should bear the greatest burden of responsibility. External shocks had clearly played an important role in the problem, although that did not imply that mistakes had not been made in economic policy management. It was nonetheless doubtful that the policy mistakes had been any more serious than those made by other countries facing similar circumstances but enjoying greater political stability. Perhaps the issue should be looked at in a more positive manner by thinking in terms of the ideal domestic economic policy that could have been followed in the framework of an unstable world.

In general, financial crises and wide fluctuations in output could have been avoided if external shocks had been counterbalanced by economic policy over the cycle, Mr. Teijeiro commented; for example, economic policy might have been addressed in a way that would have reduced foreign indebtedness when the terms of trade had been abnormally high. Such an approach could serve as an appropriate anticyclical policy for any country experiencing wide fluctuations in its terms of trade, although many other important elements would need to be present for such an ideal solution to be feasible. First, governments would have to be skillful in predicting normal terms of trade; second, they would need to resist the political temptation of taking advantage of a boom period; and, third, even after the first two conditions had been met, they would need an international banking system that was prepared to lend when the prospects for the country were not bright. Experience demonstrated that the potential for achieving a successful anticyclical policy of the sort he had mentioned was limited in most countries; more important, and more feasible, was a stable economic policy, particularly in the large industrial countries.

The Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal contained in the staff report for the 1982 Article IV consultation with Argentina. They noted that the severe economic crisis confronting Argentina since the middle of 1982 signaled an urgent need for major changes in policies, and they welcomed the decision of the authorities to introduce policies to strengthen the balance of payments, reduce inflation, and set the stage for a revival of output.

Directors noted that the objectives of Argentina's stabilization program were ambitious; indeed, some raised questions about whether the policies adopted, or in prospect, would be adequate to achieve the targets. In particular, they stressed the major improvement in confidence that would be required in the short term to produce a reversal in the capital account to net inflows in 1983. Taking into account the scheduled general elections in Argentina, Directors indicated their awareness that, in present circumstances, the chosen strategy probably was the only one on which a measure of political consensus could be built.

In stressing the difficulty of the task that lay ahead, Directors noted that the Argentine economy had for years suffered from a lack of steady policy direction needed to inspire confidence. The present program left little or no margin for error, and all its major elements would need to be fully implemented. Courage and determination would be required if the authorities were to meet the challenge; in that regard, Directors welcomed the readiness of the Argentine Government to take additional measures if necessary.

Directors emphasized the vital role that the abandonment of wage indexing would play in bringing about the desired deceleration of inflation, and they stressed that the targeted reduction in the public sector deficit was crucial to the success of the Government's anti-inflation efforts. While the correction of wage policy would be of direct assistance in the area of fiscal adjustment, Directors welcomed the intention of the authorities to keep a tight rein on other expenditures, and to bring the prices of public sector services more into line with costs. In that respect, they were encouraged by the progress that had already been made in raising public sector prices and tariffs in real terms. They observed, however, that further action would be required over the course of the program period to meet fiscal objectives. For example, there appeared to be scope for broadening the tax base by, inter alia, discontinuing the granting of tax amnesties and eliminating incentives for tax evasion. They also noted that, in the medium term, more comprehensive changes in the tax system would be in order. Reliance on export taxes--which tended to distort resource allocation--could be only a temporary expedient.

Directors observed that the magnitude of the necessary fiscal adjustment was dictated, to a large extent, by the need to contain the public sector's claim on domestic financial savings. In that connection, it was recalled that real money and quasi-money balances had dropped precipitously in the second half of 1982, and Directors noted that the correction of interest rate policy introduced at the beginning of 1983 had been long overdue. The increase in interest rates to a level at least equal to the rate of inflation would foster the growth of financial savings, they felt. But many Directors held the view that further increases in interest rates would be required in order to provide the resources needed to finance the public sector deficit and accommodate part of the credit demand of the private sector without distorting the allocation of resources. Directors stressed, moreover, that a full-fledged recovery of the economy would require resumption of foreign lending to the private sector and a substantial measure of capital repatriation.

Directors agreed that the lack of consistency between interest rate and exchange rate policies in 1982 had accounted, in good measure, for the large differential between the commercial exchange rate and the parallel market rate and, consequently, for heavy capital flight. They welcomed the November 1982 unification of the exchange markets and the present policy of flexible management of the unified exchange rate. They hoped that such a policy would help to preserve the competitiveness of the Argentine economy and, together with an interest rate policy similarly guided by domestic price behavior, would stimulate the volume of financial savings and ensure their retention in Argentina.

Directors pointed to the complexity of Argentina's exchange and trade arrangements and expressed concern about the potentially adverse effect of existing restrictions on resource allocation and on the level of economic activity. They urged the authorities to move boldly toward simplifying existing practices as balance of payments conditions improved. They welcomed the authorities' commitment to proceed with a comprehensive review of the exchange and trade system midway through the program period and, at that time, to reach precise understandings with the Fund on a schedule for the elimination of existing restrictions on payments and transfers for current international transactions by the end of the year at the latest.

A number of Directors referred to the restriction described by the staff at the outset of the meeting that discriminated against a member country of the Fund, and they underscored the importance of discontinuing the practice at the earliest possible date or, at any rate, before the May review. The Board welcomed Mr. Teijeiro's statement that the Argentine authorities "will make their best efforts to ensure that all exchange arrangements that are in effect beyond the May review, including any restrictions that may temporarily remain, will be completely nondiscriminatory in both character and operation." The staff will review the situation in the context of the understandings as a performance criterion, to be reached between Argentina and the Fund by July 31, 1983 under paragraph 4(f) of the stand-by arrangement. If any discriminatory practices were still to be in effect at that time, high priority would be given to their rapid termination; indeed, such termination would be essential to reaching the needed understandings.

Directors commented at some length on Argentina's balance of payments difficulties and noted in particular the severity of the debt problem. They expressed satisfaction at the timely efforts made by the international banking community--through a short-term loan and a medium-term loan being arranged in connection with Argentina's request for a stand-by arrangement with the Fund, and through understandings to restructure Argentina's external debt--to help Argentina eliminate arrears and alleviate the debt service burden in the period immediately ahead. They stressed that such emergency financial assistance attested to the catalytic role that the Fund could play in securing international cooperation to assist countries in difficulty. At the same time, they noted that the need for emergency action underscored the crucial importance of the Government's efforts to restore confidence in the economy, and thereby to reverse the capital outflow. It also underlined the need to exercise utmost prudence in relying on foreign sources of finance and to hold external borrowing to amounts and terms that are consistent with the economy's debt-carrying capacity.

In general, Directors saw the situation in Argentina as very serious and allowing no room for any slippage in the program; an effective, steady, and determined implementation would be crucial for the country. Many Directors noted that the full rehabilitation of the Argentine economy would require a medium-term approach. They hoped that, following the successful implementation of the present program, an appropriate longer-term arrangement could be worked out with the Fund.

The Executive Board then took following decisions:

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Argentina's exchange measures subject to Article VIII, Sections 2 and 3, in the light of the 1982 Article IV consultation with Argentina conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund welcomes Argentina's intention to eliminate progressively its multiple currency practices and restrictions on payments and transfers for current international transactions in the context of the adoption by Argentina of comprehensive policies for balance of payments adjustment, which are supported by a stand-by arrangement with the Fund. In the meantime, the Fund grants approval for the retention of the practices described in items 1(a)-(b) and items 2(a)-(e) of Appendix IV of EBS/83/8, until July 31, 1983.

Decision No. 7311-(83/18), adopted
January 24, 1983

Stand-By Arrangement

1. The Government of Argentina has requested a stand-by arrangement for the period January 24, 1983 to April 23, 1984 for an amount equivalent to SDR 1.5 billion.

2. The Fund approves the stand-by arrangement set forth in EBS/83/8, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7312-(83/18), adopted
January 24, 1983

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request by the Government of Argentina for a purchase of SDR 520.1 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund notes the representations of Argentina and approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7313-(83/18), adopted
January 24, 1983

2. FIJI - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with Fiji (SM/82/242, 12/29/82; and Sup. 1, 1/11/83). They also had before them a report on recent economic developments in Fiji (SM/83/8, 1/10/83).

Mr. Jaafar made the following statement on behalf of Mr. Habib:

The staff report on the 1982 Article IV consultation with Fiji (SM/82/242) and the report on recent economic developments (SM/83/8) give a very balanced and fair assessment of the recent economic developments, policies, and prospects for the Fiji economy. It is obvious that the Fiji economy in 1982 has felt the full impact of the recession taking place in the major industrial countries and in neighboring countries. In addition, protectionist tendencies in a number of potential markets have further weakened opportunities for investment and growth. With a difficult international economic situation and a weak market for Fiji's major export commodities, the growth in the economy stagnated in 1982 after achieving an average growth rate of 5 per cent in the previous three years. For exactly the same reasons it has become difficult for the Government to meet either the growth target of 4 per cent set in the development plan or the diversification objectives.

The weakness in the domestic economy and the depressed state of the economies of Fiji's major trading partners has led to a sharp reduction in the inflation rate from 11 per cent in 1981 to 7 per cent in 1982. It is expected that the inflation rate will decline further in the course of 1983. At the same time there was an improvement in the balance of payments, which moved from a deficit of SDR 16 million in 1981 to a surplus of SDR 17 million in 1982 because of the depressed level of economic activity and the decumulation of motor vehicle inventory built up in the previous year, presumably in anticipation of a move by the Government to reintroduce the motor vehicle import quota that was lifted in 1980. Another factor contributing to the improvement in the balance of payments was the growth in earnings from tourism, which is estimated to have grown by 14 per cent in 1982 to a record level of SDR 139 million.

The staff notes in its report that, after remaining at a modest level in relation to GDP over the years, the fiscal deficit increased significantly to 6 per cent of GDP in 1982.

This was due partly to cost overruns in some public sector capital projects and, more significantly, to revenue shortfall arising from the depressed level of economic activity and lower level of imports. My authorities are well aware of the difficult fiscal situation that emerged in 1982 and they have taken this into account in formulating the 1983 budget. As a result of the completion of certain large capital-intensive projects in 1982, it has been possible to introduce a cutback of about 30 per cent in the capital budget, and the increase in the operating budget has been kept as low as possible. The Government has decided that, among other economy measures introduced in the 1983 budget, the intake of new personnel into the civil service will be restricted to the new graduates in teaching and medicine, which together is expected to cost only $3 million. In addition, new revenue measures have been introduced and it is estimated that the net result of the revenue-generating and expenditure-saving measures will be to reduce the level of fiscal deficit from 6 per cent of GDP in 1982 to 4 per cent in 1983. The financing of the deficit is not expected to pose a major problem and, in view of the current balance of payments position, it is expected that much of the financing will be from domestic sources. Hence, the external debt situation is not likely to increase much in 1983 although pressures for external borrowing might increase in the medium term as private sector demand for credit picks up. My authorities in Fiji are aware of the potential financing difficulties and are determined to continue with cautious fiscal policy in future.

Since the middle of 1981, the Fiji authorities have pursued restrictive credit policies in order to support the balance of payments. The banks were asked to cut back on nonessential credit to the private sector. Later in 1981 interest rates were increased, and in 1982 positive real rates of interest were maintained. Domestic credit increased by 21 per cent and broad money (M-3) rose by only 6 per cent in 1981. For the 12 months ended September 1982, domestic credit growth was reduced to 17 per cent and broad money growth was 9 per cent. In addition, my authorities have met with some success in their policy of directing credit away from import financing and other low-priority classes of lending and directing them to high-priority sectors of the economy. This policy should ensure that real sector developments would not be impeded by lack of finance.

Incomes policy in Fiji has met with a measure of success. Wage growth has been kept slightly below the inflation rate in recent years and it has helped engender good industrial relations. However, certain difficulties have arisen in recent years with the decline in export prices, on the one hand, and the indexation of incomes in the nontraded goods sector on the other. This has led to the deterioration in the terms of trade of the export sector vis-à-vis the nontraded goods sector. Another adverse impact of the high wage rates in recent years has been on unemployment, which is currently estimated at over 11 per cent of the labor force. My authorities are gravely concerned with the situation and only last month Fiji's Prime Minister pleaded with the representative of organized labor on the Tripartite Forum to accept a wage freeze for the current year. There is evidence that labor groups are getting increasingly concerned about the need for maintaining jobs and for creating new jobs and indications are that they may be willing to accept the freeze proposals for the current year.

Finally, I would like to express my Fiji authorities' and my own appreciation to the staff for the thorough analysis of the problems and the prospects, and for the fair and balanced appraisal of the Fiji economy.

Mr. Yamashita observed that, in response to a sharp deterioration in the balance of payments in 1981, the authorities had initiated restrictive demand mangement policies. Monetary policy--especially in the area of domestic credit extension to the private sector--had been tightened markedly and, as a consequence, considerable progress had been made in 1982 in the balance of payments and the fight against inflation. On the external side, the current account deficit had declined to 5.8 per cent of GDP from 13.4 per cent of GDP in 1981, while the overall balance had moved into surplus. At the same time, the rate of increase in consumer prices had decelerated to 7 per cent in 1982 from 11 per cent in 1981.

Notwithstanding the improvements he had mentioned, there remained a few areas of concern to which the authorities' adjustment efforts should be addressed, Mr. Yamashita continued. The external improvement in 1982 had been mainly due to a substantial decline in imports, reflecting the decline in private final demand and the decumulation of stocks. In fact, exports had shown little or no increase in real terms in recent years. In the circumstances, any pickup in imports to a more normal level could lead once again to external weakness. Also, adjustments in fiscal policy had been slower than those in monetary policy, and the overall budget deficit in 1982 had reached 5.9 per cent of GDP, exceeding the original target of 3.8 per cent of GDP, due to a shortfall in revenues and an overrun of capital expenditures.

It was thus apparent that the two main tasks of the authorities in 1983 were to strengthen the export sector while reducing the overall budget deficit, Mr. Yamashita remarked. The authorities had appropriately given high priority to export diversification in the Eighth Development Plan; a more flexible exchange rate policy might also play an active role in promoting exports, especially nonsugar exports. He noted that the Fiji dollar had been pegged to a basket of currencies--which reflected the country's import flows--and had shown a small appreciation in real terms in recent years. The appreciation had unfortunately exacerbated the impact of the decline in the external terms of trade on the profitability of the export sector. In that context, the recent change in the currency basket rates and the subsequent reversal in the exchange rate movement were to be welcomed. Further efforts toward a more flexible exchange rate policy would be desirable, together with greater flexibility in the wage determination process. Since the establishment of the Tripartite Forum in 1977, the unions had voluntarily limited wage settlements to guidelines set by the Forum on the basis of the previous year's increase in the consumer price index. Unless the system was modified, a flexible exchange rate policy would serve only to create an increase in the consumer price index, which would in turn be transmitted to a wage increase. Consequently, the improvement in the profitability of the export sector would be short lived. He therefore strongly supported the view of the Minister of Finance that nominal wage increases would have to be reduced below the inflation rate.

With regard to the targeted reduction in the overall budget deficit, Mr. Yamashita said that it was encouraging to note that the 1983 budget was aimed at lowering the overall deficit to 4.1 per cent of GDP through new tax measures and through a reduction in capital appropriations. Like the staff, however, he was concerned about the rapid growth in certain current expenditures, particularly wages. One way of containing the growth in the wage bill was to modify the wage determination process along the lines suggested by the Minister of Finance. Another way was to curtail the number of civil service personnel; in that regard, the authorities had already taken a commendable decision not to fill those posts that had become vacant in 1982. However, he noted that the impact of that decision had been largely offset by the creation of new posts for graduates in teaching and medicine as part of the Government's effort to meet its obligation to provide employment for individuals in those fields. He would be interested in hearing staff elaboration on the history of that obligation and its possible impact on the future growth of wage and salary bills. Finally, on the revenue side, he wished to express his support for the Government's intention to re-examine the tax system with a view to achieving a more balanced and growth-oriented revenue structure.

Mr. Ainley stated that, in general, he could agree with the remarks in the staff appraisal. The Fiji economy, like many others, was clearly passing through a difficult period, and there seemed little prospect that the pressures on the Government's finances and on the balance of payments would ease over the short to medium term. Commendable progress had been made in reducing the rate of inflation, although that progress might be jeopardized by recent and prospective wage developments. The improvement in the external accounts in 1982 might also be short-lived, given the poor outlook for exports and the continued worsening in the terms of trade. The authorities should be commended for maintaining the momentum of development, despite growing fiscal constraints. In particular, he encouraged them to take further action toward diversifying export earnings away from sugar, despite the problems associated with doing so. There seemed to be little to be gained by delay in the area of export diversification, especially considering the unfavorable prospects for the sugar sector and the likely deterioration in the external position through the period to 1985.

The more restrictive stance of demand management policies in Fiji since late 1981 was to be welcomed, Mr. Ainley continued. Fiscal policy on the whole had been well balanced, although the overall budget deficit was currently at a very high level; he endorsed the intention of the authorities to reduce the deficit in absolute terms during 1983 through the measures outlined in Supplement 1 to SM/82/242 and in Mr. Habib's statement. Like Mr. Yamashita, he looked forward to the promised review of the tax system and of the pricing policies of public enterprises.

Strict control over government expenditure would also be required to meet the authorities' stated objectives, Mr. Ainley remarked. However, the scope for reducing public expenditure in line with the slower growth in revenue was apparently restricted by the rapid growth in the public sector wage bill. It therefore seemed important to devise a more appropriate wage policy, not only to improve the Government's finances and make sufficient resources available for development but also to limit inflationary pressures and maintain Fiji's competitive position. He had noted with interest Mr. Habib's comments about a possible wage freeze in 1983, and he would appreciate further elaboration on that matter. Like the staff, he felt that wage policies should be closely coordinated with exchange rate policy, although he would place greater emphasis on the desirability of securing lower wage growth in the nontraded goods sector than on exchange rate adjustment to redress the relative deterioration in the export sector. Also, it would be useful if account were taken of changes in the external terms of trade in the formulation of future wage guidelines.

On the monetary side, the Central Monetary Authority had moved effectively to tighten policies in recent months, and the results had been impressive, Mr. Ainley said. However, he noted from page 9 of the paper (SM/82/242) that the authorities were explaining the large increase in the domestic financing of the budget deficit in 1982 by reference to the improved balance of payments position. If private sector demand for credit should pick up--as was expected during 1983--and government borrowing from the banks continued at a high level, an undesirable rate of monetary growth could result. He therefore hoped that the authorities would continue with their cautious credit policies in the coming months.

For the medium term, he welcomed the recent moves by the Central Monetary Authority to deregulate and broaden the financial system, Mr. Ainley commented. Despite the unfavorable external environment, a flexible stance on interest rates and the possible introduction of bond issues could help to stimulate private savings and allow part of the budget deficit to be financed by the nonbank private sector.

Turning to the external side of the economy, Mr. Ainley commended the authorities for their adherence to a liberal exchange system during a time of world recession. Unfortunately, balance of payments prospects were not encouraging; and the official forecast--as the authorities themselves had noted--had an optimistic bias. The sharp fall in import values in 1982 was unlikely to recur in 1983, and the projected increase in sugar sales might not materialize, especially if world prices remained depressed. Even though tourist earnings might be boosted by the depreciation of the Fiji dollar against the U.S. dollar during 1982, they could be offset by the effects of the continued relative strength of the Fiji dollar against the currencies of Australia and New Zealand, which were the main source of tourist earnings in Fiji. He shared the staff's precautionary attitude toward external borrowing, and he endorsed the need to "husband carefully" Fiji's borrowing ability and to improve the procedures for monitoring external debt.

The section of the staff paper on medium-term issues and the comparison of developments in 1980-82 with those in the 1974-78 cycle were particularly helpful in providing a framework within which to assess the adequacy of present policies and the need for further adjustment, Mr. Ainley said. He encouraged the staff to include similar forward-looking analyses in Article IV consultation reports for other countries where possible. On a somewhat different matter, he noted from the paper that the structural problems faced by Fiji were similar to those of other small island economies lacking a strong resource base. The country was heavily dependent on agricultural exports and tourism and was extremely vulnerable to external factors beyond its control. Because of that vulnerability, it was necessary for the authorities to maintain reserves at a relatively high level, especially since access to international capital markets was limited. It might be useful if the staff could examine as a general issue--perhaps in a separate paper--the extent to which small island economies faced common problems and whether any generally applicable lessons could be drawn from the design of adjustment policies or programs for such members.

Mr. Prowse observed that Fiji was a small but relatively successful island economy with a per capita income of about $1,800. The Government had managed to maintain some real growth despite very adverse external circumstances, and it had made notable advances in reducing inflation. Hence, the GDP deflator--which had been 20 per cent in 1980 and 5.3 per cent in 1982--was estimated to be only 3.4 per cent in 1983. In general, it could be said that the Fiji economy was a model for some of its smaller regional neighbors with whom it shared the problems of small island economies. In that respect, he could warmly endorse Mr. Ainley's suggestion that the staff should conduct a study of such economies. He had no doubt that the study would give weight to his long-held view that such economies experienced distinctive or special problems.

With a moderate population growth of less than 2 per cent and a significant resource base, Fiji was one of the island economies that probably had the potential for complete financial independence, given satisfactory economic management over the coming decade or so, Mr. Prowse commented. Still, there were problems with respect to the budget deficit and the external balance, and he accepted the staff analysis and appraisal of the difficulties in those areas.

He endorsed Mr. Yamashita's remarks on exchange rate policy and the staff comments on the external debt situation, Mr. Prowse said; he also wished to underline the staff view that the emerging debt situation could prove difficult to manage within a few years. The debt service ratio had moved from 4 per cent in 1981 to 7 per cent in 1982; and it was expected to be 9 per cent in 1983 and 11 per cent in 1984. The authorities were apparently fully aware of the problems, and he hoped that they would pay appropriate attention to resolving them.

Another point deserving of emphasis was the problem of wages, which could not be divorced from the external sector, Mr. Prowse considered. There was a serious danger of a wage increase-exchange rate devaluation spiral and, in that regard, the staff should perhaps have given greater emphasis to the need to restrain wage growth in the coming period. On page 16 (SM/82/242), the staff had noted that, in 1983, large real gains for wages were projected. If they were obtained, in his view, they could lead to an unsustainable situation. The authorities were apparently aware of the risks involved, and Mr. Habib's remarks on the matter were encouraging. However, the previous wage guidelines were becoming increasingly inappropriate in a situation in which other sources of cost and price increases were moderating. The wage adjustments that had been made thus far would tend to slow the reduction in the rate of inflation and, while the achievements in wage restraint and in industrial relations over the previous decade were commendable, the need for rethinking the approach in those areas in current circumstances was evident. He hoped the authorities would double their efforts and their commitment to achieving a viable wage and income growth.

The section on price controls in the staff report could have been expanded, Mr. Prowse suggested. He presumed that the total impact of price controls was not great in Fiji, and the staff had provided an informative paragraph on the matter on page 11. However, there was no consideration of price controls in the staff appraisal, and he wondered whether the staff had any view on the effect of such controls on resource allocation, especially given the serious structural problems in the economy. In particular, he wondered whether the staff felt that price controls would have some effect on the balance between the export and nontraded goods sectors of the economy in terms of their respective profitability. The data in the paper seemed to suggest that any effects thus far had been quite modest, implying that price controls could perhaps be eliminated; he would appreciate staff comment on that matter.

Mr. Salehkhou, recalling the widely held view that the recession in major industrial countries was having a severe adverse impact on developing countries' economic activity, development policies, and adjustment efforts, noted that the assertion was particularly relevant in the case of small countries like Fiji. Such countries often had limited domestic markets, and the major sectors of economic activity were to a great extent vulnerable to adverse international developments. In such circumstances, Fiji's economic difficulties--particularly the pressures on its external payments and budgetary balance--would probably be alleviated only after some economic recovery in the markets of its major trading partners.

Economic performance in Fiji during 1981 and 1982 had been remarkable, given circumstances in the international economy, Mr. Salehkhou said. Although the relative improvement in the balance of payments and inflation had been partly due to the stagnation of economic activity, it was clear that Fiji's cautious policies had played an important role in containing domestic and external imbalances. The fact that the authorities intended to continue with their restrictive policies was thus to be welcomed.

The 1983 budget was a good example of the efforts of the authorities to cope with present difficulties, Mr. Salehkhou considered. The authorities themselves apparently shared the staff view that the major burden of reducing the budget deficit--which was low compared with the deficits in most developing countries--would have to be borne by expenditure cuts. They had reduced capital expenditures by 27 per cent and had allowed for only a small increase in operational expenditures; at the same time, they had been negotiating with labor unions for a wage freeze in the current year. Appropriately, the expenditure cuts had been complemented by revenue-raising measures; the authorities were stimulating exports through the removal of some export duties and more than compensating for the resulting loss to the budget by increasing a number of tariffs and excise taxes. On a related point, he wished to join those speakers who had called on the Fiji authorities to give serious consideration to a diversification of exports.

Mr. de Groote remarked that Fiji was an economy with a very competent and responsible civil service, an industrious population, a harmonious society, few income discrepancies, and important investments in fundamental areas such as hydroelectric energy production. There appeared to be only three major problem areas. First, it was regrettable that the exchange rate had appreciated, since the move had compounded the difficulties already resulting from the deteriorating terms of trade. Second, it was not appropriate to allow wages to increase faster than prices, because such a situation tended to further the disequilibrium. It was particularly regrettable that indexation was continuing in areas not exposed to foreign trade and in the areas producing nontraded goods.

Third, he was concerned about the budget situation, Mr. de Groote commented. In particular, he was worried that the ability of the authorities to cover the deficit without recourse to foreign borrowing had come about mainly because of a recession-induced improvement in the balance of payments situation. When the economy began to move out of the recession, much more effective management would be required. It was satisfying to note that basic investments had already been implemented and that the balance of payments would not be further burdened by borrowing for such investment, but the authorities would need to maintain their record of cautious management in future.

Mr. Williams stated that he was in broad agreement with the staff appraisal. Economic growth in Fiji had virtually stagnated in 1982, following an impressive performance in the previous three years. The authorities should be worried about the significant deviation from the targets originally set down in the Eighth Development Plan and about the potential for a significant undershooting of targets through 1985. There could be little doubt that international economic prospects were highly uncertain. However, it would be a mistake for the authorities to fail to make the necessary revisions in the Plan, since to do so would create an impression of indecision in macroeconomic policy that would exacerbate the difficulties facing Fiji's small and open economy. The Plan itself was a thorough and comprehensive one, providing the appropriate medium-term context within which macroeconomic policies could be framed and evaluated; and it would be unfortunate if it were not revised to take account of current economic circumstances. The staff papers had usefully analyzed the Plan, and he hoped that a similar approach could be followed in other cases in which medium-term development programs played an important role in framing macroeconomic policies.

A major weakness during 1982 had been in the area of fiscal policy, Mr. Williams continued. The fiscal deficit had considerably exceeded original estimates, and he therefore welcomed the authorities' commitment to reducing it from 6 per cent of GDP to 4 per cent of GDP in 1983 through fiscal restraint. He would be interested in hearing staff views on the prospects for success in attaining that objective and would welcome staff comment on any specific plans to reduce expenditures and increase revenues.

Noting the contribution to adjustment that had been borne by monetary policy since mid-1981, Mr. Williams said that he shared the view of the staff that monetary policy responses had been effective but tardy, which suggested the need for prudence in setting monetary policy in future, especially given the uncertainties surrounding the fiscal and balance of payments prospects of Fiji. He welcomed the increasing role assigned to market forces in the determination of interest rates and hoped that such a trend would be continued.

With respect to the external sector, Mr. Williams observed that the appreciation of the exchange rate in recent years had clearly had a number of adverse consequences. He agreed with the staff that a more active exchange rate policy could contribute to an improvement in the internal terms of trade of the export sector vis-à-vis the nontraded goods sector, thus providing greater incentives to those sectors earning foreign exchange. Such a development could be of major benefit as the authorities sought to further diversify exports.

Mr. Malhotra noted that the authorities' successful efforts to tackle inflation and balance of payments difficulties in the midst of an unfavorable external economic environment had been clearly brought out in the staff papers. The staff had also pointed to a number of difficulties, including the rising fiscal deficit, which had reached 6 per cent of GDP in 1982. Demand within the economy had been slack, and the lack of competition for credit had allowed for the deficit to be easily financed. It would nonetheless be important to keep the budget deficit under control in future. There was an increasing tendency in many economies to look toward foreign financing to cover large budget deficits. In Fiji's case, the debt service burden was at present quite low but was likely to rise in future; it was therefore appropriate that the authorities were determined not to resort substantially to additional foreign borrowing.

The success achieved by the authorities in bringing inflation under control and making improvements in the overall balance of payments was commendable, Mr. Malhotra said; however, attention should be paid to difficulties in other areas. In particular, caution would need to be exercised in the area of wages; he welcomed the authorities' proposal to implement a wage freeze.

The Deputy Director of the Administration Department, head of the mission to Fiji, observed that the authorities were fully aware of the problems involved in finding an appropriate mix of wage and exchange rate policy. Because the wage guidelines were based on past price increases, an acceleration of inflation tended to lead to real declines in wages, while falling inflation could lead to real wage increases, a development that was foreseen for 1983. Still, average wages over the previous three years had increased somewhat less than the previous year's inflation rate.

The authorities were aware that such increases in wages in the non-traded goods sector had aggravated the impact that adverse developments in the terms of trade and an appreciation of the exchange rate had had on profitability in the traded goods sector, the Deputy Director continued. In the Tripartite Forum, the Government had therefore proposed that terms of trade changes should be reflected in the wage guidelines; however, both the employers and the trade unions had rejected that proposal for varying reasons. At present, the authorities were attempting to reach agreement within the Tripartite Forum for a wage freeze. It was not yet clear whether discussions in the Forum would lead to such a freeze, although the staff understood that there was serious concern by the trade unions about the unemployment situation and that consideration was being given to providing greater opportunities for growth in employment rather than increased earnings for those already employed.

The prospects for success on the wage front were closely related to the effort to contain budget expenditures, mainly because the most rapidly growing items in the budget had been the wage bill and interest payments, the Deputy Director observed. Expenditures for materials and supplies had declined in real terms for four years, and investment expenditures had declined in 1982 and were expected to continue to decline through 1984, as two major projects were completed.

In the area of price controls, the Deputy Director noted that only 33 items were controlled. Of those, 21 items were imported, and a good proportion of them had been placed under such controls because of the licensing arrangements that had been established to protect local production from imports. The authorities felt that, once the licensing protection had been provided, the firms should not be allowed to exploit a quasi-monopoly situation by increasing prices, and it was for that reason that their prices were controlled. However, the staff had found increases in the prices of controlled items to be similar to increases in the general price index and therefore felt that no serious distortions were being created by the controls.

A question had been raised by Mr. Yamashita about the impact on the budget in future years of government commitment to provide employment for graduates in the fields of health and education, the Deputy Director recalled. Some estimates had been presented in the budget, and it was his understanding that the commitment was not a formal one. However, since the Government controlled the number of students allowed into schools that prepared candidates for the medical and teaching professions, it felt some obligation to provide employment to the graduates of those schools. The impact was expected to be felt mainly in the educational field where the number of students was greater; and, for the period 1983-85, the effect on the budget would be equivalent to about 2 per cent of the 1983 operating expenditures. However, half the planned increase in government wages and salaries for the period 1983-85 would come from the expected increase in compensation for medical and educational workers.

Efforts to reduce the budget deficit were also being undertaken on the revenue side, the Deputy Director commented, although the Government did not at present feel that it would be appropriate to further increase income taxes, which was the major source of revenue in Fiji. A review mission from the Fiscal Affairs Department would be studying Fiji's fiscal system some time during 1983 in order to identify other sources of revenue--perhaps indirect taxes--that could help to reduce the budget deficit.

Mr. Jaafar considered that the staff had clearly answered all the questions raised by his colleagues, whose views he would convey to his authorities.

The Chairman made the following summing up:

> Executive Directors agreed with the appraisal contained in the staff report for the 1982 Article IV consultation with Fiji. They noted the near stagnation of economic growth in 1982, the marked decline in inflation, and the significant improvement in the balance of payments despite a further deterioration of the terms of trade. With a fiscal policy stance that had led to a large increase in the public sector deficit in 1982, the burden of adjustment had fallen on monetary policy.

A tighter credit policy during the year had slowed the growth of credit in 1982, and interest rates had been raised to real positive levels.

Prospects for 1983 are for a resumption of GDP growth and a continued slowing of inflation. Directors stressed that, although balance of payments projections showed a further decline in the current account deficit, the authorities should pursue cautious financial policies, particularly in view of the uncertainties in the international economic environment. Directors expressed concern about the deterioration in the budgetary position in 1982 and welcomed the authorities' intention to reduce the overall budget deficit in 1983. In that regard, they underscored the need to contain the fiscal deficit within the 4 per cent of GDP limit targeted by the Government. They agreed that it would be necessary to accompany the reduction in the deficit with a cautious credit policy and, in particular, to limit the Government's recourse to the banking system within the confines allowed by the evolution of private sector credit. However, in the search for a sustainable budgetary position more attention would have to be devoted to containing the growth of current expenditures, Directors said. In that respect, they noted the crucial impact that the wage bill had had on the increase in current expenditures and they shared the authorities' concerns in that regard. They therefore welcomed the Government's effort to contain the increase in nominal wages and, in particular, the consideration that was being given by the social partners to a wage freeze in 1983.

Commenting on the medium-term strategy of economic diversification contained in the Eighth Development Plan, Directors noted that savings and growth performance were well below the Plan's targets; however, they felt that the overall strategy should place the economy on a more stable growth path and reduce the vulnerability of the external position. In that connection, they pointed to the role that an appropriate and sufficiently flexible exchange rate policy could play in stimulating export growth and diversifying the export base, and they welcomed the recent change in the currency basket and the consequent reversal of the effective appreciation of the currency.

Directors commented that heavier than expected reliance on external borrowing to finance public sector investments had led to a rapid increase in the debt service ratio. While noting that the level of the external debt remained comparatively low, Directors shared the authorities' concern over its rapid increase; and they welcomed the intention to monitor more closely the evolution of private sector debt.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/17 (1/24/83) and EBM/83/18 (1/24/83).

3. MAURITIUS - TECHNICAL ASSISTANCE

In response to a request from Mauritius for technical assistance, the Executive Board approves the proposal set forth in EBD/83/19. (1/18/83)

Adopted January 24, 1983

4. PANAMA - TECHNICAL ASSISTANCE

In response to a request from Panama for technical assistance, the Executive Board approves the proposal set forth in EBD/83/20. (1/18/83)

Adopted January 24, 1983

APPROVED: June 30, 1983

LEO VAN HOUTVEN
Secretary