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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/69

3:00 p.m., April 30, 1984

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

Executive Directors	Alternate Executive Directors
	N. Toé, Temporary
	G. Ercel, Temporary
	C. Flamant, Temporary
	M. Teijeiro
	M. K. Bush
M. Finaish	T. Alhaimus
	M. B. Chatah, Temporary
	T. Yamashita
J. E. Ismael	
R. K. Joyce	L. Leonard
	D. I. S. Shaw, Temporary
	C. Robalino
	G. Grosche
G. Lovato	
R. N. Malhotra	
Y. A. Nimatallah	
	T. de Vries
A. R. G. Prowse	
	O. Kabbaj
	E. I. M. Mtei
	S. M. Hassan, Temporary
	E. Portas, Temporary
	A. Lindø
N. Wicks	T. A. Clark
Zhang Z.	Wang E.

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

Also Present

African Department: M. W. Bell, E. L. Bornemann, E. A. Calamitsis, A. Jbili, S. M. Nsouli. Central Banking Department: M. R. Vaez-Zadeh. European Department: P. L. Hedfors. Exchange and Trade Relations Department: D. K. Palmer, Associate Director; S. Mookerjee, Deputy Director; E. H. Brau, H. W. Gerhard, S. Kanesa-Thasan, D. Lee, R. Pownall. Fiscal Affairs Department: R. K. Basanti, R. D. Kibuka. IMF Institute: A. R. H. El Tayed, A. A. Mohamed, S. Zaid, Participants. Legal Department: G. P. Nicoletopoulos, Director; Ph. Lachman, S. A. Silard. Middle Eastern Department: P. Chabrier, Deputy Director; A. K. El-Selehdar, Deputy Director; M. Arif, P. L. Clawson, F. Drees, S. Geadah, S. H. Hitti, S. Kawar, K. Nashashibi, A. Ouanes, M. Yaqub. Research Department: N. M. Kaibni. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, C. J. Batliwalla, S. El-Khouri, K. A. Hansen, L. Ionescu, J.-C. Obame, Y. Okubo, M. Z. M. Qureshi. Assistants to Executive Directors: J. R. N. Almeida, Chen J., G. Gomel, V. Govindarajan, D. Hammann, N. U. Haque, M. J. Kooymans, T. Ramtoolah, J. Reddy, D. J. Robinson, A. A. Scholten, M. A. Weitz, A. Yasseri.

1. SUDAN - STAND-BY ARRANGEMENT, AND EXCHANGE SYSTEM

The Executive Directors continued from the previous meeting (EBM/84/68, 4/30/84) their consideration of a request from Sudan for a stand-by arrangement in an amount equivalent to SDR 90 million or 53 percent of Sudan's quota (EBS/84/83, 4/11/84; and Sup. 1, 4/23/84).

Mr. Nimatallah expressed general agreement with the staff's analysis and conclusions. By successfully implementing the past two stand-by arrangements with the Fund, Sudan had helped to bring about a visible improvement in its external position: the current account deficit had declined by one third between 1981 and 1983, excluding grants, and by an even larger proportion when grants were included. As a result of major corrective measures, the authorities had reversed the decline in production and exports of cotton. During the past two years, cotton output had more than doubled, and cotton exports had again become a main source of foreign exchange earnings. Similarly, efforts to reorganize and modernize the sugar factories had contributed to a significant increase in sugar production, leading in turn to a sharp decline in sugar imports, which had eased the pressures on the balance of payments. Moreover, the tightening of fiscal policy had led to sharp declines in the ratio of the budget deficit to GDP and also in domestic bank financing relative to GDP, easing pressures on the balance of payments through diminished demand for imports. Finally, the authorities had managed exchange rate policy with greater flexibility, and the Sudanese pound had depreciated significantly.

Despite the gains achieved during the past two years, Sudan's external position remained weak, Mr. Nimatallah considered. Debt service obligations falling due in the next few years appeared to be almost beyond the country's capacity to meet, so that Sudan would require further debt reschedulings and continued assistance from donor countries. To secure reschedulings and assistance, the authorities had to maintain two commitments: they should continue to pursue adjustment efforts and should honor existing debt service obligations.

The proposed stabilization program represented another commendable step forward in the authorities' adjustment efforts, Mr. Nimatallah went on. Fully supporting the program and endorsing the proposed decision, he welcomed the program's emphasis on strengthening the productive base of the economy, as growth would be essential to enable Sudan to meet its debt obligations. Recent increases in procurement prices for the main agricultural commodities, together with continued rehabilitation efforts with the help of the World Bank, should help to expand agricultural production. Furthermore, sharp increases in the price of sugar and continued improvements in management and maintenance should stimulate an expansion in sugar output.

In view of continued high inflation, it would be important to bring monetary expansion under control, Mr. Nimatallah noted. He had been encouraged that the expansion of liquidity had slowed during the first eight months of FY 1983/84. However, there was a need to improve monetary statistics to help to achieve better-designed financial programs and performance. On exchange rate policy, he had been encouraged by the staff's statement that the authorities intended to implement further exchange reform, which should promote adjustment.

The authorities should be commended for measures taken during 1983/84 to keep the budget deficit under control, Mr. Nimatallah said. Although the deficit as a proportion of GDP was projected to rise in 1983/84, the rise resulted entirely from higher payments for interest on external debt.

For two reasons, the intended switch to a zakat fund--financed by a flat-rate levy on assets--and the elimination of taxes on incomes of Moslems could have a favorable impact on revenue, Mr. Nimatallah noted. First, although the tax rate was generally lower under a zakat system, the tax base was generally wider, including not only profits and dividends, but also net worth and part of assets. Second, the zakat tax might be administratively easier to collect owing to the religious incentive behind it. Nonetheless, if the tax base proved too narrow to compensate for the lower tax rate, it might be prudent for the authorities to combine a zakat tax only on personal income with a revived corporate tax. At present, guesses and theoretical conclusions about the zakat system and other new policies could be more confusing than helpful. The policies would clearly have to be tested in practice, which would take some time. The midterm review of the stand-by arrangement would give the staff and Executive Directors an opportunity to evaluate further the effects of the new policies.

Ms. Bush remarked that her authorities were pleased that Sudan had met all the performance criteria under the previous stand-by arrangement. During the present stand-by arrangement, the Government must pay some minimum amount of principal to official creditors; on the same terms as in the previous year, agreement had been reached with the commercial banks early in the present month. She hoped for a successful outcome to the Paris Club negotiations and encouraged the Sudanese authorities to reach agreement with bilateral creditors and commercial banks, while continuing to eliminate arrears to suppliers. Depending on the outcome of the Paris negotiations and the petroleum financing arrangement, the Executive Board might have to re-examine Sudan's request for a stand-by arrangement. Any remaining financing gap would logically mean that further economic adjustment, or greater assistance by donors, or some combination of both, would become necessary.

Economic performance in 1983 had fallen below expectations, but she was heartened by the perseverance of the authorities in pressing ahead with appropriate adjustment measures, Ms. Bush continued. The proposed economic program, a continuation of the 1983 effort, correctly emphasized reinforcing the productive base of the economy in order to stimulate exports, restrain domestic demand, and attract larger flows of workers' remittances. Unfortunately, the domestic outcome had been less satisfactory than in 1981/82. Nevertheless, progress had been achieved in the irrigated agricultural sector, with substantial gains in production; the budget deficit had fallen from 8.9 percent of GDP in 1981/82 to 6.1 percent in 1982/83, below the program forecast.

Owing in large measure to excessive monetary expansion, there was a risk that inflation might resurge, Ms. Bush remarked. To attain the inflation target of 20 percent, the authorities would have to remain committed to a tight monetary and fiscal policy during the program period. They should be mindful of the inflation outcome when reviewing the budget for the next fiscal year in June 1984. They had already demonstrated their commitment to the new program by raising procurement prices for cotton and other export commodities, taking steps to expand sugar production, keeping government recourse to the banking system to a minimum, and strengthening public sector enterprises.

Although the balance of payments continued to be under severe pressure, the current account deficit was lower than projected and well below the 1982 figure, Ms. Bush noted. She was pleased that the proposed one-year stand-by arrangement sought to improve the balance of payments gradually over the medium term by aiming for a rapid rate of economic growth and moderation in inflationary pressure. She concurred with the staff that relative price adjustments should play an important supplementary role in stimulating export growth and enhancing the inflow of remittances. She would underscore the staff's point that appropriate interest rate and exchange rate policies were of great importance. The fiscal policy review planned for June would provide an opportunity early in the program year to assess the appropriateness of those policies so that timely corrections, if necessary, could be made. She welcomed the staff's remarks at EBM/84/68 about imminent reforms in the exchange system and hoped that they would materialize forthwith.

Perhaps the staff could comment further on the suitability of the recommended use of Fund resources of 53 percent of quota, given Sudan's prolonged use of Fund resources and its relatively weak adjustment effort, Ms. Bush concluded. Concerning resource mobilization, she would be interested in the results of the June review of the new Islamic practices affecting interest rates and fiscal policy. Finally, in the belief that the Sudanese authorities were committed to building on the accomplishments of recent years, she supported the proposed stand-by arrangement.

Mr. Wicks expressed support for the proposed decision. As earlier speakers had emphasized, Sudan's economic situation was one of particular difficulty; the authorities deserved sympathy in their efforts to attack long-standing problems. His comments would be mainly technical, relating to the program's design, and would not primarily be concerned with the authorities' policies, which seemed to be proceeding broadly in the right direction, although, as Ms. Bush had pointed out, the pace of the adjustment effort was perhaps questionable.

During the previous program, Sudan had observed all the performance criteria and had been able to make all the drawings, Mr. Wicks recalled. Nonetheless, GDP had declined by 2.7 percent instead of growing by the projected 3.5 percent, inflation had been 40 percent instead of the projected 30 percent, and monetary expansion in 1982/83 had been worryingly rapid at 37 percent instead of the projected 28 percent. Although the monetary situation had improved in the beginning of 1983/84, previously there had occurred renewed acceleration for which no explanation had been given, something that added to his concern. Indeed, he always found it worrying when, by great effort and sacrifice, the authorities of a country managed to attain the performance criteria yet saw the economic indicators move in a different direction. Was it because the Fund lacked understanding of that particular member's economy? The staff paper did not provide a full explanation.

As to the general design of the program, Mr. Wicks said that he welcomed the conditions requiring that understandings be reached on fiscal policy and the exchange rate. Both the reviews scheduled under the program would be of great importance. Despite Mr. Nimatallah's helpful statement, the financing gap did seem to have been growing a little, at least potentially, during the past few days. For Sudan and a few other countries, the Fund had indeed followed the practice of provisionally considering a program on the assumption that the financing gap would be closed, but he was becoming increasingly concerned on a technical level with that approach, especially when he had learned of the staff's assumption that "disbursements in 1984 from the donors who did not indicate specific commitments at the Consultative Group would be maintained at the level of 1983." In his view, the assumption did not provide a satisfactory basis for a sound program unless there were very good reasons to believe it justified, and that did not seem to be the case. In particular, he did not like the presumption that gaps should be closed by additional financing. There should not be too long a delay between approval of a program and its activation. An extended delay could mean that the starting point and the external environment assumed for the program were no longer appropriate.

As to the structural content of the program, Mr. Wicks welcomed the various price adjustments introduced during the preceding year. Indeed, the staff paper could well have included proposals for liberalizing domestic prices further. Although the staff paper listed the recent adjustments in prices, it provided little information on how present prices in Sudan stood in relation to world prices; such information would have helped Executive Directors and might be made a feature of staff assessments generally.

On page 15 of EBS/84/83, the staff had identified the key structural issue for the medium term as that of securing greater investment, which would require greater domestic savings, and which, in turn, would require both suitable fiscal policies and positive real interest rates, Mr. Wicks noted. On the fiscal elements, it was difficult to reach a clear view, because decisions on fiscal policy for the main part of the program period rested on the budget for 1984/85, which had not yet been determined. Moreover, the substantial shift in the fiscal structure entailed by the introduction of the zakat in September would have a great effect on the budget figures for 1984/85. He hoped that the zakat system, when it became operational, would perform as well as or perhaps better than the present one; it did represent a major change, and uncertainties remained about how well it would work in practice and how large the eventual yield would be. He had been heartened to hear from Mr. Nimatallah that, because of the wider tax base, yields might actually increase. In any event, the program before the Executive Board was incomplete because not enough information was yet available.

More generally, he would have liked to see greater involvement by the World Bank in Sudan, Mr. Wicks observed. Indeed, the suggestions that he had made at EBM/84/56 (4/6/84) on Ghana were apposite to Sudan as well. Economic measures traditionally associated with the Fund could not by themselves restore stability to Sudan's economy; supply-side microeconomic measures within the Bank's scope of responsibility would be just as important for the success of the proposed Fund program. Perhaps a series of microeconomic measures was already in hand to speed the development of the Sudanese economy; there were scattered references to such measures throughout the staff report. Nonetheless, such references and the rather inadequate Appendix II to EBS/84/83 were not good enough. Executive Directors required a coherent, comprehensive, authoritative evaluation of microeconomic developments in Sudan.

The Islamization of Sudan's financial system represented a large structural change and would raise questions about the efficacy of the new arrangements as a proxy for the positive real interest rates needed to promote domestic savings, Mr. Wicks went on. He noted the authorities' intention to reduce the growth of domestic liquidity to 12 percent in 1984/85. He did not disagree with the staff statement on page 19 of EBS/84/83--"Such a reduction in liquidity growth, in conjunction with a projected annual expansion in real GDP of about 5 percent in 1983/84 and 1984/85, would be expected to result in a substantial decline in the underlying rate of inflation"--but he did wonder how realistic it was in practice. Experience in other countries suggested that much of the initial impact of a sharp cut in the rate of the money supply growth might fall on economic activity rather than on price rises. He would welcome staff views on that point.

From the staff's own comments, it appeared that statistical information about the Sudanese economy was as yet far from adequate and that, in consequence, the monitoring of financial developments was neither as timely nor as complete as the staff would like, Mr. Wicks noted. Perhaps the Fund could provide help through further technical assistance, a point on which he invited the staff to comment.

It hardly needed pointing out that Sudan's balance of payments position was chronically weak, Mr. Wicks observed. In the current year, the country's current account deficit, not counting official transfers, would approach 15 percent of GDP; including official transfers, the deficit was still likely to be some 7 percent of GDP. For the next few years, the debt service ratio without rescheduling would remain above 100 percent of export receipts. On external policy generally, he had been encouraged to learn of the steps taken toward setting a unified exchange rate for the Sudanese pound at a more realistic level. While recognizing potential problems arising from too large or sudden a shift in transactions from the official market to the free exchange market, the authorities should try to make determined efforts in that direction. Perhaps the best chance of strengthening the external account over the medium term lay in the development of the oil deposits in Southern Sudan. Indeed, he noted from Table 8 in EBS/84/83 that the assumed expansion of oil production and exports more than accounted for the projected shift in the current balance up to 1989. Although he was hopeful, uncertainties in that sphere remained.

In conclusion, Mr. Wicks said, Sudan would have to travel a long, difficult path before there could be any real prospect of a return to economic viability on the external front. In the meantime, there was bound to be a continuing need for financial support both from grants by concessional donors and from rescheduling by banks and export credit agencies; Sudan would also need some new money. That prospect had important implications for the Fund's own position. Sudan had had Fund programs for the previous six years; only modest signs of progress had appeared in the domestic economy. A great deal remained to be done, as the Sudanese authorities recognized. However, where would the Fund's involvement be leading in the medium term? What would the Fund's role be in relation to other sources of finance? At 53 percent of quota, the size of the proposed arrangement seemed entirely appropriate, but, with outstanding drawings at the present level, the net flow of new money from the Fund to Sudan in the future would necessarily be modest.

Mr. Joyce expressed broad agreement with the staff appraisal and support for the proposed decision. The authorities' commitment to the adjustment effort and their compliance with all the performance criteria under the previous stand-by arrangement were encouraging. Nonetheless, as the staff had noted, the results of the previous program had been mixed; indeed, the pace of adjustment in certain areas was open to question. For instance, reduced production in the rain-fed agricultural sector, even though attributable in large part to the continuing drought, had nonetheless been disappointing. Even more worrying, many manufacturing enterprises continued to operate below capacity, in part because of a lack of supplies, equipment, and at times foreign exchange. In the future, it would be important to reduce constraints on manufacturers' access to capital occasioned by credit allocations and the structure of the foreign exchange system. As a result of such constraints on manufacturing and agriculture, real GDP had fallen in 1982/83, although the program had called for growth. Moreover, despite what the staff had characterized as "generous debt relief and the devaluation of the Sudanese pound," the balance of payments remained under pressure.

On the positive side, Mr. Joyce went on, the authorities were to be commended for a number of successes. The overall fiscal deficit had been reduced; the deficit on current account had been lower than projected.

Admittedly, the decline had been attributable largely to compression of imports, a trend that might not turn out to be sustainable, and also to a large increase in official transfers. Recently, the authorities had adopted more realistic pricing policies, adjusting the prices of consumer goods sold by the public sector to ensure that subsidies did not re-emerge. The elimination of subsidies, especially those on wheat and flour, had been a courageous accomplishment, and it would be important to avoid them in the future. He also welcomed the increases in electricity tariffs and water rates.

Having effectively begun to adjust, the authorities should consider the nature and size of the adjustment likely to be required in the medium term, questions analyzed in detail in EBS/84/83, Mr. Joyce considered. While he agreed that the proposed stand-by arrangement built on the previous program and took account of medium-term prospects, a number of uncertainties remained that led him to wonder about the medium-term and even the short-term viability of the proposed measures.

First, as the staff had pointed out, the main weakness in 1982/83 had been rapid growth in the money supply, Mr. Joyce said. As a result of such growth and a slower rise in output, the rate of inflation had substantially exceeded the program target. Like Mr. Wicks, he found it worrying that the rate of increase in the money supply had accelerated in November and December 1983. Fortunately, there had been a marked slowdown in the growth of liquidity in January and February 1984, and the staff believed that the program target for 1983/84 was attainable. The staff would however do well to examine the credit ceilings closely during the midterm review to ensure that liquidity growth would stay consistent with the fiscal targets over the remainder of the program. He also agreed with Mr. Wicks that Executive Directors would need a detailed review of Sudan's fiscal position and fiscal outlook at the time of the midterm review, particularly in the light of changes that might be made in the tax system.

Second, Mr. Joyce noted, interest rates continued to remain negative in real terms. While he recognized the social and religious importance of the alternative arrangements involving Islamic practices, incentives to save and the costs of using capital would still have to be such as to ensure a proper allocation of resources, especially an appropriate allocation of credit. In the absence of other incentives, the authorities had no choice but to follow a more active interest rate policy. More flexible interest rates would also have the immediate benefit of attracting increased workers' remittances from abroad. Admittedly, the credit controls introduced in August 1983 had been helpful but were clearly a second-best technique. More important was the uncertainty that the new Islamic regulations appeared to be causing. He shared the staff's concern that such changes, coupled with continued instability in Southern Sudan, might adversely affect the program. Was the present the best time to introduce major reforms whose economic consequences might put the program itself at risk? The Executive Board would have to look carefully at recent developments resulting from those changes when it examined the program following the discussions in June.

Third, although improvements had occurred, the exchange rate system remained a source of concern, Mr. Joyce observed. He had been glad to hear from Mr. Mtei that the authorities' goal was to unify the exchange regime. Nonetheless, the emergence of a third exchange rate during the previous year was particularly worrying and would seem to indicate that the parallel market--the so-called free foreign exchange market operated by banks and licensed dealers--was not working effectively. Moreover, it was unclear from the staff paper what "appropriate measures" the authorities would be taking to improve the functioning of the free foreign exchange markets or what timetable they had in mind for unifying the exchange rates.

Fourth, he supported the staff's suggestion that the program should become effective only after the authorities found additional nonproject aid to fill the remaining gap of $40 million in the balance of payments, Mr. Joyce continued. In addition, the requirement that debt rescheduling should be essentially in place should help to avoid the disruptions that had occurred in earlier programs. At present, however, there appeared to be no clear indications where the required $40 million was to come from. Indeed, if he understood the staff correctly, there was a question whether the gap could be limited to $40 million. He welcomed Mr. Nimatallah's statement, but it was clear that, if aid flows proved smaller than originally forecast or if the oil financing arrangement were not set up as planned by May 31, a radically different situation would emerge, in which the program would not be adequate. How was Sudan's balance of payments to be financed over the medium term? The Fund had been deeply involved in Sudan for a number of years and continued to hold large amounts of Sudanese pounds relative to quota. Therefore, in future arrangements, the Fund's role should be limited principally to that of catalyst vis-à-vis Sudan's creditors, bilateral aid donors, and international development institutions. Sudan's prospective financing requirements suggested that the country needed longer-term development assistance rather than short-term financing.

Finally, he noted the staff's comment that the statistical base in Sudan was highly unsatisfactory, and he would strongly support the allocation by the Fund of additional technical assistance to correct that deficiency, Mr. Joyce concluded. The program with Sudan entailed high risks, at least until there was more assurance about the availability of resources for the coming year. He agreed with Mr. Mtei that adjustment could not be completed in the short term and that Sudan would require sizable external flows and, indeed, continued debt relief for many years to come. The program represented merely another step along a difficult road, but it deserved the Board's conditional support.

Mr. Nimatallah said that he understood that the proposed date for establishing the petroleum facility was set for June. The facility would generate savings that represented part of the covering of the financing gap. What steps would the Board require the authorities to initiate during May? Some specific requirements should be set up for that petroleum financing arrangement during May to make sure that it would indeed be established in June, as projected.

The staff representative from the Middle Eastern Department explained that in its balance of payments calculations, the staff had assumed that the petroleum financing arrangement would generate about $80 million a year in savings, if it became effective on July 1. For the arrangement to be included as a means of narrowing the financing gap, the staff had to receive assurances in May to be able to tell the Executive Board that both the financing and the associated structural changes were in place. Some of the donors to the petroleum financing arrangement were insisting on certain associated structural changes involving the distribution and acquisition of oil, which would depend in part on how far distribution was privatized. In particular, the U.S. Government was imposing certain preconditions over a three-year period; it wanted certain structural measures to be implemented. The resident representative of the Fund in Khartoum had indicated that the Sudanese authorities might be unable to meet some of those criteria by May. Assurances would be needed that the financing arrangement was in place, or else the savings would not materialize. Moreover, the extra cost was basically attributable to the high interest rates and high support prices being charged owing to the unwillingness of suppliers to accept regular prices; thus, the authorities had to deal with intermediations and commissions and extraordinary payments. The three factors would not disappear unless the petroleum financing arrangement was in place.

Mr. Nimatallah suggested that the Chairman might provide clarification about the petroleum financing arrangement so that the Sudanese authorities understood that they would have to take steps during May to satisfy the Executive Board.

The Chairman suggested that the Board could expect that, at the end of May, agreement between Sudan and the providers of the petroleum financing arrangement would be sufficiently firm, at least on the principles, to ensure its inauguration by midyear. There should be no difference of view on any point of substance.

The staff representative from the Middle Eastern Department noted that soon after the Paris Club meeting a meeting with all the participants was going to be convened by the Minister of Finance of Sudan to fix the details of the petroleum financing arrangement. The staff needed the information by about May 20 in order to be able to include it in the paper.

Mr. Ismael recalled that the main objective of the 1983 program had been to reduce Sudan's external payments difficulties without disrupting the flow of essential imports and capital goods required to expand production. As GDP had declined by 2.7 percent, the argument could be made that the program had not been a success. Part of the difficulties had arisen from bad weather, but delays in project implementation rather than compression of operating expenditure had also contributed. He hoped that in 1984 further improvements in the fiscal position could be achieved through greater revenue efforts and especially through better expenditure control. Any further technical assistance that the authorities might require to improve fiscal maangement should be provided by the Fund.

He was concerned that, under the 1983 stand-by arrangement, the growth of the money supply had been allowed to exceed the target by such a large margin, Mr. Ismael went on. Could the staff comment on the effectiveness of the measures introduced in August 1983 to limit monetary expansion? As to the proposed stand-by arrangement for 1984, the objectives and measures contemplated seemed appropriate. However, he had some doubts whether domestic credit expansion in 1984 could be reduced by 40 percent, as planned, without adversely affecting economic activity. Both the monetary target and inflation target for 1984 seemed too ambitious, and he would not be surprised if they were not met.

One of the key elements in the program was the need to provide adequate producer incentives, Mr. Ismael went on. The staff study in April 1983 had shown that the exchange rate for the Sudanese pound was appropriate and provided adequate incentives for export producers. Since that time, prices of some export commodities had risen, but the rise had been largely offset by an inflation rate in Sudan of about 40 percent. In such a highly inflationary environment, producer incentives could erode fairly rapidly; the authorities might have to review the exchange rate at fairly short intervals. He attached great importance to the maintenance of export incentives, without which the Fund program would not succeed, and would urge the staff to look into the matter.

Another important element in the success of the program would be the willingness of official creditors to reschedule Sudan's debts, Mr. Ismael concluded. Should the external debt service obligation of the public sector exceed the total national income of Sudan in 1984, as projected, large-scale rescheduling involving substantial maturity transformation would clearly be required. He hoped, as in the past, that creditor countries would demonstrate their understanding of Sudan and would assist it through the current difficult period. He supported the proposed program.

Mr. Malhotra expressed satisfaction with the outlines of the new stand-by arrangement for Sudan that had been worked out in a three-year medium-term framework. He could support the proposed decisions. Sudan had been facing deep-rooted structural and financial imbalances, which the authorities had endeavored to redress by pursuing corrective policies under successive Fund-assisted adjustment programs. Improvements were occurring in several sectors of the economy, and progress under the most recent stand-by arrangement had been reasonably satisfactory; in particular, the series of measures taken to reduce the budget deficit and expand agricultural production, especially in irrigated areas, had had positive results. Yields of cotton had increased dramatically through better crop management practices, and also in response to price incentives, while output of cotton goods had benefited from advanced technologies. The measures taken recently to generate more revenue and to reduce expenditure had resulted in a decline in the budget deficit from 9.8 percent of GDP in 1980/81 to 6 percent in 1982/83, so that domestic bank financing of the budget in the latter fiscal year had been well below the program target of 1.2 percent of GDP. In addition, the authorities had increased utility tariffs and virtually eliminated budget subsidies.

Mr. Grosche agreed with previous speakers that the economy of Sudan continued to be beset by serious internal and external imbalances. In addition, still-untackled security problems were having serious repercussions on the economy, especially on the prospects for developing petroleum deposits. As Sudan's economic problems were of a deep-rooted structural nature, the authorities could find solutions only by taking a medium-term approach; indeed, the program before the Board was designed to continue previous efforts. Therefore, he supported the proposed decisions. The amount chosen corresponded to the envisaged adjustment effort, to the probable need for further programs supported by Fund resources, and also to the catalytic role of the Fund. Like previous speakers, he noted that Sudan had observed all the performance criteria under the previous stand-by arrangement.

He endorsed paragraph 3 of the proposed decision on the stand-by arrangement, Mr. Grosche continued; in view of the financing gap in Sudan's balance of payments, it was appropriate for the Executive Board to take only a decision in principle. The stand-by arrangement would become operative if the Sudanese authorities had succeeded in filling the gap before the end of May 1984. Unfortunately, the staff's initial statement at the present meeting suggested that the gap had turned out to be wider than foreseen. Could the staff or Mr. Mtei provide further indications about the probability of a timely closing of that gap, taking into account Mr. Nimatallah's statement?

Beginning in 1983, the Sudanese authorities had embarked on major institutional changes designed to enforce Islamic practices and regulations, Mr. Grosche noted. The speed at which the transformation was being undertaken had been accelerated during the past few months to cover fiscal policy, monetary policy, the legal framework in which economic units could operate, and also general economic activity in the south of the country. The staff paper implicitly assumed that it was still possible to evaluate the short-run repercussions of those changes on domestic demand, tax revenue, and inflation, at least until the end of the current fiscal year. Nonetheless, he doubted whether the data provided by the staff would serve as a basis for judging Sudan's development in the medium and long term. Great importance should therefore be attached to the next review, when Executive Directors would have an opportunity to make a more detailed evaluation of the changes under way.

Monetary policy in Sudan had to contain, then reverse, the deflationary pressures that had been aggravated under the previous stand-by arrangement, Mr. Grosche said. He welcomed the authorities' intention to halve the rate of monetary expansion, but, like other speakers, he regarded the objective as quite ambitious. In addition, interest rates continued to be negative in real terms; the Sudanese authorities believed that their commitment to a progressive Islamization of the economy precluded an active interest rate policy. He looked forward to the September review, which should include the new arrangements intended to achieve results similar to those under an active interest rate policy.

Fiscal policy would be characterized by poorer budgetary prospects, a point on which the detailed list on page 21 of EBS/84/83 was worrying, Mr. Grosche went on. For instance, he wondered whether the establishment of another regional government including Khartoum and its environs really belonged to the measures deserving the highest priority. On the revenue side, losses were to be expected owing to the ban on producing, importing, and consuming alcoholic beverages; together with higher interest rate payments for external debt, the ban strongly reinforced the need to mobilize domestic resources for the budget.

As to structural policies, the authorities should certainly enhance Sudan's productive capacity, Mr. Grosche remarked. They should implement price incentives, a diversification of the agricultural sector, and a broadening of manufacturing activities, especially when inputs were domestically produced. Although they had already taken a series of measures to strengthen agriculture and manufacturing, he shared the concerns expressed by Mr. Wicks that an assessment by the World Bank of Sudan's microeconomic measures was missing from the staff paper.

On external policies, Mr. Grosche welcomed the information supplied by the staff on exchange rates. He nonetheless felt obliged to note that in view of the expected persistence of balance of payments gaps, the high burden of debt service, and the repurchase obligations toward the Fund, Sudan for many years to come would rely heavily on continuing debt relief from bilateral and multilateral sources. Hence, there was virtually no room for policy slippages.

Mr. Flamant recalled that at EBM/84/28 (2/22/84) the Executive Board had been asked by the staff, on the last day of the previous stand-by arrangement, to approve an extension and modification of that arrangement involving the establishment of an escrow account. He was happy that the course of events had given retrospective evidence that his chair had been correct in asking for postponement of the decision on the escrow account, which had eventually appeared to be unnecessary. In the future, the staff should avoid that kind of last-minute action.

He had read EBS/84/83 and had heard the staff representative at EBM/84/68 with mixed feelings, Mr. Flamant continued. Were it not for the meeting of the Paris Club on May 2, he would in fact have strong hesitations about concurring with the proposed decision. However, as it was being proposed that the Executive Board should approve the stand-by arrangement only in principle, he would go along with the proposed decisions. The reason behind those reservations was that the Sudanese authorities seemed to have engaged in a complete upheaval of a number of internal policies at the very moment when the success of the adjustment effort required, above all, continuity in policy. Those policy changes had disruptive effects. In particular, they seemed to have triggered internal disturbances in the south of the country, which had led to the abandonment of the Jonglei Canal, designed to permit a sizable increase in agricultural production, and also to the abandonment of a pipeline necessary to allow Sudan to export petroleum. Such disturbances affecting half of the country might well entail a reduction in government revenue and a rise in expenditure that would make it impossible to bring the budget deficit under control.

Since November 1982, the official exchange rate for the Sudanese pound had remained unchanged, despite the high inflation rate that had prevailed during the subsequent year and a half, Mr. Flamant noted. It was therefore unsurprising that the gap between the official exchange rate and the free-market rate had widened and that a third, unofficial rate had emerged. That development obviously went in the wrong direction, as the gap was supposed to be progressively reduced; there would probably be a renewed buildup of cost-price distortions in the economy that might well jeopardize the supply side of the program with the Fund. Like other Directors, he was therefore convinced that a reunification of the exchange rate, along the lines of the reunification in Zaïre, was indispensable and should be carried out quickly. He also hoped that the actions announced by the staff would be taken soon.

The poor statistical base in Sudan made it difficult to interpret monetary developments correctly, Mr. Flamant continued. For instance, he had had some difficulty in trying to understand what had happened in the monetary sphere during 1983. The staff report indicated that the slippages had been due to the less contractionary impact of the external sector. Nonetheless, could not the performance criteria have been devised so as to offset automatically the impact of the external sector by reducing pro tanto the credit ceilings? As for 1984, the performance criteria for end-June did not preclude the reappearance of the same problems, and he invited the staff to comment further on the question.

As for fiscal policy, he failed to understand why the authorities had decided to introduce a major reorganization of revenue and expenditure in order to achieve greater conformity with Islamic fiscal practices by setting up a zakat fund and eliminating taxes on incomes of Moslems, measures to become effective on September 26, 1984, Mr. Flamant went on. Could the staff provide further information on the possible outcome of the reform on government revenue? He would hope that such major changes in fiscal policy would not be the final straw that would cause the program to fall apart.

In conclusion, Sudan's creditors had made a sizable effort within the framework of the Paris Club to help the country to overcome its financial difficulties, Mr. Flamant said, and the creditors might be prepared to renew their efforts. It was therefore most unfortunate that the Sudanese Government, instead of remaining committed to the adjustment effort--which implied continued implementation of sound economic and financial policies--had engaged in various revisions of policy that might well reduce to nothing the results obtained painfully over many years.

Mr. Toé recalled that the economic program supported by the stand-by arrangement ended in March 1984 had been intended to address a complex series of internal and external imbalances plaguing the Sudanese economy since the mid-1970s. Those imbalances were deep rooted and originated mainly from structural factors. The authorities were to be commended for successfully addressing most of those factors: they had reduced the budget deficit as well as the domestic bank financing requirement of the

Government, had contained spending by public entities below the program targets, and had encouraged agricultural output in irrigated areas to expand substantially, although output from rain-fed agriculture had fallen short of expectations. Moreover, exchange rate policy had been flexible, and the free foreign exchange market had been broadened with a view to unifying the exchange system in the future. In sum, the authorities had observed all performance criteria under the 1983 program. However, given the structural nature of the problems confronting the Sudanese economy, the outcome of the program had been mixed, reinforcing the perception that, in order to restore viability, unceasing efforts by the authorities in the medium term, together with generous assistance by creditors and donors, would be of the utmost importance. It was reassuring that the Sudanese authorities were cognizant of that need, as shown by the request for a stand-by arrangement in support of an economic program that was a continuation of the previous one.

The proposed program was acceptable, Mr. Toé went on. It aimed at consolidating the progress achieved so far, strengthening the productive base, and alleviating pressures on the external sector. Agriculture should benefit from the increases in procurement prices of 23-45 percent in October and December 1983 as well as from the 12 percent increase in the irrigated acreage devoted to cotton and groundnuts. With the expected improvement in the financial position of sugar factories following the rise in their output price, and also with the various incentives given to textiles to alleviate the constraints therein, manufacturing was likely to be operating at a higher rate of capacity utilization.

In the fiscal area, he welcomed the authorities' intention to pursue their efforts to enhance expenditure control with Fund technical assistance in order to improve the budget outcome, Mr. Toé concluded. In addition, the latest information provided by the staff concerning monetary expansion was encouraging. Concerning the external sector, the statement made by Mr. Nimatallah at EBM/84/68 had clarified the unfinanced gap in the balance of payments. In conclusion, he supported the proposed decisions.

Mr. de Vries remarked that in the past year, some progress had been made, but many fundamental problems remained. As Mr. Grosche had pointed out, the Sudanese economy continued to confront serious internal and external imbalances, and the inadequacy of the statistics on Sudan made it difficult to identify precisely what the imbalances were. For six years, the Fund had been involved with Sudan, and no great progress was visible. Of course, the authorities had made a number of adjustments and had taken a number of correct decisions, yet many Executive Directors had noted that the country would be dependent on the Fund for many years to come. To what extent should the Fund continue to remain involved with Sudan for many years? Like Mr. Wicks, he had been struck by the fact that a thorough analysis by the World Bank was missing from the staff paper. What Sudan needed was structural and microeconomic adjustment; the authorities would have to take action in fields outside the Fund's expertise. As Mr. Wicks had also observed, even though Sudan had met all the performance criteria under the previous program, the economy had moved in the opposite direction from what was expected. Perhaps that was a case of what had become known as "Goodhart's Law": as soon as an economic variable became quantifiable and was included as a performance criterion, that statistical entity in a sense became irrelevant because the variable could be calculated in such a way as to arrive at different answers.

In any event, involvement by the Fund in Sudan could not continue to grow; indeed, during the coming year, the net increase in Fund assistance to Sudan was going to be quite small, Mr. de Vries went on. That was perhaps as it should be, although it raised the difficult question of who should take care of the difficult problem of providing help for the Sudanese authorities to continue their adjustment effort, which, as Ms. Bush had noted, was continuing at a slow pace.

He was ready to support the proposed decisions, Mr. de Vries continued, which were conditional on the authorities' closing the financing gap. Should it turn out, before the stand-by arrangement became operational, that the basis on which Executive Directors had expected the program to work would no longer be tenable, the Chairman would so inform the Board. From an economic point of view, the Sudanese authorities might have been better advised to continue a steady program.

The staff appraisal mentioned a few areas in which the authorities were expected to make progress, Mr. de Vries concluded. He was not certain how, according to the Islamic way of doing business, the authorities could pursue an active interest rate and exchange rate policy. Moreover, would it be possible under Islamization to impose selective controls on credit, as cited in the staff appraisal? He hoped that the authorities would find it possible to make further reductions in the expansion of the money supply. Finally, he was uncertain about what the Islamization of the tax system would bring about. He continued to hope for the best, and he was ready to support the proposed program.

Mr. Zhang expressed support for the request for a new stand-by arrangement and could generally accept the staff appraisal. Current developments in Sudan underlined its deep-seated structural problems, whose solution--as in many developing countries--had to be sought within a medium-term framework. Effective solutions required not only a persistent effort by the authorities to pursue corrective policies, but also continued financial support from donors and large-scale debt relief for a number of years to come. The proposed stand-by arrangement was essential for those purposes. It was heartening that the Sudanese authorities were determined to continue the difficult process of adjustment and to implement the measures required to restore equilibrium in the economy. Under the stand-by arrangement that ended in March 1984, performance had been mixed: the continued decline in the budget deficit had been striking, but activity in the real sector had fallen below expectations, and real GNP had declined. Sudan's external payments position remained weak, while external pressures had intensified.

Under the proposed stand-by arrangement, Mr. Zhang noted, the economy was expected to grow at an annual rate of 5 percent from 1984 to 1989, or higher than the actual rates attained in the 1970s. How could future growth be insulated from the influences of variable weather conditions at home and economic fluctuations throughout the world, trends that had adversely affected Sudan's growth in the past? Moreover, progressive increases would be required if investment in public infrastructure were combined with large private investment in manufacturing. What was the total amount of investment required, and what value for the capital/output ratio was assumed in that calculation? An even more important question was how such investment would be financed. In view of Sudan's debt financing problem, was it reasonable to expect that there would be sufficient net inflows of foreign capital to be used for those purposes?

As to the balance of payments, the export projections seemed optimistic, Mr. Zhang concluded. By 1986, the prospects for petroleum production for exports would still be uncertain. Was it really possible for increases in volume and prices for "other exports"--traditional commodities besides cotton and petroleum--to double in value in five years' time? Furthermore, as shown in Table 8 of EBS/84/83, the improvement in the midterm balance on current account would depend largely on whether the flow of official transfers continued. Finally, he hoped that the disbursement of foreign aid and the debt relief would come through on the original schedules so that the proposed stand-by arrangement could become effective on May 31, 1984.

Mr. Chatah expressed support for the program and for the proposed decisions.

The staff representative from the Middle Eastern Department noted that a number of Directors had raised questions about Sudan's performance in 1982/83 under the previous program. Economic growth had been lower than the staff had expected, and monetary expansion had been higher, so that the inflation rate had also been higher than projected. All the policies affecting output had been implemented, and in the policy-related sector--basically the irrigated agricultural sector--there had been a substantial response from output, particularly of cotton. In spite of the sharply higher cotton crop and higher yields of other commodities produced in the irrigated sector, poor weather had been a major reason for a reduction in output in rain-fed areas. Agriculture being a dominant component in the economy, GDP had declined instead of increasing as projected.

The program targets for credit ceilings had been met, the staff representative continued. Even though the authorities had carried out all the policies under the program, some of the assumptions made by the staff about the behavior of the external sector and the accumulation of blocked accounts in the public sector--intended to sterilize some of the external debt relief given for balance of payments purposes--had turned out to be invalid. The foreign sector had been much less contractionary than expected. The authorities had also drawn a substantial amount from the blocked account to provide the capital of the new export-import bank. Furthermore, the exchange rate adjustment in November 1982 had resulted in the revaluation of residents' foreign currency deposits, part of the quasi-money evaluated previously at the old rate; purely for that reason, the money supply had expanded by 2-3 percent.

Realizing that in 1982/83 there had been overshooting of the monetary target, the Sudanese authorities had told the staff that in 1983/84 they would take determined measures to reduce monetary expansion in order to compensate fully for the overshooting, the staff representative explained. Thus, by the end of the two fiscal years covered by the program period, in June 1984, monetary expansion would turn out to have been of the same order as conceived at the beginning of the program. The question was how such a sharp deceleration of monetary growth could be carried out without damaging the productive sectors of the economy. In consultation with the authorities, the staff had attempted to ensure that priority in credit allocation would be given to production units in the agricultural sector and distribution units in the trade sector. In the staff's judgment, notwithstanding the substantial reduction in the monetary growth target, the credit needs of the productive and trade sectors would be fully satisfied. The authorities were bringing about the curtailment by applying greater restraint on the less essential components of credit demand.

A related question asked by Mr. Wicks concerned whether the slowdown in money supply growth would necessarily reduce prices or would result in lower economic growth, the staff representative recalled. In Sudan, when credit was rationed, and provided that agricultural entities and other productive and export activities had sufficient financing, a credit squeeze would discourage speculative activities like stockpiling, smuggling, or real estate purchases. Thus, growth in the economy would probably not be as stringently affected by the credit squeeze, although it might be affected by many other factors. Moreover, most development projects were financed from foreign assistance, and in that sense growth would not be as affected. Of course, prices were influenced by a variety of factors, but one of the major causes of inflation in any country was the gap between the availability of goods and services and the expansion of the money supply. Thus, the staff hoped that the reduction in money supply growth, coupled with a rise in output, would narrow the gap and, to that extent, bring down the rate of inflation.

Of course, the performance criteria relating to credit expansion could have been adjusted as new information had emerged, the staff representative noted, but, once the criteria had been negotiated with the authorities and included in the program, they had remained. A related question had been whether different performance criteria could have been adopted for June 1984. In making the projections for monetary expansion in 1983/84, a neutral impact from the foreign sector had been assumed; the staff had not felt that the Sudanese economy would be in a state to accumulate foreign assets, which would have an expansionary impact. Thus, the staff had not assumed any contractionary effect on the money supply because of a reduction in net foreign assets. As Directors would recall, partly for that reason the staff had not set credit ceilings for the subsequent period. In June, the staff would review the situation and be more realistic about the country's requirements.

The staff had been unable to provide a full explanation for the sharp increase in the money supply in November and December 1983, the staff representative admitted, in spite of efforts to disaggregate data on the major components that created money in Sudan. Preliminary analysis and comparisons with previous periods did show that part of the explanation lay in the seasonal pattern of the demand for credit in the months of November and December of each year; the demand for credit declined each year after January or February. Under the ceilings, an acceleration of credit had been provided for up to November 1983, following which a much slower rate of growth had been expected. It was heartening to observe that in January and February 1984 the money supply had grown hardly at all; therefore, the eight-month figure gave some hope that the target for the entire fiscal year would be attainable, provided that the seasonal retirement of agricultural credit continued.

In response to Mr. Wicks, the staff representative explained that the staff had had to make assumptions about those countries that had not yet made commitments of aid to Sudan. The staff believed the assumptions to be realistic.

A question had been asked about the relationship between world prices and the prices prevailing in Sudan, the staff representative observed. Domestic prices fully reflected import prices: there was no longer any explicit subsidy being given through the budget to support any price level. Nonetheless, an implicit subsidy did remain, because a number of essential commodities, including petroleum, were being imported at the official exchange rate, which was overvalued. Despite being aware of the implicit subsidy, the authorities were greatly concerned about the sociopolitical consequences of making any sudden large adjustment in the prices of essential commodities. Therefore, they had agreed to adopt a more gradual approach to adjusting the prices charged for such commodities by shifting the basis of price determination from the official to the free-market exchange rate.

The Fund staff had been working closely with the World Bank in Sudan, the staff representative went on. Analyzing projects and priorities, the World Bank staff had played an important role in the preparation of the revolving three-year investment program. The regrettable lack of full details about the World Bank involvement and assessment of developments did not mean that the Fund and Bank had failed to coordinate their efforts in Sudan. On a number of occasions, Fund staff members had gone on Bank missions, and vice versa. A large part of the staff's medium-term projections had been based on the three-year investment program and associated projections prepared by the Sudanese authorities in conjunction with the World Bank staff.

Great uncertainty continued to exist because of the major efforts being made to restructure the fiscal system, the staff representative pointed out. As Mr. Nimatallah had said, the introduction of a zakat fund could contribute importantly to resource mobilization in the public sector. At present, the income tax base was quite small, being limited to those receiving salaries in urban areas, while those working in agriculture were essentially untaxed. Under a zakat system, the tax on agricultural produce might be 5 percent or 10 percent. If implemented effectively, the wider base would indeed compensate for the lower rate, but the staff was not yet in a position to know precisely how the Sudanese authorities intended to carry out the reform. For that reason, the staff would prefer to examine the system in June and report to the Board with a more detailed analysis of the likely fiscal outcome. In response to Mr. Lovato, the introduction of a profit-and-loss-sharing system in Sudanese banks was one option for implementing the process of Islamization. Until the staff knew how the authorities were going to go about implementing Islamization, it would be difficult to give a detailed analysis of their intentions regarding what would serve to ensure an adequate return on financial instruments.

In the past eight or ten years, the quality of statistics in Sudan had deteriorated because of a large exodus abroad of qualified Sudanese public officials, the staff representative went on. The Fund staff had attempted partly to compensate for the exodus by increasing the provision of technical assistance in the fiscal and monetary fields. Some improvements had been carried out, but, notwithstanding the progress made, the staff had found other areas in which weaknesses also existed. He hoped that with further technical assistance and support from the Fund, Sudan would improve the statistical base.

Sudan's comparative advantage clearly lay in the irrigated agricultural sector, the staff representative from the Middle Eastern Department said. Indeed, for two or three years, the authorities had been stimulating production in the sector, with favorable results. At the time of the previous Board discussion on Sudan, the staff had undertaken a comprehensive study on the adequacy of the exchange rate for agricultural commodities; at the time, the staff had concluded that, given the cost structure, yields, and international prices expressed in U.S. dollars, the effective exchange rate of about LSd 1 = $1.45 provided enough resources to assure a rate of return attractive enough to stimulate output of export commodities. Since that time, the staff had found that increases in costs had been lower than inflation in Sudan, because most agricultural inputs were priced at the official exchange rate, and international prices had been moving up much more slowly than domestic prices. Thus, the staff had reached the rough conclusion that the rise in international prices more than compensated for the increase in domestic costs, so that the Government could permit an additional increase in procurement prices without giving any subsidy to farmers.

The Deputy Director of the Exchange and Trade Relations Department recalled that Ms. Bush had raised a question about the proposed amount of the stand-by arrangement, which was equal to 53 percent of quota. In arriving at that figure, the staff had taken into account factors such as the outstanding use of Fund resources by Sudan, the nature of the program, and the possibility of further use in the future. The figure of 53 percent of quota was not out of line with what the Executive Board had agreed to provide in recent months in other similar cases in which the role of the Fund had been primarily that of catalyst. In such cases, the range of access had been between 40 percent and 60 percent of quota. Moreover, as shown by Table 1 in the staff report, the net flow of resources to Sudan from the Fund during the period of the proposed arrangement would be marginal. In view of Sudan's heavy repurchase obligations to the Fund in the coming period, access in the future on an appropriate scale might well result in net repurchases from the Fund in those years.

On access for countries that were or were likely to be prolonged users of Fund resources, the staff representative continued, Mr. Wicks and Mr. de Vries had asked what the role of the Fund should be in such cases. A paper issued by the staff on prolonged use of Fund resources, addressed to that and other issues, would be discussed by the Board shortly. The staff looked forward to receiving the Board's guidelines on that question.

How the exchange reform would proceed in Sudan had been the subject of a question by Mr. Joyce, the staff representative recalled. The staff saw three important elements in exchange reform. First, the rates in the free market would be unified, and from then on, commercial banks would adjust quotations flexibly to developments in the market. There should also be an improvement in the efficiency of the free market with banks and dealers encouraged to participate more actively. Second, imports still effected at the official exchange rate would have to be gradually shifted to the free market. Third, as such shifts were made, the foreign exchange requirement for official transactions would progressively diminish, making it possible to increase the proportion of export earnings that might be exchanged at the free market rate. Thus, the exchange rate for exports would effectively be depreciated. The Sudanese authorities had agreed that those were the lines along which they would take action.

Mr. Mtei re-emphasized that the authorities were quite aware of the difficult situation that they had been facing with regard to the external payments position. They were taking all possible measures to contain and, if possible, to reverse it. However, he would like to stress three points. First, a lasting improvement in Sudan's balance of payments position would take some time and could be brought about only through achievement of a high growth rate in output, particularly in the export sector. Second, continued cooperation among creditors, multilateral institutions, and donor countries would be indispensable. His authorities in Sudan were appreciative of the response given by creditors and donors so far, and he appreciated the statement made at the previous meeting by Mr. Nimatallah regarding the generous assistance provided by Saudi Arabia. Third, after 1986, when Sudan expected to begin exporting petroleum, the balance of payments constraints would ease somewhat. As pointed out in the staff report, the petroleum exploitation project was actively being implemented and, despite all the hurdles encountered, the authorities were determined to make sure that it was completed on time. All possible measures were being taken to enhance security in the area through which the pipeline was passing, so that no disruption took place.

As noted by other Executive Directors, Mr. Mtei continued, the Sudanese authorities had permitted the exchange rate for the pound to depreciate substantially. They were willing to continue to review the exchange rate with a view to unifying the official and free-market rates later in the program period.

On Islamization, the authorities believed that the proposed changes in the banking system or the introduction of the zakat system of taxation would have no negative impact on resource mobilization or government finance, Mr. Mtei remarked. As Mr. Nimatallah had suggested, not only would the tax base be widened under the zakat system, but people's incentive to pay taxes would be heightened by a religious compunction. The Fund would do well to give the Sudanese authorities time to implement zakat measures, after which they would be prepared to review them with the staff. The authorities were also considering possible alternatives to increasing interest rates that would help to mobilize private sector savings and promote better resource allocation, alternatives already tried by five banks in Sudan that operated on a noninterest basis. The fundamental idea was that both deposits and loans were made on a profit-and-loss-sharing principle, according to which depositors were entitled to a share in the profits made by banks instead of receiving a fixed rate of interest on deposits. In their brief experience, the few noninterest banks that had been operating in Sudan had paid to depositors a rate of return much higher than what they could have received as fixed-rate interest on their deposits. Nonetheless, there was an element of uncertainty in the profit-and-loss-sharing system. In fact, such noninterest banks were operating in a number of other countries in the Middle East; a study of their operation had appeared in the Fund's Staff Papers for March 1982. The authorities would discuss progress in that aspect of their banking system as well as the proposed tax reform with the Fund staff at the time of the next review.

The authorities were aware of the security problem in the southern part of the country, Mr. Mtei said. They were taking necessary measures to ensure a secure environment for resumption of work on the pipeline as well as the canal and several other projects.

A number of Executive Directors had expressed disappointment at the performance of the Sudanese economy, Mr. Mtei recalled. It should be noted that the authorities had made the right decisions, often with Fund support. Their efforts to implement those decisions had also been forcefully carried out: many of the performance criteria designed by the Fund and approved by the Executive Board had been fulfilled. Nevertheless, developments had occurred beyond the authorities' control like the drought, low international commodity prices, high oil prices, and high interest rates, all of which had caused damage and had made Sudan perform less well than the authorities would have liked. They remained committed to working closely with the Fund and also with other multilateral and bilateral creditors and donors; they would continue to honor their obligations faithfully, as far as it was physically possible.

The Chairman made the following concluding remarks:

Directors acknowledged the efforts made by the Sudanese authorities and the positive results obtained in three areas. First, Sudan had met all performance criteria in 1982/83. Second, the budget deficit had been significantly reduced and all budgetary subsidies eliminated. Third, output and exports of cotton had expanded as a result of a shift in policy. The main shortfall in policy implementation had been the excessive monetary expansion. The disappointing developments that Directors noted in GDP growth performance had in part been related to adverse weather conditions.

Directors underscored the weaknesses of the external position of Sudan and the enormous weight of the external debt; before any debt relief was granted, Sudan's debt service in 1984 was projected to exceed the amount of export receipts forecast for the year. Given the extreme fragility of the balance of payments--characterized by large and persistent current account deficits--Directors urged the authorities to pursue their present course of adjustment and even reinforce it where needed. In particular, Executive Directors highlighted the following concerns.

First, given Sudan's balance of payments position and high rate of inflation, Directors observed that pursuit of an active, flexible, realistic exchange rate policy was indispensable to enhance Sudan's competitiveness and provide adequate prices to producers. The Fund would be monitoring closely the needed reforms.

Second, Directors were concerned that demand management, in particular monetary policy and fiscal policy, should be kept under strict control if inflation and the balance of payments were to be kept in line with the objectives of the program. The budget for 1984/85, not yet decided, would be a key element of the authorities' policies in the year to come. On the monetary side, a number of Directors stressed the need to give active encouragement to financial savings by offering savers realistic interest rates.

Third, owing to Sudan's need to place heavy reliance on foreign external assistance for a number of years, Directors felt that the program required full support from the authorities at the highest level. In this respect, the announcement of a number of structural reforms affecting interest rates and taxation aroused considerable uncertainty in the minds of a number of Directors. At a time when efforts to adjust were vital to maintaining confidence and when the balance of payments remained fragile, the shifts in basic policies touching on revenues and financial incentives raised a question about the continuity of efforts geared to achieving these objectives of the program. Executive Directors expressed a strong desire to be informed in detail, after the staff conducted discussions in June with the authorities, on the scope of the measures, their possible impact on the program, and also the means of carrying them out in order to arrive at a clear view of the repercussions of such structural shifts.

Fourth, Directors agreed that, before the program and the stand-by arrangement could come into force, the financing gap that had been identified would have to be closed in a satisfactory way by May 31, 1984 through reschedulings and aid commitments, which would be of crucial importance, but also additional measures if necessary. Directors also indicated that agreement between all the interested parties on the principles and modalities of the petroleum financing arrangement was called for before May 31, even if it took somewhat longer to implement the arrangement.

Fifth, in the light of the structural problems and the need for corrective policies, Directors stressed the importance of continuing firm, active collaboration between the Fund and the World Bank. For the future, they wished to be better acquainted with the assessments and policies made by the World Bank concerning Sudan's structural efforts.

Sixth, Executive Directors noted the deficiencies of the statistical base in Sudan and urged further Fund technical assistance in the provision of economic statistics. The Board would be kept informed of any developments that might be relevant to this technical assistance program as soon as they became known to the staff and management.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of Sudan has requested a stand-by arrangement for a period of one year for an amount equivalent to SDR 90 million.

2. The Fund approves the stand-by arrangement set forth in EBS/84/83, Supplement 2, subject to paragraph 3 below, and waives the limitation in Article V, Section 3(b)(iii).

3. The stand-by arrangement set forth in EBS/84/83, Supplement 2 shall become effective on the date, but not later than May 31, 1984, on which the Fund finds that satisfactory arrangements have been made to finance the uncovered gap in Sudan's balance of payments in 1984.

Decision No. 7684-(84/69), adopted
April 30, 1984

Exchange System

1. The Fund approves the multiple currency practice arising from the existence of the dual exchange market, as described in EBS/84/83, until the completion of the next Article IV consultation with Sudan, but not later than December 31, 1984.

2. The Fund approves the restriction on payments and transfers for current international transactions arising from payments arrears, as described in EBS/84/83, from the date in paragraph 3 of Executive Board Decision No. 7684-(84/69), adopted April 30, 1984, until the expiration of the stand-by arangement set forth in EBS/84/83, Supplement 2.

Decision No. 7685-(84/69), adopted
April 30, 1984

2. SOMALIA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Somalia (SM/84/71, 4/2/84). They also had before them a report on recent economic developments in Somalia (SM/84/72, 4/4/84).

The staff made the following statement:

The World Bank has provided the following additional information to that contained in SM/84/71:

During recent exchanges with the World Bank, the Government of Somalia has reaffirmed its commitment to the approach to Juba Valley development worked out at the October 1983 meeting of the Consultative Group for Somalia. An understanding was reached in the past few weeks between the Government and Bank staff on the terms of reference for a prefeasibility study of interim water storage facilities in the Juba Valley, along with a timetable for its execution. The Government has requested World Bank financing of the study and of an international panel of experts to review it upon completion. This study, and others ongoing and planned, should assist in establishing the most economic sequence of investments in the Juba Valley.

The Bank's endorsement of the public investment program, given at the Consultative Group meeting, is specifically predicated upon the assumption that the Government will carry out the policy actions described in its Medium-Term Recovery Program. Total resource availabilities needed to implement the program, both domestic and external, would be of a magnitude approximating that projected last October. The understanding reached in the past weeks on the Juba Valley permits the Bank staff to reaffirm its support of the public investment program. However, in view of the changes in Somalia's present and prospective resource position, due to continuing difficulties in marketing its cattle exports and the changing perspectives for external financial assistance, it is inevitable that the size of the public investment program will have to be reduced. A World Bank economic mission, expected to visit Somalia in May, will provide an occasion to review the Government's resource position, the current status and the size of the public investment program, as well as the liberalization program in general.

The authorities are continuing their negotiations with donors on individual assistance programs. At the present time, the Government is not pursuing its previous plan to contact participants in the 1983 Consultative Group meeting, in consultation with the World Bank, to firm up indications of assistance made at the time of the Consultative Group meeting and to secure additional financing. The Government needs to ensure adequate funding of its external requirements. The Bank staff is of the view that adequate external financing is not likely to become available unless an appropriate adjustment program is adopted.

Mr. Finaish made the following statement:

Several internal and external developments in the latter half of the 1970s had by the end of the decade led to a virtual stagnation of economic activity in Somalia and to a substantial widening of financial imbalances. Faced with that situation, the authorities launched a major adjustment effort, which has continued during the past three years. Helped by successive stand-by arrangements with the Fund, the most recent of which was successfully concluded last January, the authorities have been able during this period to implement a wide range of corrective measures, both for demand management and structural adjustment. Demand management was improved through tighter monetary and fiscal policies, while allowing a greater allocation of credit to the private sector. Measures for structural adjustment included several devaluations, the adoption of a flexible exchange rate system, significant liberalization of the trade regime, reform of public enterprises, improvements in the tax system, a relaxation of price controls, and adjustments in interest rates. As a result of these measures, Somalia's economic performance improved substantially, notwithstanding a difficult external environment.

An examination of the record over this period of adjustment shows an encouraging picture of renewed growth, lower inflation, and an improved external position. During the three years 1981-83, output is estimated to have grown at an average annual rate of 6.5 percent, compared to about 2 percent in 1980. The average annual rate of inflation dropped to a little over half the rate of 1980. As a proportion of GDP, the budget deficit fell from an average of 13 percent during 1979-80 to 4.5 percent during 1981-83. The average current account deficit declined by one third over the same period. Developments on the monetary side included a sharp reduction in credit expansion, reflected in a large decline in real money balances, and a contraction of government indebtedness to the banking system made possible by the improved budgetary position.

Looking more closely at the year under review, 1983, economic performance was adversely affected on account of certain exogenous developments, particularly poor weather and the imposition of a ban on Somalia's principal export, cattle, in its largest market. However, the strength gained by the economy in the preceding two years and the continued pursuit of appropriate adjustment policies helped to mitigate the impact of these developments. The growth rate fell to about 4 percent. In the agricultural sector, the mainstay of the economy, while the growth rate fell sharply, it is to the credit of the authorities' policy of improving producer incentives that, despite poor weather, output was maintained at a somewhat higher level than that of 1982 when favorable weather had prevailed. The drop in agricultural growth was also reflected in a slowdown in manufacturing activity.

In the external sector, owing principally to the cattle ban, a substantial shortfall in export receipts is estimated for 1983. While continuing efforts to resolve the matter, the authorities, in recognition of the need to enter new markets, reduced the minimum export price for cattle. With respect to another major export item, bananas, where the recent upward trend in production and export volume continued, export receipts nevertheless stagnated owing to a sharp decline in prices in the Italian market in dollar terms. In response to the reduced availability of foreign exchange, imports were cut back, with the result that the current account position improved during the year. The shortfall in export receipts also led the authorities to request a drawing under the compensatory financing facility.

Since the adoption last July of an exchange rate system based on a peg to the SDR, adjusted for relative price developments, the Somali shilling has depreciated by 13 percent in foreign currency terms. The authorities recognize the importance of a unified and realistic exchange rate policy, and intend to continue to exercise due flexibility in this regard, keeping in view the requirements of export competitiveness and the conditions created by the recent exogenous developments.

With respect to monetary policy, the authorities continue to emphasize the targeting liquidity growth to rates consistent with reduced inflationary pressures. In 1983, despite a 13 percent decline in domestic liquidity, the rate of inflation seems to have increased, which appears to be related to the less favorable supply conditions resulting from poor weather and the shortfall in foreign exchange receipts. However, it may be noted that, in view of the decline in liquidity and the restriction of the coverage of the price index to the Mogadiscio area, where urbanization pressures are at their highest, the current measure of inflation may be overstated. For improved monitoring of inflation, a new countrywide index is currently under preparation.

In line with the policy of promoting private sector activity, an increasing share of domestic credit expansion has been allocated to this sector. Thus, while credit to the public sector, including public enterprises, fell in absolute terms in 1982 and 1983, credit to the private sector rose substantially. In order to encourage savings and improve resource allocation, the interest rate structure has been revised upward twice since 1981, and is being kept under review in light of inflationary developments. Furthermore, steps have been taken to enhance the process of financial intermediation through improving bank efficiency, partly through increasing competition, and expanding banking facilities.

Fiscal restraint remains an important area of policy emphasis. The budget deficit was reduced in 1983, though not to the extent projected because of a less than projected realization of grants and the impact of a higher than projected rate of inflation on expenditures. Nevertheless, a combination of foreign financing and the effect of the currency depreciation on budgetary receipts enabled the Government to reduce for the second year its net indebtedness to the banking system. For 1984, though domestic revenues are projected to grow again by 20 percent, a widening of the budget deficit is expected, due mainly to a significant decline in foreign grants.

Fiscal policy in the recent period has aimed at both enlarging the flow of revenues and establishing a better control over expenditure growth. On the revenue side, the recent tax reforms, including the implementation of many of the IMF Tax Survey recommendations, have helped to expand the base of the tax system and improve its elasticity. Furthermore, a considerable strengthening of the tax collection procedures has taken place. A study on the simplification of the tariff structure and further improvement of collection procedures for customs duties is being prepared. On the expenditure side, measures taken include the discontinuation of the policy of guaranteed employment of high school graduates, the withholding of cost of living salary adjustments for public employees, assigning representatives of the Finance Ministry to other ministries, and effecting economies through limiting allocations.

The policy of improving the performance of public enterprises, whereby a number of enterprises have been closed and several other steps have been taken to improve operational efficiency, is expected to be further strengthened in the light of the recent report of the Interministerial Commission on public enterprises that is currently being studied. A reorientation of the pricing policies of these enterprises toward a better reflection of market values has been under way. The authorities are also considering abolition of all price controls, whose enforcement at any rate has been considerably eased in recent years. In addition, some institutional changes have been made to increase private sector participation in certain activities; these include the sale of the majority share of the National Banana Board to the public, the change in the previous monopsonistic role of the Agricultural Development Corporation to that of a price stabilization board only, and a movement away from government monopoly over imports.

In order to place their efforts toward the attainment of sustained growth with financial stability in an appropriate medium-term framework, the authorities have prepared, in collaboration with the World Bank, a public investment program for 1984-86, which is backed up by a consistent set of macroeconomic policies aimed at improved resource mobilization and utilization. The program, which was endorsed by a Consultative Group of donors last October, focuses on augmenting commodity production--especially in agricultural, export-related activities--and seeks to maximize returns on available resources by concentrating on quick-yielding high-return projects and improved utilization of existing capacities. The authorities intend to implement the program over its three-year duration in a flexible manner, in line with the availability of financing and actual experience with project implementation.

In conclusion, despite an unfavorable external environment, Somalia--a poor, pastoral economy--has been able to undertake an extensive adjustment effort for improved demand management and structural reform over a relatively short period of time, and with commendable results. In the course of this adjustment, two Fund programs have been fully and successfully implemented. The authorities recognize that in order to consolidate the gains made thus far and to make further progress toward the longer-term goal of sustained noninflationary growth, they would need to continue their adjustment efforts to tackle financial imbalances and structural weaknesses that remain. In the light of their continuing commitment to adjustment, a follow-up structural adjustment program was negotiated with the Fund as the most recent stand-by arrangement was approaching its conclusion. In view of the evolving situation in the wake of the adverse exogenous developments that intervened last year, the authorities later felt that the timing of some of the envisaged measures needed to be reconsidered. They, however, remain in accord with most of the provisions of the program, and intend to carry out the needed adjustments within an appropriate time frame, and in continued cooperation with the Fund. In their future endeavors, particularly the implementation of the public investment program, continued support of the international financial community will remain important.

Mr. Lovato expressed agreement with the staff appraisal and support for the proposed decision. It was clear from the staff report that the Somali authorities had done a good job: they had adopted numerous corrective measures affecting both demand and supply. Following the impressive results obtained under the adjustment program of 1981 and 1982, the authorities had intensified their efforts in 1983. In particular, they had compressed expenditures in real terms by a greater percentage than foreseen, by strictly observing the limit on new recruitment, by freezing salaries, and by cutting back investment expenditures. Such policies were difficult to implement, all the more so in a low-income country. The authorities should be commended for their efforts.

Unfortunately, poor weather had adversely affected domestic supply; owing to the ban imposed by Saudi Arabia, exports of cattle had declined sharply; inflation had recently accelerated while external pressures had intensified, Mr. Lovato noted. Nevertheless, he was confident: in 1983, besides observing all the performance criteria, the Somali authorities had continued to demonstrate strong political will and great flexibility in dealing with difficult adjustment problems. He had the impression that their determination to follow a flexible stance, according to circumstances, and their pursuit of market-oriented policies affecting prices, the exchange rate, and public enterprises, would demonstrate the will to overcome the country's underlying structural and institutional problems.

The question was how fast they should carry out adjustments that could help to increase and maintain competitiveness, to promote nontraditional export items, thus diversifying the economy and making it less vulnerable, and to reduce by better export performance the difficulties associated with increasing imports and accelerating development, Mr. Lovato noted. He agreed with the staff that there was a need for a serious program of structural adjustment and welcomed the agreement reached with the authorities on the appropriate measures. Although he would like to see the measures implemented rapidly, he understood the economic constraints imposed on the authorities, who were trying to overcome a temporary slowdown in the momentum of adjustment.

At the end of 1983, Somalia's public external debt had reached $1.2 billion, Mr. Lovato noted. The fact that most of the debt was on concessional terms could blur the severity of the external position. Actually, as the staff had pointed out, the maturities of external debt were bunched in the next four years, when Somalia would have a sharply increased debt service obligation. If the authorities were to be able to fulfill their duty, creditors should display more readiness to reschedule the debt and to disburse the loans associated with projects. Fortunately, the Somali authorities had succeeded in rescheduling or converting their debt. He hoped that they would also succeed in obtaining further relief from donors.

He welcomed the medium-term recovery program for 1984-86 prepared in consultation with the Fund and the World Bank as well as the principles agreed upon for selecting high-priority projects for the investment program, particularly for agriculture and infrastructure, Mr. Lovato went on. He endorsed the view of the World Bank that the agreed-upon public investment program should be a part of Somalia's overall medium-term recovery program, which had to bolster the shift toward a more open and market-oriented economy. He thus encouraged the Somali authorities to make structural and administrative reforms, improve tax collection and the efficiency of public enterprises, strengthen controls on expenditure, and especially keep investment expenditure within the limits allowed by available current financing.

Mr. Toé recalled that during previous Board discussions of Somalia, his chair had commended the authorities for appropriate and timely measures taken to deal with imbalances in the economy. Indeed, 1981 and 1982 had been two good years for the country: reflecting both well-inspired economic policies and good weather, real GDP had grown by impressive amounts in both years, while inflation had been on a remarkable decline. Progress had also been achieved in dealing with the overall fiscal deficit, although less so in 1982 than in 1981. Results had been mixed in the external sector, being better in 1981 than 1982, when the current account deficit had grown by 37 percent while the overall balance of payments deficit had deteriorated. The bright spot of 1982 had been that, by the end of the year, all of Somalia's outstanding external payments had been eliminated. In 1983 and 1984, the overall economic situation appeared to be evolving in an unfavorable direction. Although real GDP had grown by 4.1 percent in 1983, there were signs of a resurgence of inflation, even if the precise degree was unknown. The overall fiscal outturn was worse than previously expected, while the overall balance of payments deficit continued to increase. The two major problems, whose early resolution would help greatly to set the economy onto a firm footing, were how to deal with the ban on Somali livestock products in Saudi Arabia and how to stem increasing capital outflows.

Although it was commendable, as the staff indicated, to reduce Somalia's short-term vulnerability in traditional export markets and thus the need for further devaluations of the Somali shilling in order to penetrate other markets, Mr. Toé continued, he wondered whether Somalia might not be worse off in the long run if it lost the advantage deriving from consumer preference for Somali products. Further efforts should be directed at lifting the ban on cattle exports.

It was not easy to deal with the capital outflows, which appeared to be on the rise, Mr. Toé observed. Could the staff explain what the effect would be of further devaluations of the Somali shilling on such capital outflows? External accounts denominated in U.S. dollars seemed to have provided a convenient means for capital outflows, although they had been supposed to discourage such outflows. Would the introduction of various financial instruments be of great help? As the banking structure did not lend itself to such instruments for the time being, the effort to improve financial intermediation by reforming the banking system was welcome.

The authorities had taken other commendable measures such as halting the automatic hiring of high school graduates, Mr. Toé concluded. Recruitment had to be done on a competitive basis if the civil service were to perform efficiently. Measures such as relaxing price controls and weeding out inefficient public enterprises while streamlining others showed that the authorities were capable of implementing unpopular decisions whenever the situation so dictated. More such decisions would be needed in the immediate future in order to arrest what might turn out to be a rapid deterioration in Somalia's economy. In conclusion, he supported the proposed decision.

Mr. Nimatallah voiced agreement with the staff's analysis and conclusions. During the previous three years, Somalia had brought about substantial adjustment, successfully carrying out two stand-by arrangements with the Fund. The cooperation between the authorities, management, and staff had been exemplary. Indeed, in one of his recent speeches, the Managing Director had cited Somalia as a case in which successful adjustment had taken place with Fund support. Nonetheless, the economy still required medium-term structural adjustment. Therefore, he hoped that an agreement on an extended arrangement could be concluded soon. It would be a pity if the arrangement did not go through, after all the sacrifice and efforts of the Somali authorities to reduce economic imbalances.

Being keen to see a prosperous Somali economy with a comfortable standard of living, Saudi Arabia had helped the country in many ways, Mr. Nimatallah noted. Saudi Arabia was doing everything possible to enhance the flow of imports from Somalia; his authorities were taking positive steps to make possible the resumption of cattle imports, which had been interrupted for health reasons. A high-level Ministerial Commission appointed by the King had looked into specific recommendations on how to resume cattle imports, with necessary health precautions. The recommendations were being discussed with the Somali authorities, and he hoped that the discussions would soon yield positive results.

Clearly, the Somali authorities might have to take some additional measures: besides instituting health precautions, they might have to try to make the price of their livestock exports more competitive, Mr. Nimatallah remarked. After all, the Saudi economy was wide open, and the Government could exert little influence on private importers, who were quite sensitive to considerations of price and quality.

Aware as he was of the tremendous difficulties facing the Somali economy, Mr. Nimatallah said, he could see only limited alternatives to adopting a course of medium-term structural adjustment. The external sector had to be strengthened on both the export and import sides. Import control should be eased over time, helping to make available much-needed imports for a sustainable growth path. Meanwhile, every effort should be made to reduce the cost of Somali exports and make them more competitive.

Finally, Mr. Nimatallah noted, it was encouraging that the World Bank had reaffirmed its support for Somalia's public investment program. The authorities had realized that appropriate policies would be essential for Somalia to attract external financial assistance for development. He wished the authorities success in their efforts to adjust and develop the economy.

Ms. Bush expressed broad agreement with the staff appraisal and support for the proposed decision. During the past three years, Somalia had benefited from its commitment to major adjustment efforts, including a 64 percent devaluation of the shilling and restructured monetary and fiscal policies. In 1982, real annual growth in GDP had soared to 10 percent; the rate of expansion of domestic liquidity had been cut in half; exports had risen by 15 percent; no new external debt had been contracted. In 1983, the Government had continued to pursue economic adjustment, adopting measures to curb capital outflows, encourage the inflow of workers' remittances, make interest rates more competitive, achieve a more flexible exchange rate, and keep the budget deficit under control. Among the positive results, the budget deficit had fallen from 29 percent of expenditure in 1982 to 23 percent in 1983, while domestic revenues had been higher than projected, and monetary developments had been better. Unfortunately, a number of reversals had occurred in 1983, owing in large measure to forces beyond the Government's control. For instance, the current account deficit, although smaller than in 1982, had exceeded the projection; debt servicing had become more burdensome; economic growth had slowed to a modest 4 percent; inflation had picked up again to about 35 percent, against 24 percent in 1982.

Overall, the positive direction and results of the Government's policies in recent years appeared to have strengthened Somalia's capacity for coping with the decline in export earnings, Ms. Bush went on. Given the progress achieved to date and the agreement reached with the staff on measures for coming to grips with some of the fundamental structural problems, she regretted that the authorities deemed it necessary to postpone key measures. She was concerned that any failure to implement such measures soon would turn out to be harmful. Although pressures might have intensified recently, that was all the more reason for the authorities to continue on a course of prudent and responsible action.

Like Mr. Lovato, she was concerned with the trend toward a higher debt service ratio, which had risen from 12 percent of export earnings in 1982 to 17 percent in 1983 and was projected to reach 55 percent by 1986, Ms. Bush continued. Early establishment of a debt monitoring system with Fund support would increase the authorities' capacity for managing external debt, and she strongly supported efforts in that direction.

She hoped that the special subcommittee on public enterprises would soon release its recommendations, Ms. Bush said, and also that the authorities would take follow-up measures to eliminate or restructure public enterprises, as appropriate. Even though they had taken measures to improve the elasticity of the tax system during the previous few years, she shared the staff's concern about the sharp increase projected for the budget deficit in 1984. As the staff had noted, one way to boost budgetary receipts from grants and customs duties would be by reforming the exchange system. She also shared the staff's concern about the possibility of higher inflation unless the authorities suitably dealt with the expansion of money and credit expansion.

Mr. Hassan commented that the authorities had demonstrated the capacity and the will to carry out adjustment policies, when it became necessary. The steps taken during the previous three years, supported by two stand-by arrangements with the Fund, attested to that fact: they had devalued the shilling several times, liberalized prices, improved the performance of public corporations, and installed both revenue-generating and expenditure control measures. Their policies had proved rewarding: economic growth had rebounded strongly in 1981 and 1982, while the rate of inflation had fallen, and the external payments position had improved.

Shortcomings that had begun to emerge in 1984 showed that the economy continued to be vulnerable to external factors, Mr. Hassan remarked, and that a number of structural problems remained, requiring sustained efforts aimed at improving resource allocation and diversifying the productive base. The public sector investment program for 1984-86, focusing on expanding domestic production in general and that of export commodities in particular, appeared to be a step in the right direction. A number of donors had indicated interest in the 1984-86 program and had made substantial commitments in the form of grants and loans. For those commitments to be followed by timely disbursements, coordination between donors and the authorities would be required to ensure that the program's targets were attained.

The staff had pointed to the urgency of effecting a further adjustment in the exchange rate for the shilling and the need to liberalize the import system, Mr. Hassan went on. A depreciation might help the country to sell cattle on other markets, as the staff suggested, and also to reduce the gap between the parallel and official exchange rates. Nonetheless, he wondered how effective the exchange rate could be in an economy like Somalia's in bringing about the multitude of goals listed on pages 12 and 14 of the staff report. Furthermore, although he had no problem in principle with the liberalization of the import system, the crucial issue would be determining the pace at which liberalization was to occur, particularly in view of severe foreign exchange shortages.

Somalia's debt burden was expected to increase sharply, reaching 55 percent of export earnings in 1986, Mr. Hassan noted. A considerable part of the payments would result from repurchases from the Fund, so that the authorities would have little room for maneuver. Donor countries should be aware of the prospects, with a view to providing more assistance to Somalia on concessional terms.

According to the staff, the authorities preferred to go slowly in introducing new reforms, Mr. Hassan continued. Experience had shown that it was better to act forthrightly when problems began to emerge, because waiting could mean that more difficult measures would have to be taken in the future. Thus, the Somali authorities might wish to make every effort within the realm of what was practical and feasible to continue on the course begun under the adjustment program a few years previously.

Mr. Grosche expressed regret that, having effectively implemented two stand-by arrangements, Somalia had decided to defer implementing further measures to deal with the underlying structural and institutional problems. Although the drought, the cattle ban, and speculation in foreign exchange markets had added substantially to the fragility of the economy, he shared the fear that postponing measures aimed at underlying structural deficiencies might aggravate Somalia's problems, at least in the medium term. In particular, the exchange and trade system should be reformed to ensure greater export incentives and better supply conditions, which could also be improved by pursuing the investment program agreed upon in the consultative group. On the Juba Valley development, he welcomed the information provided by the World Bank indicating that Somalia had indeed reached understandings with the Bank that should assist in establishing the most economic sequence of investments.

On the other hand, Mr. Grosche said, he was concerned about the availability of external funding for the investment program. He fully shared the view expressed by the World Bank staff that external financing was unlikely unless the authorities adopted a suitable adjustment program. Indeed, it was worrying that current financial policies seemed to add to the persistent pressures of excess demand, particularly by a budget deficit planned to be sharply higher in 1984. The deficit would need to be financed by the banking system, thereby crowding out nongovernment borrowers. Measures to improve budgetary receipts and to adjust interest rates was called for.

In conclusion, Mr. Grosche joined the staff and other Directors in urging the Somali authorities to pursue their adjustment efforts. Without an early implementation of the adjustment program, on which agreement had already been reached with the World Bank, the progress made in recent years could easily be jeopardized. He supported the proposed decision.

Mr. Shaw agreed with the staff appraisal and supported the proposed decision. He was appreciative of the extensive discussion in the staff paper on the consultations held between the World Bank staff and the Somali authorities. Analysis of the investment program was crucial; the list of criteria for decision making on projects, and the authorities' recognition that their public investment program was "a dynamic process," represented an important step forward. Finally, he was surprised there had been no recommendation provided with regard to the next Article IV consultation.

The staff representative from the African Department, responding to questions, noted that a number of issues regarding the gradual approach to adjustment in Somalia had been raised. Beginning in mid-1981, the effective implementation of programs had resulted in a considerable reduction in the rate of inflation and an improvement in the external sector position, while economic growth had accelerated considerably. The authorities had taken wide-ranging measures affecting both supply and demand. Concomitantly, considerable work had been done by the Fund, the World Bank, the Somali authorities, and the UN Development Program to prepare a structural adjustment program to be launched at the beginning of 1984. The efforts exerted during the previous three years could generally be viewed as providing the foundation for launching the structural adjustment program, which had been endorsed by donor countries at a meeting of the consultative group held in Paris in October 1983. Subsequently, agreement had been reached between the Fund and the Somali authorities on a structural adjustment program that would have begun early in 1984.

The ban on cattle exports to Saudi Arabia in effect during 1983 and the emerging drought had subsequently prompted the Somali authorities to consider that the timing might not be propitious for undertaking the program, the staff representative stated. However, the cattle ban had been taken into account when negotiations had been under way for the structural adjustment program, and the authorities had included measures in the program to increase the competitiveness of Somali cattle in other markets. While the drought had indeed created an additional uncertainty, they had increased the urgency for introducing adjustment measures intended to reduce supply difficulties that could emerge under such conditions.

A number of questions about the reform of the exchange and trade system had been raised by Mr. Nimatallah, Mr. Toé, and Mr. Hassan, the staff representative observed. In the staff's view, the exchange and trade reform was required to enhance the competitiveness of Somali exports. In addition, the reform would help to diversify the structure and direction of Somali exports over time, gradually reducing the vulnerability of the external sector due to its current dependence on one commodity and one major export market.

The responsiveness of production and exports to price incentives had already been shown by the favorable reaction of banana exports in the last few years to various exchange rate actions and adjustments in producer prices, the staff representative pointed out. During the previous year, there had been a 38 percent increase in the volume of banana export volume from Somalia. Furthermore, the reform was important to improve and rationalize the flow of imports into Somalia. At present, a complex system of import licensing remained in place associated with a complicated system of foreign exchange allocation, which tended to restrict the flow of imports into the country and impede the most efficient allocation of imported goods within the country. The exchange and trade reform would simplify the system, liberalizing it in order to permit a freer flow of imports. The reform would also be designed to enhance the profitability of existing and potential import-substituting industries. Finally, it would encourage inflows of workers' remittances from Somalis living abroad and, in response to Mr. Toé, should reduce the scope for capital outflows by increasing the profitability for alternative uses of foreign exchange.

With regard to the cattle ban, the Somali authorities had indicated that they had taken a number of measures to ensure that only healthy animals were exported, the staff representative continued. They had begun to vaccinate cattle and had set up a number of quarantine centers, issuing directives that only cattle from such centers should be exported. As Mr. Nimatallah had indicated, there were ongoing discussions between the Somali authorities and the Saudi authorities aimed at resolving the matter.

Concerns about debt servicing had been expressed by Mr. Lovato and Ms. Bush, the staff representative recalled. In the absence of a sharp increase in exports that could be brought about by a liberalization of the external sector, and in the absence of debt rescheduling, the debt service ratio would rise to 55 percent of export earnings in 1986, even assuming that present frozen debts were converted officially into grants. The authorities were fully aware of the serious implications of the projected rise, and they were contacting countries bilaterally to seek debt rescheduling. In the view of the staff, however, it was also important for the authorities to take necessary measures in order to expand the export base, thus reducing the debt service ratio.

In response to Ms. Bush, the Somali authorities had indeed requested technical assistance in dealing with external debt, and the staff was responding positively, the staff representative from the African Department explained. An expert in external debt had been located and would be assigned shortly to Somalia. His duties would be to help to establish a system of external debt reporting, to improve collection of data on external debt, and to ensure timely debt servicing.

Mr. Finaish observed that there was no major disagreement between Executive Directors and the Somali authorities about the future of the country. The authorities recognized that they had to continue their adjustment efforts in order to consolidate the gains achieved in the past and to address current financial and structural weaknesses. In that context, an extended arrangement had been negotiated with the Fund earlier in the year. Although the authorities had come to consider that the timing of some elements in the program needed some further consideration, they continued to emphasize their agreement with most of the provisions in the program and intended to implement needed adjustments in continued cooperation with the Fund. Of course, when a country like Somalia embarked on a major adjustment program, certain political and social constraints could not be completely ignored, and other parties, including the Fund and the World Bank, should display reasonable understanding of such constraints, particularly given the harsh environment and limited resources available to Somalia.

He was happy that Mr. Nimatallah had reported that the Saudi authorities were reconsidering their ban on the importation of Somali cattle, Mr. Finaish continued. He hoped that the matter would be resolved soon, as cattle exports were essential for the Somali economy.

Owing to the cautious approach taken by the authorities in managing external debt during the previous four years, Mr. Finaish explained, Somalia's current stock of debt consisted mainly of long-term concessional loans, with a high proportion being owed to international financial institutions. He hoped that rescheduling arrangements, and in some cases the conversion of debts into grants, would enable Somalia's debt servicing to be kept within manageable proportions throughout the difficult period of adjustment. Meanwhile, for better monitoring of the debt situation and for facilitating timely debt service payments, an external debt unit was being set up within the Ministry of Finance with Fund assistance.

On the liberalization of the external trade and payments system, Mr. Finaish concluded, the advice commonly given to small countries was to liberalize their economies, while the recent trend had been in the other direction in the larger industrial countries. Though such advice was difficult to accept fully, especially in view of the domestic resource constraints and the severe shortage of foreign exchange, the authorities in Somalia were doing their best.

The Chairman made the following summing up:

Directors were in agreement with the thrust of the staff appraisal contained in the report for the 1983 Article IV consultation with Somalia. They commended the Somali authorities for implementing during the past three years in an effective manner major adjustment programs that had contributed to a considerable improvement in economic conditions. It was noted that during 1981 and 1982 economic growth had picked up significantly, the rate of inflation had dropped sharply, and the overall external position had improved. Directors noted that the intensification of the adjustment efforts in 1983, including important supply-oriented measures and tighter financial policies, had mitigated somewhat the impact on the economy during 1983 of the ban introduced in Somalia's principal market for cattle exports and of the deterioration in weather conditions. The tightening of fiscal policy had contained the effect of the decline in foreign exchange receipts in 1983 on economic activity and inflation, while the fall in imports had allowed a narrowing in the current account deficit.

Directors noted with regret that the Somali authorities had concluded that, in present circumstances, they had to postpone the launching of their structural adjustment program with the Fund. The hope was expressed that particular difficulties, such as the question of cattle exports could be resolved soon. Directors stressed the need for Somalia to tackle the remaining structural problems with a view to achieving a sustainable rate of economic growth, a gradual reduction in inflation, and a viable balance of payments position over the medium term. Directors encouraged the authorities to undertake a liberalization of the exchange and trade system, in order to improve the competitiveness of Somalia's exports, the allocation of foreign exchange, and resource allocation in general.

Directors commended the authorities for completing the study of public enterprises and encouraged them to implement as soon as possible the recommendations of that study. The need to review pricing policies of public enterprises was also cited.

Directors welcomed the reaffirmation of the authorities' commitment to the public investment program for 1984-86, endorsed at the Consultative Group Meeting in 1983, and stressed that such investment needed to be carried out in an appropriate policy framework. The understandings between Somalia and the World Bank on the public investment program were warmly welcomed.

Directors noted the need for Somalia to continue financial policies geared to containing the growth in demand in accordance with the expected availability of domestic and external resources. Concern was expressed that, without further measures, the 1984 budget would result in an increase in the deficit, which would be incompatible with financial stability. Directors also noted the need for further adjustments in the interest rate structure. The authorities were praised for their decision to undertake a reform of the banking system. The need to improve the monitoring of the external debt was emphasized, as well as the need to curb rising capital outflows.

It was recommended that the next Article IV consultation with Somalia should be held on the standard 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Somalia's exchange measures subject to Article VIII, Sections 2(a) and 3, in concluding the 1983 Article XIV consultation with Somalia, and in the light of the 1983 Article IV consultation with Somalia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The approval by Decision No. 7331-(83/84), adopted February 22, 1983, of Somalia's multiple currency practice arising from a bonus scheme described in EBS/83/15, which was extended by Decision No. 7594-(83/185), adopted December 29, 1983, is further extended until December 31, 1984.

Decision No. 7686-(84/69), adopted
April 30, 1984

3. DEATH OF MR. OVERBY

The Chairman informed Executive Directors of the death in New York City the previous Saturday of Mr. Andrew N. Overby at the age of 75. Mr. Overby had distinguished himself both in the public sector and in private life. After a decade in commercial banking, he had joined the Federal Reserve Bank of New York in 1942 and the U.S. Treasury in 1946, becoming the Executive Director for the United States in the International Monetary Fund in 1947. For two years, he had served in the Executive Board, then consisting of 13 Directors, and had subsequently become the Fund's first Deputy Managing Director from 1949 to 1952, serving under Camille Gutt and Ivar Rooth. Following his years as Deputy Managing Director, Mr. Overby had returned to the U.S. Treasury and in 1957 had joined First Boston Corporation, where he had held high posts until his retirement in 1974. On behalf of all those at the Fund, condolences would be sent to Mr. Overby's wife.

The Executive Directors took note of the statement by the Chairman.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/68 (4/30/84) and EBM/84/69 (4/30/84).

4. MOROCCO - TECHNICAL ASSISTANCE

In response to a request by Morocco for technical assistance, the Executive Board approves the proposal set forth in EBD/84/126 (4/24/84).

Adopted April 30, 1984

APPROVED: October 12, 1984

LEO VAN HOUTVEN
Secretary