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Minutes of Executive Board Meeting 84/110

10:00 a.m., July 18, 1984

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

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	S. Kolb, Temporary
	X. Blandin
	M. Teijeiro
	J. Delgadillo, Temporary
	M. K. Bush
	M. Lundsager
	T. Alhaimus
	T. Yamashita
J. E. Ismael	
	L. Leonard
	G. W. K. Pickering, Temporary
A. Kafka	
G. Laske	W. Moerke, Temporary
	N. Coumbis
	A. Vasudevan, Temporary
	J. E. Suraisry
J. J. Polak	
A. R. G. Prowse	
	O. Kabbaj
	E. I. M. Mtei
	E. Portas, Temporary
	I. Fridriksson, Temporary
	T. A. Clark
	D. J. Robinson, Temporary
	Shao Z., Temporary

J. W. Lang, Jr., Acting Secretary
B. J. Owen, Assistant

Also Present

African Department: R. J. Bhatia, Deputy Director; O. B. Makalou, Deputy Director; E. L. Bornemann, E. A. Calamitsis, F. d'A. Collings, M. E. Edo, J. E. Greene. Central Banking Department: L. E. Molho. Exchange and Trade Relations Department: M. Guitián, Deputy Director; W. A. Beveridge, Deputy Director; E. H. Brau, T. Hatayama. Fiscal Affairs Department: H. R. De Zoysa, E. S. Kreis. IMF Institute: Z. N. Namoya, Participant. Legal Department: A. O. Liuksila, J. K. Oh. Middle Eastern Department: C. Sassanpour. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J.-P. Amselle, M. Caiola, H. M. Flickenschild, A. Furtado, J. E. Gonzalez, K. J. Keller, H. E. Khor, P. Kohnert, C.-J. Lindgren, A. Lopez-Claros, M. C. Spinola, S. J. Stephens, J. E. Sundgren, G. L. Terrier, G. Yadav. Personal Assistant to the Managing Director: S. P. Collins. Advisor to Executive Director: S. R. Abiad. Assistants to Executive Directors: J. R. N. Almeida, R. Bernardo, J. Bulloch, M. Camara, M. Eran, C. Flamant, L. Ionescu, J. M. Jones, H. Kobayashi, E. Landis, A. A. Scholten, A. J. Tregilgas, M. A. Weitz.

1. ZAMBIA - 1984 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1984 Article IV consultation with Zambia, together with a request for a stand-by arrangement in an amount equivalent to SDR 225 million, or 83 percent of quota (EBS/84/135, 6/21/84; and Cor. 1, 7/9/84). They also had before them a report on recent economic developments in Zambia (SM/84/125, 6/1/84; and Cor. 1, 6/14/84).

The staff representative from the African Department made the following statement:

The latest available information indicates that the Zambian authorities further depreciated the kwacha between end-May and July 13 by 5.9 percent against the U.S. dollar. Thus the total depreciation during 1984 now amounts to 17.6 percent. The Government is closely monitoring world copper prices and has informed the Fund staff of its willingness to accelerate future exchange rate adjustments if needed to preserve the profitability of the mining industry. During the first six months of 1984, the average world price was 65.2 U.S. cents a pound, in line with the projection included in the program. However, during the first half of July the price has fallen to an average of about 59 U.S. cents a pound. Taking account of seasonal variations in production, copper shipments were slightly above the level anticipated in the program during the first half of the year.

The authorities have completed the legal work necessary for the introduction of the additional tax measures reported in the staff report, including the imposition of a 10 percent minimum import duty on virtually all items except petroleum and government imports, and a shift in the tax basis for levying import duties from f.o.b. to c.i.f. The additional measures are expected to become effective around the beginning of August.

In addition, the consumer price for maize meal has been increased by 21.7 percent effective July 1, as agreed in the program.

Mr. Mtei made the following statement:

The last Board discussion on Zambia was in January 1984 in connection with the review of Zambia's exchange rate policy under the stand-by arrangement approved by the Fund on April 18, 1983. At the time, it was clear that despite the wide array of policy measures being implemented by the authorities as agreed with the Fund, including a substantial depreciation of the kwacha, Zambia's external position remained weak. The problem resulted from the sharp fall in copper prices in the international market as well as from lower shipments due mainly to transportation bottlenecks.

Conditions in the copper industry remain at the core of Zambia's economic problems. The continued weakness in the balance of payments and the accumulation of external arrears, resulting largely from adverse developments in the copper industry, translate into a lack of adequate spare parts, raw materials, and equipment and, consequently, a low level of economic activity.

The adjustment efforts of the authorities must be seen in this light. In the absence of a pickup in the international market for copper--not to mention a further decline--the ability of the economy to move toward a sustainable balance of payments position will be severely constrained in spite of the appropriate domestic policies now being implemented. This is one of the important lessons that has become quite evident from the experience of 1983. The performance record under the recently expired stand-by arrangement attests to the appropriateness of domestic economic policies while highlighting the vulnerability of the economy to external influences. On the domestic scene, the fiscal deficit relative to GDP declined by about 12 percentage points in just one year, from 18.9 percent in 1982 to 6.9 percent in 1983; monetary policy supported the objective of containing aggregate demand (Bank of Zambia credit to Zambian Consolidated Copper Mines (ZCCM) that had been used to finance operating losses in 1982 was eliminated); producer prices were kept at remunerative levels in order to encourage increased agricultural production; and cost-saving measures were initiated in the mining company such that it was able to break even after payment of taxes compared with a loss of K 130.6 million incurred during the preceding year. The exchange rate was managed flexibly, contributing to the profitability of the mining sector and restoring the competitiveness of a number of agricultural crops. It was in the external sector that problems emerged. Export receipts were significantly lower than had been expected, largely as a result of factors beyond the control of the authorities. The shortage of foreign exchange therefore made it difficult for Zambia to meet the ceiling on external arrears and, consequently, the last purchase under the stand-by arrangement could not be made.

The program that is being presented to the Board today demonstrates the commitment of the Zambian Government to continue the adjustment process, building on the achievements that have been made thus far, and its willingness to continue working closely with the Fund in seeking solutions to the country's economic problems. However, as suggested earlier, given the difficult external payments situation of the country, it is very important that the international community support the efforts of the authorities through increased concessional aid and meaningful debt relief, not only at present but over the medium term as well. It is encouraging that the policy reforms in Zambia were well received by donors at the recent Consultative Group meeting and that the World Bank has endorsed its development strategy and program. It is also to be noted that the Paris Club is scheduled to meet soon to discuss Zambia's request for debt relief. The authorities have also been in touch with other creditors with the aim of concluding rescheduling arrangements.

The program continues to reflect the Government's commitment to the diversification of the economy in order to reduce dependence on copper and ensure a reasonable level of economic growth. In this connection, priority is being accorded to the agricultural sector to increase output of both food and export crops. Producer prices for 1984/85 have been raised on average by 21 percent and extension and marketing services are being improved. In addition, the Zambian Agricultural Development Bank has been instituted in order to provide credit more efficiently to farmers. The World Bank is currently processing an agricultural sector rehabilitation credit to enable the Government to carry out its medium-term policies.

Strengthening the manufacturing sector is also an important aspect of the Government's diversification strategy. The Government provides a broad range of incentives for investors, including tax exemptions on certain investment projects, with particular attention being paid to export-oriented enterprises and those which are located in rural areas. Moreover, manufacturing establishments should also benefit from the liberalization of prices throughout the economy, especially public enterprises which account for a large part of manufacturing activity in Zambia, as well as from the development of cheaper sources of energy, such as hydroelectric power, which provided about 70 percent of energy needs in 1983.

The continuation of fiscal restraint is central to the success of the adjustment process in Zambia. Accordingly, the budget deficit as a percentage of GDP is expected to decline further from 6.9 percent in 1983 to 4.5 percent in 1984. The change would have been greater but for the substantial increase in interest payments. In order to achieve the budgetary target, new tax measures have been introduced while steps have been taken to contain expenditure. Excise and sales taxes have been increased and a minimum rate of import duty of 10 percent will be levied effective August 1984 on all items other than petroleum, government imports, and certain items exempt by law. A new revenue unit has been created in the Ministry of Finance with the intention of improving the efficiency of tax administration. As regards expenditure, no general wage increase is planned for 1984, and recruitment into the civil service will be restricted to only a few ministries. Subsidies are expected to fall substantially in real terms, reflecting a 21.7 percent increase in the price of maize and an 11 percent rise in the price of fertilizer. Transfer payments will be reduced by 15 percent from the 1983 level by strictly limiting the operating costs of decentralized public agencies. Capital expenditure is projected at slightly less than the outlays in 1983.

Monetary targets reflect the expected progress in the budget and are consistent with the need to contain inflation and reduce pressure on the balance of payments. The increase in credit to the Government will be limited to 8 percent, while the improved financial position of the mining company has eliminated its need for financing from the Bank of Zambia to cover operating losses. Particular attention is being given to the need to make adequate provisions for loans to the agricultural sector which, as has been mentioned, is an important part of the diversification program. Broad money is projected to increase by 15 percent, far less than the expected growth in nominal GDP of 25 percent. Interest rates have been adjusted further by an average of 2 percentage points. The maximum lending rate is now set at 15 percent, providing greater flexibility to commercial banks in setting interest rates to reflect the risks associated with different types of loans.

The authorities remain aware of the importance of expanding and diversifying Zambia's export base. As such, they will continue to maintain a flexible exchange rate policy in 1984, cognizant that the depreciation of the kwacha in 1983 played an important role in restoring the profitability of the mining company, and has provided adequate financial incentives for the production of a variety of crops, both for export and domestic use. In addition, attempts are being made to reduce administrative bottlenecks in respect of exports, including efforts geared toward improving the allocation of foreign exchange. Nontraditional exports are being given special incentives through preferential tax treatment, a policy that became effective on April 1, 1984. Efforts have been intensified to increase the production of emeralds and to channel exports of this commodity through the official market.

Despite the positive steps that have been taken in the export sector, Zambia's external payments position is expected to remain difficult, at least for the next few years. Moreover, the country will remain heavily dependent on developments in the international market for copper in the foreseeable future, although the policies that are now being put in place offer a better prospect for diversification of the country's economy. The heavy debt service burden shows the magnitude of the continuing problem that the authorities will have to grapple with.

In sum, the policies of the Zambian authorities represent a major effort toward rehabilitation of the economy. In the circumstances, Fund support is essential not only in terms of the financial resources that will be provided under a program with the Fund, but also in terms of attracting resources from other multilateral institutions as well as official sources and the private market. Given the authorities' long record of cooperation with the Fund, I urge Directors to support the request for a stand-by arrangement.

Mr. Clark observed that the extremely difficult economic situation that Zambia was facing was for the most part not of its own making but reflected the particularly severe impact of the world environment on the Zambian economy. Yet in that environment, it was encouraging that both the public sector and balance of payments current account deficits were estimated to have been cut by half in 1983, as a percentage of GDP, attributable to the implementation of substantial adjustment measures. However, as shown in Table 10 of the staff report, Zambia would be subject to severe pressures through the rest of the 1980s and beyond, arising in particular from debt service commitments and from the heavy concentration on exports of a commodity for which demand prospects were uncertain. Although, in time, measures to encourage export diversification should go some way toward alleviating that problem, it would be many years before their effect would be fully felt.

Against that background, the staff in its appraisal pointed to the need in future years for substantial debt relief associated with continued Fund support, Mr. Clark went on. The amount of the proposed stand-by arrangement had to be limited, simply because Zambia could not afford to incur large amounts of new debt on nonconcessional terms, and also to allow headroom for future programs. With the Fund no longer able to be a large net contributor of resources to Zambia, other creditors and donors would have to play a larger role.

He endorsed the broad thrust of the proposed program for 1984, which built on the improved fiscal and monetary positions and the more competitive pricing policy achieved under earlier arrangements, Mr. Clark said. He welcomed the authorities' determination to consolidate those achievements, in particular through the further strengthening of fiscal administration and through the pursuit of an active and flexible exchange rate policy.

The urgency and importance of economic diversification was rightly stressed in the staff appraisal, especially with a view to expanding the range of exports beyond the mineral sector, Mr. Clark commented. He would have welcomed a more detailed discussion in the staff report of the scope for both export diversification and import substitution. Perhaps the available options could be assessed, possibly drawing on World Bank expertise, during the first review under the proposed stand-by arrangement.

The World Bank was contributing to Zambia's efforts to improve the efficiency of copper production, Mr. Clark remarked. Both the $75 million loan approved by the World Bank in March and the World Bank Group support for the Tailings Leach project would help to increase copper extraction. The world copper price was of course a major uncertainty underlying the program. The staff had wisely based the 1984 program on the rather conservative assumption of 65 cents a pound; however, its medium-term export projections in Table 11 (EBS/84/135) were based on an increase in that price over the next five years to $1.15, which seemed much less realistic. Zambia's vulnerability to fluctuations in the copper price was well illustrated by the statement in the staff appraisal that a gain of 1 cent in the U.S. dollar price of copper per pound would make a difference of SDR 11 million to exports. It was evident that careful coverage would have to be given to the evolving prospects for copper in each review of the program.

The other major uncertainty concerned the financing gap, which under the 1984 program would be SDR 419 million, Mr. Clark observed. The figures in the staff report suggested that just under half of that gap could be covered by exceptionally favorable debt relief from the Paris Club; even on that assumption, much would still depend on the response of other creditors. Furthermore, it was unfortunately clear that Zambia would continue to face financing gaps beyond the immediate future. The limited scope for further adjustment indicated the need to look for greater concessional aid, directed especially at boosting production and exports. It would be helpful if, in future reviews, the staff could do more than estimate the size of the financing gaps and could consider just how they might be bridged, linking the analysis closely to an assessment of the scope for export diversification and for the development of copper export earnings. In conclusion, he agreed with the staff appraisal and supported the proposed decisions.

Mr. Suraisry said that he was in general agreement with the staff analysis and conclusions, and he could therefore support the proposed decisions. Zambia had made commendable progress in implementing the 1983 adjustment program with the Fund. The budget deficit had been sharply reduced, both in nominal terms and in relation to GDP. The rate of credit expansion had been significantly curtailed. The profitability of the mining company, as well as the competitiveness of exports, had improved mainly owing to the authorities' pursuit of a flexible exchange rate policy. One disappointing development had been the failure of copper exports to increase as planned, because of the continued weakness of world copper prices as well as domestic production difficulties. As a result, Zambia had been unable to discharge its external obligations as programmed, and the last purchase under the stand-by arrangement could not be made.

Despite the gains made during 1983, Mr. Suraisry continued, much remained to be done to restore domestic and external financial viability, and to achieve the necessary diversification in the economy. The new adjustment program adopted by the authorities represented an important step toward achieving those objectives. He welcomed in particular the continued emphasis on fiscal restraint, a cautious monetary stance, and flexible domestic pricing policies. He also supported the continued commitment to a flexible exchange rate policy, designed to maintain export competitiveness and encourage efficient import substitution. The efforts of the authorities to diversify the productive and export base of the economy, with the help of the World Bank, were commendable and appropriate.

Referring to the design of the adjustment program, Mr. Suraisry noted that the cautious assumption with respect to the copper price was appropriate, given the experience with the 1983 program. He was encouraged that the authorities were ready to implement additional measures should the copper price fall significantly below the projected level. On the other hand, he hoped that they would not relax their adjustment efforts if the copper price turned out to be better than expected.

He understood that the program was being approved in principle and that it would not go into effect unless the large balance of payments financing gap was covered, Mr. Suraisry commented. As the arrangements for filling that gap were still not fully clear, he asked the staff to indicate what scope there was for further adjustment in case not all of the required financing became available.

The balance of payments would remain under strong pressure, even if the price of copper increased steadily, according to the medium-term projections in the staff report, Mr. Suraisry concluded. Therefore, Zambia would need to pursue vigorous adjustment policies for a number of years in order to reduce the imbalances in its economy, thereby helping the country to obtain the necessary external assistance.

Mr. Polak observed that Zambia should indeed be complimented on sticking to a major adjustment program in 1983, with results that were in many respects impressive, in spite of highly adverse external conditions. It was understandable in the circumstances that one performance criterion, on the accumulation of arrears, had not been met. The Fund should unquestionably be prepared to remain associated with Zambia by supporting a program for a further year; therefore, he endorsed the decision to that effect.

The most recent decline in the price of copper, which was 40 percent below the projection made in 1983 for the present year, Mr. Polak noted, had aggravated Zambia's balance of payments situation to the point where, as the staff had stated, "any further reduction in import volumes would likely lead to a downward spiral of falling output and export earnings." In the circumstances, and for the reasons mentioned by the staff at the end of its appraisal, where reference was made to the catalytic role of the Fund, a new stand-by arrangement for Zambia seemed appropriate in spite of the bleakness of the medium-term balance of payments outlook. The 1984 program, like the well-implemented program for 1983, could contribute to providing the conditions for a resumption of growth, once the external environment improved. The arrangement alone could not provide much relief; net purchases under it would be small, and debt service payments to the Fund were forecast to average 75 percent of quota annually in 1986-88.

He was basically in agreement with the structure of the program, Mr. Polak remarked. However, he asked the staff how it assessed the appropriateness of the newly introduced export retention scheme, under which the mining company, the Zambian Consolidated Copper Mines, retained 35 percent of its foreign exchange earnings. He also asked what likelihood there was that the authorities would achieve the anticipated significant increase in nonbank financing of the budget deficit.

In conclusion, Mr. Polak encouraged the Zambian authorities to continue on the adjustment path that they had taken. He hoped that the external payments gap for 1984 would soon be covered, with some margin to allow for a small increase in reserves. The commitment of the authorities gave grounds for hope that they could weather the extremely difficult period through which the economy was passing. In that connection, the renewed cooperation between Zambia and the World Bank was welcome. An interesting implication of Zambia's situation was that a good case could be made for Fund assistance in certain circumstances even when a return to a sustainable balance of payments position was not clearly visible in the medium term.

Mr. Alhaimus observed that it was clear from the staff papers that the severe difficulties faced by Zambia in recent years were likely to persist. That was not unexpected in an economy so highly dependent on copper exports, which had been the victim of persistently weak market conditions that were not projected to recover to any appreciable extent. A further factor cited was the pursuit of inappropriate domestic policies in certain periods; but that had not been the case in 1983 when strong adjustment had been effected in line with the stand-by arrangement.

The Executive Board had widely considered the 1983 program to be strong and optimistic, Mr. Alhaimus recalled. Yet the authorities had been able to adhere to the fiscal and monetary measures of the program, thus achieving a substantial decline in the fiscal deficit as well as a sharp reduction in the net domestic assets of the banking system and in net credit to the Government. Real GDP had risen by about 1 percent in 1983, although no increase had been envisaged in the program, and price increases on a full-year basis had been less than expected. Furthermore, the exchange rate had depreciated greatly since early 1983. Nevertheless, Zambia had experienced serious difficulties in the external sector, leading to a failure to observe the performance criterion on arrears on external debt and to its consequent inability to make the final drawing under the stand-by arrangement. That unfortunate end to the program had been attributed entirely to developments in the copper market, which had fallen short of program projections.

Zambia's experience highlighted the difficulties of designing programs under stand-by arrangements in circumstances of great uncertainty in commodity markets, Mr. Alhaimus went on. More accurate projections for exports were certainly in the interest of the member concerned, which did not wish to end up with a failed program in spite of its efforts and sacrifices in taking strong measures of adjustment. Perhaps the scope for significant improvement was limited in the prevailing unsettled circumstances, but it would nevertheless be useful to seek greater elaboration on the methodology being used to project commodity prices and on whether it had possibly been too narrowly related to the general global prospects set forth in the World Economic Outlook. For example, it had been stated during the Board's discussion for the 1983 Article IV consultation and stand-by arrangement for Zambia (EBM/83/63, 4/18/83) that a copper price of 94 cents a pound for 1984 might turn out to be a conservative estimate, if the rate of growth projected in the World Economic Outlook at that time--of about 3 percent in 1984 in the industrial countries--was realized. Copper prices had turned out to be far below that--about 65 cents a pound--although average growth rates had been significantly higher than projected for both 1983 and 1984.

Against that background, Mr. Alhaimus commented, it was encouraging to note that the 1984 program attempted to develop more realistic assumptions relating to the external sector, while keeping in mind the possibility that adverse external conditions might disrupt the program. The authorities' determination to continue with their adjustment efforts despite the uncertainties was the only viable course of action. The 1984 program included the necessary elements for strong adjustment, particularly in demand management. Over the longer term, successful diversification of the economy away from the present dependence on copper would allow Zambia to cope better with the difficult circumstances that still lay ahead, including the severe debt problem. The medium-term outlook depicted by the staff for the rest of the decade was very bleak. It could hardly be tackled by Zambia without global assistance, including further support by the Fund, for its strong adjustment effort.

Ms. Lundsager considered that even though Zambia had missed some of the targets under the 1983 program, the improvement over 1982 had been noteworthy, including higher growth and a lower current account deficit. Although that deficit had been larger than programmed, the causes had been mainly beyond the control of the authorities, including reduced copper revenues and lower than anticipated official transfers. As a result, the performance criterion on arrears had not been met, and the program had not been completed. Those developments reinforced the urgent need for Zambia to adhere to a strict adjustment program, which would reduce its vulnerability to external events. The process would be difficult but it was unavoidable. In the short to medium term, not only demand management policies, but also structural changes in the economy were needed.

The Government of Zambia had taken significant exchange rate and budgetary measures in 1983, Ms. Lundsager said, notably tight expenditure controls which had brought about a large reduction in the budget deficit. It was also encouraging to note that the devaluations in 1983 had contributed to maintaining the profitability of the mining company and had restored the competitiveness of a number of agricultural products. The devaluation had apparently also increased awareness of the possibilities for export diversification and the production of import substitutes. Such quick results were welcome, and she urged the authorities to continue their flexible management of the exchange rate, and to produce new import substitutes that were competitive goods. Her authorities supported the thrust of the 1984 program, namely, "to consolidate the progress made in 1983 toward reducing domestic and external imbalances." It was of course difficult to project the payments balances, given the large proportion of receipts generated by copper. With that uncertainty, and the high debt service payments due, Zambia did indeed need debt relief and additional balance of payments assistance. According to their own analysis, the U.S. authorities believed that extraordinary debt relief by both official and private creditors would fill the projected balance of payments gap. Nonetheless, Zambia would not have much breathing room, and the planned adjustment effort should continue.

The policy mix, which aimed at containing domestic demand within the bounds of available supply, was appropriate, Ms. Lundsager considered. The budget deficit target--4.5 percent of GDP, after grants--was ambitious but attainable with strict control over expenditures. She was pleased to note the commitment to further reductions in subsidies, as shown by the increase in petroleum prices in April 1984. Monetary growth should have a restraining influence, but she hoped that sufficient credit would be available to the private sector in order to stimulate increased investment. She would also urge the authorities to raise interest rates on commercial bank deposits further, because they remained significantly negative in real terms, thereby reducing the incentives for financial savings.

Her authorities were uncomfortable with the projected increase in inflation, but they supported the price increases needed to restore producer incentives, which could be as important, if not more so, than the availability of credit to producers, Ms. Lundsager remarked. It would be helpful if the staff could indicate how profitable the agricultural sector had become following the price increases.

The Government had made a welcome commitment to continue its effort, begun in 1983, to reduce the costs and increase the efficiency of the state enterprises, Ms. Lundsager continued. The report that that effort, together with price decontrol, had restored profitability in many subsidiaries of the Zambian Industrial and Mining Corporation (ZIMCO) was welcome news, as was the report of the initiation of a new joint venture with a foreign company in the mining sector. Zambia's current economic difficulties might not make it very attractive to foreign investors, but a demonstrated willingness to improve the economic situation would be the most effective means of generating foreign investment. The foreign exchange allocation system had reportedly been improved, and was admittedly necessary at the present time. However, the controls should be dismantled as soon as possible; the market could best determine the appropriate use of foreign exchange.

The medium-term outlook for Zambia appeared to be somewhat bleak, especially the decline in real per capita income projected by the World Bank for the rest of the decade, Ms. Lundsager remarked. In large part, the slow rate of development of the economy was responsible, particularly the slow movement away from total reliance on primary commodities for foreign exchange earnings. She urged the Government of Zambia to work closely with the World Bank in developing additional responses to Zambia's structural problems, and she suggested that Zambia consider placing greater reliance on private sector initiatives and resources.

In conclusion, Ms. Lundsager endorsed both the many actions already taken and the comprehensive macroeconomic adjustment program outlined in the staff report, including the recent maize price increase, which she understood was facing domestic opposition. She reiterated the importance of supplier incentives if the needed diversification of the Zambian economy was to be stimulated. She supported the proposed decisions.

Mr. Laske remarked that he too was in broad agreement with the staff appraisal and that he could support the proposed decisions. Because of the as yet uncovered financing gap, approval of the requested stand-by arrangement in principle only was justified. He endorsed the amount of the stand-by arrangement, which had been determined by taking into account the existing financing gap, the strength of the adjustment effort, Zambia's track record, and the distinct probability of the necessity for subsequent Fund-supported adjustment programs. His support was also based on his confidence that the authorities would remain committed to the adjustment path upon which they had embarked with the Fund's financial support.

Despite the remarkable progress made so far, Zambia's external position remained exposed or even critical, Mr. Laske considered. Therefore, he urged the authorities to give particular emphasis to fiscal policy in persevering with their adjustment efforts. A comprehensive set of measures, including monetary and external policies as well as further adjustments in the structure of the economy, would have to be implemented so as to strengthen Zambia's weak external position. The country's extreme dependence on the mining industry and on exports meant that progressive diversification of the economy, and especially of exports, should be given the highest priority. Zambia's potential, for agricultural development in particular, was a long way from being adequately tapped; therefore, he believed strongly that efforts in that direction should be reinforced and carried out with determination. The success of the 1984 program would depend crucially on closely coordinated demand management and structural policies; otherwise, the desired and essential diversification of the economy might not be achieved as quickly as necessary.

Zambia's economic dependence on one single export commodity made it more vulnerable to external shocks than other more broadly based developing economies, Mr. Laske observed. Therefore, he welcomed the intention to improve incentives for agricultural producers and to increase the efficiency of the manufacturing sector. In that context, he underlined the role to be played by an appropriate exchange rate policy. The staff representative had stated that the authorities had moved further in that direction; by letting the kwacha depreciate in real terms, they had protected the profitability of the mining industry, restored and maintained the competitiveness of a number of agricultural crops, and provided the basis for export diversification and import substitution. He was pleased that the entire set of policies would continue to be geared toward serving those incentives. Lasting success could be achieved only if the structure of relative prices continued to reflect adequately the underlying demand and supply relationships in the Zambian economy.

Under the previous stand-by arrangement, which could not be utilized to the full extent because of the nonobservance of certain performance criteria, Zambia had nevertheless made commendable progress in the fiscal area, Mr. Laske noted. By strengthening revenues, cutting expenditure, and reducing the public sector deficit, the basis had been laid for the eventual resumption of better balanced growth. It was important not only to preserve but to extend that progress. The reduction of the public sector deficit from 18.9 percent of GDP to close to 7 percent of GDP was remarkable, but the ratio was still rather high and should preferably be further reduced. It was also important, as had been pointed out on page 25 of the staff report, that the increase in expenditure should remain below that of nominal GDP and that further improvements should be achieved in tax administration. All the steps taken to reduce costs and to increase managerial efficiency in the state enterprises were welcome. Since those enterprises loomed large in the economy, the rehabilitation of virtually each one was a condition for the rehabilitation of the whole economy.

Interest rates had continued to remain strongly negative in real terms in 1983, Mr. Laske observed. It was regrettable that no significant change appeared to be in prospect. The weak external position of Zambia clearly indicated the need to mobilize additional domestic savings. In his view, positive real interest rates would make a helpful, and perhaps essential, contribution to achieving that objective.

At present, Zambia was suffering from the very low price of copper and was carrying a high external debt burden, Mr. Laske said. The medium-term projections for foreign indebtedness in Table 12 of the staff report made it obvious that Zambia could not deal with that difficult situation without further generous assistance from creditors and aid donors. For example, the Paris Club would be asked to reschedule debts that had already been rescheduled once. Additional assistance of that nature would however only be forthcoming if Zambia continued to make a strong effort to correct its external imbalance. The probability of inflationary pressures and other strains on competitiveness made it imperative to continue to pursue a flexible exchange rate policy. In that respect, the staff representative's statement was encouraging. A delicate balancing act in the management of the import regime would be needed to restrain imports to a level that could be financed and that would provide the most urgently needed inputs for the manufacturing sector. The utmost care should be taken to allow only those imports needed to assure the functioning of Zambia's mining and manufacturing industy, as well as that of the agricultural sector. Again, an appropriate exchange rate policy could make an important contribution to allocating in the most efficient way the extremely scarce foreign exchange resources.

Production costs in Zambia's industrial and agricultural sectors had been unavoidably pushed up by the depreciation of the kwacha, but also by import restrictions and by the shrinkage of overall demand, Mr. Laske noted. The change in the import tax, which was mentioned on page 25 of the staff report, might therefore serve to aggravate further the plight of manufacturing industries. It might be advisable to analyze the whole system of taxes, import duties, and administrative restrictions to find out whether it was sufficiently geared toward the promotion of structural change.

The assumption relating to expected developments in the copper price for the duration of the 1984 program was not totally unrealistic, but the medium-term projections did seem to be on the optimistic side, Mr. Laske remarked. If those assumptions were not borne out by actual price movements--and he was not fully convinced that they would be--there could be no doubt about the need for further corrective action to permit the Zambian economy to benefit from the gains already made and secure those that would be made by the program under discussion. Perhaps the staff could comment on whether there was not already too little scope for such action.

Mr. Kabbaj endorsed Zambia's request for a new stand-by arrangement. The previous arrangement had sought to lay the basis for a viable balance of payments and to initiate further diversification of economic activities away from total dependence on copper, with its unstable prices and prospects. The Zambian authorities had observed the main features of the program, and all the performance criteria had been met, save the one on arrears, because of a lack of sufficient foreign exchange due to a shortfall in copper exports. The terms of trade had deteriorated, following an unanticipated fall in international copper prices, and infrastructural difficulties had manifested themselves, mainly in railway transportation, and had adversely affected the volume of copper exports. As the staff had mentioned, Zambia's external reserves position remained serious.

The 1984 program's main objective was to strengthen the progress achieved so far in redressing the imbalances so deeply embedded in the economy, Mr. Kabbaj continued. In that light, steps were planned to contain domestic demand, boost revenue, and increase production and agricultural incentives. The budget deficit on a cash basis would be limited to some 4.5 percent of GDP. Measures would also be taken to increase taxes and contain expenditure growth, including a wage freeze for higher-paid workers.

In the external sector, the flexible exchange rate policy would continue and a further reduction in commercial payments arrears of SDR 20 million was envisaged, Mr. Kabbaj observed. The broad design of the program took into account the available opportunities and prospects for Zambian exports and the inflow of financial resources. The staff had stated that, in its present situation and with the lackluster prospects for copper, Zambia would continue to depend heavily on aid from donors and continued rescheduling of the bulk of external debts falling due in the near future. As the real purchasing power of Zambia's exports had fallen by some 60 percent in the past decade, serious steps must be taken to speed up the process of diversification. Also, because the shortage of necessary foreign exchange had been a serious culprit in the stagnation of other productive sectors of the economy, it was essential for donors and other creditors to show considerable sympathy and understanding for Zambia in rescheduling and other Consultative Group meetings. He trusted that the Fund's representatives at those meetings would stress the seriousness of the situation.

The medium-term balance of payments projections did not paint a bright picture, Mr. Kabbaj remarked, and he agreed with the staff that there was a continued need for further strong adjustment policies. However, with a low per capita income and a persistently falling standard of living, due attention should also be paid to the approaching social and political limits to the acceptance of a further deterioration in the quality of life in Zambia. Unless adjustment policies were accompanied by a fresh injection of capital, investment, and employment, hope for the future might gradually fade away and be replaced by permanent despair. A concerted, multipronged adjustment scheme was therefore essential in order to tackle all aspects of Zambia's problems, including the need for development finance. He was therefore somewhat concerned that the program assumed no increase in real GNP and that no effective investment projects were in the pipeline. Most of the main supply-oriented measures were geared toward rationalization and cost-price improvements rather than toward the injection of new resources.

While he appreciated the aim of the program to diversify the economy, in view of the persistence of the adverse external environment, the program might well have addressed some serious problems in the real sector of the economy by emphasizing more production-oriented investment, Mr. Kabbaj commented. He realized that Zambia had few resources to work with, in the absence of outside funds. But that was where the Fund could play a crucial role in mobilizing outside financing, especially when, for no apparent or logical reason, such financing was not forthcoming.

Mr. Orleans-Lindsay, speaking on behalf of Mr. Tshishimbi, noted that the Zambian authorities were facing extremely serious financial difficulties. As a continuation of their efforts to deal with deteriorating economic and financial conditions that had worsened in 1982, the Zambian authorities had initiated a comprehensive adjustment program in 1983, in support of which the Fund had approved a one-year stand-by arrangement. When the Executive Board had had the opportunity in September 1983 and in January 1984 to review Zambia's performance under the program, it had become clear that, being highly dependent on foreign exchange earnings from copper exports, the overall performance of the economy had remained weak, and the restoration of internal and external financial balances was becoming difficult.

That situation was largely a reflection of the sharp deterioration in the terms of trade arising from the steep drop in world copper prices and from lower export volumes due to domestic transportation difficulties, Mr. Orleans-Lindsay went on. During the past year, the Zambian authorities had made significant efforts to keep the program going, especially in the fiscal area, and had taken additional exchange rate action by further depreciating the kwacha. Despite the considerable progress made toward achieving the program's objectives in 1983, it was disheartening to note that the adverse external conditions had persisted and, together with the continued decline in international copper prices and the volume of exports, had led to a reduction in export receipts. The resulting shortage of foreign exchange had prevented most manufacturing industries from importing needed raw materials and spare parts; manufacturing and construction output had thus declined. However, agricultural output had increased by 8 percent, reflecting a favorable response to better producer price incentives and improved weather, and real GDP had shown a slight improvement of 0.8 percent in 1983.

The significant fiscal adjustment that had been made encompassed a reduction in the budget deficit, from 18.9 percent of GDP in 1982 to 6.9 percent of GDP in 1983, Mr. Orleans-Lindsay noted, by means of a reduction in total expenditure of 4 percent and an expansion of total revenue by 20 percent. That effort had been appropriately supported by tight monetary and credit policies. Credit to the ZCCM to finance operating losses had been eliminated. But the balance of payments position had remained difficult, largely due to lower export receipts.

He was concerned about the extremely difficult external position projected for the period 1984-89, Mr. Orleans-Lindsay continued. It was a relief to know that the Zambian authorities would continue their adjustment efforts, in order to consolidate the gains of 1983. He endorsed the measures to be implemented in the 1984 program, including the principal ones relating to the budget, money and credit, pricing, and other structural policies. In particular, the steps introduced to strengthen the finances of the public and mining sectors, and to ensure the diversification of the economy away from its high dependence on the mining sector, went in the right direction. He welcomed the authorities' intention to continue to manage the exchange rate in a flexible manner, in combination with the new monthly monitoring system and a mechanism for adjusting the rate geared to developments in the mining sector. The arrangement to establish better coordination between an improved foreign exchange budgeting system and import licensing was another encouraging step that should ensure the efficient allocation of scarce foreign exchange.

Although the authorities had taken steps to improve the outlook for the export sector, Mr. Orleans-Lindsay commented, a significant improvement in Zambia's external payments position would depend crucially on developments in world copper markets, which remained uncertain. The recovery of copper prices was not imminent; on the contrary, prices were declining further, and the price of 65 cents a pound assumed under the 1984 program seemed on the high side and might have to be revised downward in the course of the program. In that connection, he associated himself with Mr. Clark's remarks concerning the need to examine more closely the technical problems of determining copper prices.

While the authorities' adjustment efforts deserved the Fund's support, even greater support and assistance from the international community, in the form of additional relief and concessional aid, was essential for the success of the present program and for medium-term external payments viability, Mr. Orleans-Lindsay observed. Therefore, he hoped that, following the successful outcome of the recent meeting of the Consultative Group, and the World Bank's endorsement of Zambia's investment program, the Government of Zambia's request for additional debt relief under the aegis of the Paris Club would be favorably considered.

Mr. Fridriksson stated that over the past few years, the Zambian economy had been subjected to severely deteriorating external conditions. The economy's dependence on a single export commodity made it highly vulnerable to external shocks, and developments in world copper markets had been such that it was remarkable that the authorities had been able to implement the adjustment policies agreed upon under the previous stand-by arrangement. It was indeed striking that the terms of trade had deteriorated so sharply in recent years, that exports in 1983 had turned out to be 10 percent below the amount envisaged even at the time of the review under the stand-by arrangement, and that copper prices in 1984 were expected to be almost 40 percent below the level assumed when the previous arrangement had been negotiated. It was difficult to escape the conclusion that Zambia had exhausted its capacity to deal with the deterioration of external economic conditions. In that connection, the information on recent developments in copper prices provided by the staff representative was disquieting.

The program outlined in the staff report was appropriate, Mr. Fridriksson considered. In view of Zambia's extremely volatile external situation, he would emphasize in particular the importance of the flexible exchange rate policy, not only in the short run but also in the medium term, in the context of the necessary diversification efforts of the authorities. The medium-term outlook presented by the staff was bleak at best. Zambia provided one more unfortunate example of a heavily indebted developing country having little choice but to run a current account surplus over a number of years. The economy was thus left in a straitjacket making it all the more difficult to implement the long-term development policy that was so badly needed.

In those circumstances, and in view of the structural problems that Zambia would have to tackle in the years ahead, heavy World Bank involvement would be essential, Mr. Fridriksson stated. The participation of bilateral donors would be equally important. The Fund could be counted on only to play a marginal catalytic role; Zambia's financing would have to come mostly from other sources, in the form of either direct aid or long-term concessional credit. Moreover, Zambia's need to reschedule its debt in the years ahead had to be recognized. Given those facts and Zambia's likely need to continue to rely on Fund support, the amount of the stand-by arrangement in relation to Zambia's quota seemed appropriate. Finally, he agreed with the staff appraisal and fully supported the proposed decisions.

Mr. Pickering remarked that his chair broadly agreed with the staff appraisal and joined in the general commendation of the authorities for the progress they had made in 1983. He fully supported the proposed decisions.

Zambia's economic and financial performance had deteriorated substantially over the past few years, Mr. Pickering noted, in spite of the authorities' various attempts to deal with many of their problems. The current situation was serious; weakness in real output in Zambia had contributed to the likelihood that real per capita incomes would fall throughout the rest of the decade. Although external factors had played a particularly important role, owing to the country's overwhelming dependence on its copper exports, certain economic and financial policies had contributed to slippages in performance.

It was important that there should be some consolidation of policies with a medium-term supply-side orientation, Mr. Pickering considered. In that connection, he welcomed the description on pages 27-29 of EBS/84/135 of the supply-oriented policies of the authorities; it was a particularly valuable part of the staff report that could be developed further in the first review of the program. Clearly, although the improvements needed in the copper sector were important in the near term, over the medium term they would need to give way to measures to strengthen the agricultural sector and diversify the export sector. In an overall medium-term package for that purpose, he would emphasize four points. First, it was encouraging that the authorities were working closely with the World Bank in formulating medium-term policies in the agricultural sector, including significant measures to increase producer prices. It appeared that the necessary policy measures had already been agreed upon, and he hoped that they could be implemented quickly.

Second, Mr. Pickering noted, the Government needed to make a broad and ambitious review of the managerial efficiency of state enterprises, not only ZIMCO, the most important of the parastatals, but several others as well, including those related to agricultural activities. The World Bank could make a significant contribution to the exercise.

Third, it would be essential for the authorities to pursue a flexible exchange rate policy, Mr. Pickering considered. The monthly monitoring of the rate provided for in the program should ensure that adequate adjustments took place. Fourth, multilateral and bilateral assistance, and private investment, would be a basic condition of a medium-term development strategy.

The staff representative from the African Department noted that the copper price was indeed of crucial importance for Zambia's future, and for the effective implementation of the program, as the staff had tried to emphasize in its report. As stated, the forecasting record, of both the Fund and the World Bank, had not been good, and copper prices had invariably been lower than forecast. Earlier in the year, when the staff had discussed the program with the Zambian authorities, the copper price projected for 1984 of 65 cents a pound had been a significant downward revision from the previous estimate, yet for the first six months of the year, the average price had in fact been in line with that forecast. In the past few weeks, copper prices had declined further to about 59-60 cents a pound, possibly reflecting the prospect of action by the United States to limit imports of copper to protect its domestic copper industry. It was also difficult to forecast with any certainty the medium-term price of copper. The main usefulness of the staff projections was to illustrate the possible impact of different assumptions. A number of reviews had been built into the program, and further action would have to be considered if, inter alia, copper prices did not develop as suspected. Unfortunately, as many Directors had noted, Zambia had a limited number of options for further adjustment action, although a further intensification of the flexible exchange rate policy was one of those options, as many Directors had indicated.

As for Zambia's balance of payments financing gap, the staff representative added, likely debt relief by members of the Paris Club, which was scheduled to meet on July 20, 1984, and other creditors should enable Zambia broadly to cover the balance of payments gap foreseen in the program.

The foreign exchange retention scheme had been designed basically to ensure that the export sector, and more particularly the mining industry, was assured of a reasonable supply of foreign exchange for planning purposes, the staff representative continued. Previously, the mining industry had been dependent on ad hoc allocations of foreign exchange from the central bank. Moreover, production problems in Zambia had been mainly related to the shortage of foreign exchange. Although the primary initiative for the retention scheme had come from the World Bank, in the context of the $75 million loan to rehabilitate the copper sector, the staff of the Fund agreed that it was extremely important to ensure that the mining industry had enough foreign exchange to function properly in the short run, because of the effect on Zambia's future foreign exchange receipts.

On the basis of discussions with the Zambian authorities, the amount of domestic nonbank financing foreseen should materialize, the staff representative considered.

The recent series of devaluations had clearly improved the profitability of the agricultural sector, which was also in a much better position as a result of additional producer incentives. Unfortunately, the effect on the medium-term structural adjustment of the agricultural sector would not be evident for some time. Nevertheless, developments had so far been positive.

As to whether the various tax measures taken had affected industrial production, the staff representative explained that the main impediment to the production of manufactures was the lack of imports. The World Bank was engaged in a major study of industrial protection, covering the structure of tariffs and various other measures, to determine what type of action was needed to improve output in the manufacturing sector. The various tax measures that had been or were about to be taken by Zambia were fully in conformity with the strategy discussed by Zambia and the World Bank, and also at the recent Consultative Group meeting. The main objective was to afford greater protection to intermediate industries, to encourage the use of domestic raw materials, and to increase the domestic output of inputs in the manufacturing process; so far, Zambia's industry had been greatly dependent on imported inputs.

Mr. Mtei said that he was gratified to note that the Executive Board appreciated that his Zambian authorities were doing their best to grapple with the extremely difficult situation with which they were faced. However, developments in the international market for copper that were beyond the control of the authorities were largely responsible for that situation. Whether it was a matter of the fiscal deficit, the need to intensify the diversification effort, payments arrears, or the servicing of rescheduled debt, the critical element was the same: the price of copper in international markets. Any country confronted with a worsening of its terms of trade of the severity experienced by Zambia over the past two years would probably be in no better situation. The drastic fall in the price of copper--from $1.05 a pound to $0.65 a pound in 12 months--was a graphic demonstration of the harshness of an uncontrolled world commodity market. If the fair exchange of goods and services within the international community was to be promoted, action to alleviate the adverse effects of such declines in commodity prices would have to be taken.

As could be seen in Table 12 of the staff report, Zambia's debt service ratio in 1984, owing especially to the unexpected decline in copper export earnings, stood at an unsustainable 91.6 percent before rescheduling, Mr. Mtei went on. The ratio would remain too high for the five following years up to 1989. He did not know how the Fund could help to find a feasible solution to Zambia's problems, but he urged those Executive Directors whose authorities were members of the Paris Club to argue in favor of debt relief that would enable Zambia to continue to carry on with a viable program of adjustment, bearing in mind the serious efforts that the authorities were making. Although he was not aware of the precise type of debts involved, it seemed to him that it might not be too soon to consider converting a significant part of the official debt into grants, especially if Zambia was to be allowed to concentrate on a diversification effort that would yield positive results. If Zambia was forced to take on too harsh and too immediate a debt burden, it might be unable to provide even the basic necessities in the way of services, let alone secure the essential inputs for production and a minimum of investment. The consequence might well be a disturbance of the social and political fabric that would impair indefinitely any adjustment effort that the Fund might envisage for Zambia.

The program under the stand-by arrangement before the Executive Board was predicated on the maintenance of a certain copper price, Mr. Mtei observed, over which the authorities had scarely any control.

Thus, he hoped that the Fund would monitor the implementation of the program with flexibility. The Zambian authorities had observed all the performance criteria under the previous stand-by arrangement, with the exception of the ceiling on external arrears, which had become difficult for Zambia to meet because of the shortage of foreign exchange. The ceiling had been agreed on the basis of optimistic assumptions for copper prices, and it should have been feasible--possibly with the benefit of hindsight--for Zambia to approach the Executive Board for a waiver or modification of the criterion in order to enable the final drawing under the arrangement to be made.

His authorities were aware that the long-term solution to the almost perennial problems that had afflicted the Zambian economy lay in the diversification of production to noncopper sectors, Mr. Mtei stated. Zambia was in fact rich in minerals and precious stones, and was already diversifying its mining industry, apart from intensifying exploration for petroleum products and other hydrocarbons. In the nonmining sectors, the emphasis was on agriculture, to achieve self-sufficiency in food and a surplus for export. But because misfortunes never came singly, the unprecedented drought that had affected large areas of eastern Africa had bedeviled Zambia's agricultural efforts. Nevertheless, the authorities were determined to maintain the price incentives and to create the credit policy and environment necessary to encourage existing farmers, as well as to divert other entrepreneurs into the agricultural sector. It was worth noting that substantial gains had been made in the agricultural sector over the past year or so, in spite of the drought and of the paucity of foreign exchange, which had inhibited the supply of necessary inputs, such as insecticides, fertilizers, and machinery.

In their diversification effort, the authorities were also determined to continue to encourage manufacturing, Mr. Mtei remarked. The general measures of price decontrol that had recently been announced were designed to provide incentives to that sector. Credit and investment policies were also intended to ensure a shift toward manufacturing. In full awareness of the recurring problem of a shortage of foreign exchange, the industrial strategy maximized the use of local raw materials; but inevitably the lack of utilization of industrial capacity was caused by the current shortage of necessary imported inputs.

The Chairman made the following summing up:

> Executive Directors considered the staff report for the 1984 Article IV consultation with Zambia, together with a request for a new stand-by arrangement in an amount equivalent to SDR 225 million, or 83 percent of quota, for the period ending April 30, 1986.
>
> Executive Directors agreed with the thrust of the staff appraisal in the report for the 1984 Article IV consultation. They noted that Zambia had made significant progress in implementing the Fund-supported 1983 adjustment program. The kwacha had depreciated by more than 40 percent vis-à-vis the SDR and by

more than 16 percent in real effective terms between January 1983 and January 1984, thus returning the mining company to profitability and making a large number of Zambia's agricultural products competitive as exports or import substitutes. Zambia's fiscal performance had also improved considerably, with the central government budget deficit falling to 6.9 percent of GDP from 18.9 percent in the previous year. Because of external developments beyond the control of the authorities, and in particular because export proceeds had fallen more than 10 percent below earlier forecasts, Zambia had incurred arrears under its 1983 debt rescheduling arrangements and had failed to reduce its external commercial payments arrears by SDR 30 million, as programmed.

Directors noted the strong further adjustment measures included in the new program. Continuation of a flexible exchange rate policy was viewed as essential to protect the financial position of the mining company and to maintain the competitiveness of the agricultural sector. In addition, Directors felt that restraint of domestic consumption through a further reduction in the overall budget deficit, appropriate price and incomes policies, and tight monetary policies was also vital to the success of the domestic adjustment effort. Several Directors stressed the drawbacks of the present negative real interest rates, which they urged the authorities to reconsider with a view to enhancing savings and improving the allocation of resources. Directors commended the Zambian authorities on the implementation of further fiscal measures involving a reduced level of real expenditures. Zambia's external position and its high vulnerability to external shocks would necessitate continued restraint of domestic consumption at least through the program period.

Directors stressed the importance of a progressive diversification of the Zambian economy through improved incentives for agriculture and increased efficiency in manufacturing. They urged the authorities to maintain their close cooperation with the World Bank in these and other areas of activity, and urged the staffs of the Fund and of the World Bank to continue to cooperate closely in the formulation of appropriate economic policies. The strong backing of Zambia's adjustment efforts by means of long-term development assistance geared to supply policies oriented toward agricultural production and the diversification of exports was considered essential.

Despite the substantial efforts provided for in the program, Directors noted that Zambia's balance of payments situation had become increasingly precarious. With copper prices expected to average 10 percent below their 1983 levels, Zambia's scheduled external debt service payments would be equal to about 90 percent of its export proceeds in 1984. Consequently, Zambia would need substantial debt relief and other exceptional balance of payments assistance both in 1984 and over the medium term, in order to support its own efforts at closing its external financing gap. In this respect, the willingness of official creditors to consider Zambia's request for a rescheduling and the strong support of donors at the recent meeting of the Consultative Group in Paris were encouraging.

Directors also noted the authorities' resolve in pursuing a courageous adjustment program. Full implementation of the various policy measures called for in the stand-by arrangement would be imperative for the achievement of a viable balance of payments position over the longer term.

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

The Executive Board then took the following decisions:

Decision Concluding 1984 Article XIV Consultation

1. The Fund takes this decision relating to Zambia's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1984 Article XIV consultation with Zambia, in the light of the 1984 Article IV consultation with Zambia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Zambia's exchange system remains highly restrictive. In the context of the program supported by a stand-by arrangement, the authorities intend to pursue the policies that will permit a progressive reduction in external payments arrears and facilitate other steps toward a more liberal exchange system. In the circumstances of Zambia, the Fund grants approval for the restrictions on payments and transfers for current international transactions, including the restriction evidenced by external payments arrears, and a multiple currency practice arising from the existing counterpart deposit scheme for external payments arrears as referred to in SM/84/125 until June 30, 1985, or the next Article IV consultation, whichever is earlier. The Fund urges the authorities to eliminate a multiple currency practice arising from the 10 percent levy on the sale of foreign exchange for private overseas travel.

Decision No. 7756-(84/110), adopted
July 18, 1984

Stand-By Arrangement

1. The Government of Zambia has requested a stand-by arrangement for a period ending April 30, 1986 in an amount equivalent to SDR 225 million.

2. The Fund approves the stand-by arrangement set forth in EBS/84/135, 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/84/135, Supplement 2, shall become effective on the date on which the Fund finds that satisfactory arrangements have been made with respect to the financing of the estimated balance of payments deficit in 1984, but provided that such finding shall not be made later than July 31, 1984.

Decision No. 7757-(84/110), adopted
July 18, 1984

2. DOMINICA - 1984 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1984 Article IV consultation with Dominica, together with a request for a stand-by arrangement in an amount equivalent to SDR 1.4 million, or 35 percent of quota (EBS/84/134, 6/20/84). They also had before them a report on recent economic developments in Dominica (SM/84/143, 6/27/84).

Mr. Leonard made the following statement:

A three-year entended arrangement was approved for Dominica in February 1981. Last year's review of the economy showed that, apart from one lapse, which was quickly corrected, the program remained satisfactorily on track during the two and one-half years of the extended arrangement that had by then gone by. The present staff report examines performance in the final half year of the arrangement to February 1984 and a short period thereafter and shows that in this period, too, the prudent economic management that marked the earlier years continued.

As a result, Dominica has now reached a stage which, in the conditions of the small island states of the Caribbean, is close to self-sustaining growth. For Dominica, however, as for other similarly placed islands, "self-sustaining" has to be interpreted in the light of continuing dependence on substantial inflows of concessional aid and consequent vulnerability of the external balance. Apart from this characteristic, the progress that has been made can be judged in the light of the present staff report and that of 1983.

From a deficit of some EC$17 million in 1980/81, the Government's current budget was brought into near balance in 1983/84 and is set to move into surplus in 1984/85. Public sector capital expenditure, substantially dependent though it is on receipts of external grants and concessionary loans, has been running at levels corresponding to about 16 percent or 17 percent of GDP and has been well devised so as to strengthen the economic base. Government policy in the prices area has had a moderating influence on pay settlements, both public and private, since 1982 and has been reflected in the falling trend in inflation, which is now less that 4 percent a year. On the external side, the current account balance of payments is expected to show a surplus in 1984, which will be absorbed by net repayments to the Fund and a small increase in foreign assets.

As regards monetary policy, where for institutional reasons the Dominica authorities have only limited room for autonomous action, public sector indebtedness to the local commercial banks has been substantially reduced. The resultant freeing of resources, together with the growth of the banks' deposit liabilities to the private sector, has, in turn, enabled private commercial bank credit to expand at an average annual rate of over 16 percent in the period 1981-83. In the future, the growth of resources available for investment will be augmented by increased public sector savings and will be encouraged by interest rates which are largely market-determined and which for the most part have been positive since 1982/83.

The progress in putting the national finances in order has been accompanied by improvements in economic structure. Roads and factory sites have been developed, the manufacturing base has been extended, and a start made in diversfying agricultural production. The growth of GDP, which eased to 3.3 percent in 1982, has once again been accelerated on the basis of expanding exports, especially of manufactures.

Nevertheless, despite the progress that has been made, the fact that unemployment still stands at over 18 percent of the active population and that annual per capita income is still significantly below SDR 1,000, point to the need for continued development over a period of several years to come.

The program for 1984/85, in support of which the stand-by arrangement has been requested, has been drawn up in the light of these longer-term requirements. It envisages continuing high levels of investment and related imports for some time to come. Current deficits in the external account will also continue but will taper off in later years as merchandise exports and net travel receipts increase. The deficits will be mainly financed by official transfers and loans even though these are seen as being on a reduced scale in the latter part of the decade. The stand-by arrangement will assist in the immediate external financing needs of 1984/85 and will give some ease of maneuver in economic management. At the same time, all of Dominica's foreign obligations, including net repayments to the Fund, will be met and there should be a modest rise in net foreign assets.

The essential elements of the program reflect the authorities' thinking on what needs to be done to build up government savings in support of national investment, to limit external borrowing and the burden of servicing it, and to improve reserves. Action to put these elements in place has already been taken through the Government's 1984/85 budget. Fund support for the program is seen as an important endorsement of the Government's policies and a signal to the providers of grants and concessionary aid that such funds are being well used.

In introducing the 1984/85 budget, the Prime Minister and Minister of Finance was generous in her appreciation of Fund assistance during the extended Fund arrangement. To that I would like to add my authorities' further tribute to the staff for its courtesy and high professional standards in the conduct of the Article IV consultations and the negotiation of the stand-by arrangement.

Mr. Robinson said that he could endorse the staff appraisal, and that he supported the proposed program and decision on the request for a stand-by arrangement. Dominica had made substantial progress under its extended arrangement, and the authorities were to be congratulated for meeting, with only one exception, all the performance criteria. Between 1980 and 1983, the current account deficit had been reduced from the admittedly exceptional level of 56 percent of GDP to 10 percent of GDP, public savings had been increased by 10 percent of GDP, bringing the current budget into near balance, and inflation had fallen from 30 percent to 4 percent, while real growth had continued at a respectable rate.

Despite those achievements, Dominica's economic position remained fragile, Mr. Robinson noted. Investment expenditure was almost entirely financed by foreign savings, and a further improvement in public savings would therefore be necessary if development was to continue without resort to commercial borrowing. Dominica's net reserve position with the Eastern Caribbean Central Bank (ECCB) was very low, and its vulnerability to external economic shocks and natural disaster showed the clear need for an increase in reserves.

The program outlined by the staff seemed broadly appropriate to meet those concerns, Mr. Robinson continued. Public sector savings were expected to increase by 1.5 percent of GDP, and to become positive for the first time in 40 years. Some increase in reserves should be possible in 1984 and future years, although much would depend on a continued substantial growth in exports. Thus, the size of the stand-by arrangement seemed appropriate. As the staff had said, the existence of the program should encourage direct investment, to which the authorities had taken an encouragingly positive attitude, and further concessional loans.

Fiscal policy was of course the main instrument available to the authorities, Mr. Robinson observed. As Table 4 of the staff report showed, the authorities had made substantial progress in reducing current expenditure from 41.5 percent of GDP in 1979/80 to 30.5 percent of GDP in 1983/84, due to both continued wage restraint and the virtual elimination of transfers to the parastatals. There had been a dramatic improvement in the financial situation of the parastatals in recent years, and their previously heavy demands on domestic resources had been replaced by a modest contribution to domestic financing. Nevertheless, further increases in public savings would be necessary, implying strict control of public expenditures, particularly wages, together with further improvements in the operation of the public enterprises, if the authorities were to avoid further tax increases.

The rather disappointing 3 percent increase in exports projected for 1984 reflected economic problems elsewhere in the Caribbean Community (CARICOM), Mr. Robinson remarked. The measures to revive intraregional trade announced at the recent CARICOM summit were therefore particularly welcome. But at the same time, Dominica obviously needed to continue to promote exports to other areas; for instance, exports to the United States seemed rather low.

As noted by his chair when the Executive Board had discussed the staff report for the 1984 Article IV consultation with St. Lucia (EBM/84/86, 6/4/84), the proposed exchange rate study by the ECCB was welcome, and should be completed as soon as possible, Mr. Robinson observed. As Table 8 of the staff report made clear, the link between the Eastern Caribbean dollar and the U.S. dollar had resulted in a substantial loss of competitiveness for both Dominica and other members of the ECCB; in several places in its report, the staff had pointed to the effect of the peg on exports, particularly of bananas and citrus fruit. Furthermore, Dominica had been seriously affected by the breakdown of the CARICOM payments clearing system to which it had been a net creditor. He wondered whether any steps were being taken to solve that particular problem.

The development policy of the authorities had led to impressive progress, Mr. Robinson commented, especially in the broadening of the export base to cover manufactures, including galvanized sheets and soap, which alone accounted for 30 percent of total exports. In the immediate future, the urgent need would be to improve the basic infrastructure and remove constraints on exports. It was encouraging to note that action in that respect was well in hand, in conjunction with foreign donors. In the medium term, there seemed to be prospects, among others, to increase the use of hydroelectric power and to encourage tourism. Above all, it would be important to continue to strengthen efforts to improve agricultural productivity and output, which still remained below prehurricane levels. In that context, the performance of the banana industry, which still accounted for over 40 percent of exports, remained a concern, and he welcomed the substantial steps taken by the authorities to remedy matters. But continuously falling prices to growers in past years had, as a recent World Bank report noted, resulted in a cessation of investment and little replanting. In part, the low producer price for bananas reflected the previous difficulties of the Dominica Banana Growers Association; for instance, he understood that about 15 percent of the growers' price was accounted for by debt servicing. The authorities would have to tread a fine line between ensuring adequate producer prices for bananas and stabilizing the financing of the Association.

Ms. Lundsager noted that her authorities were in broad agreement with the staff appraisal and that they could support Dominica's request for a stand-by arrangement. During the period of the extended arrangement, some progress had been made, as indicated by the improvements in GDP, in the fiscal position--on both the revenue and the expenditure sides--and in the current account deficit of the Central Government. In addition, the Central Government had moved some way toward its goal of increasing its investment expenditure, financed moreover largely through grants and concessionary loans. Her chair had emphasized, during the 1983 Article IV consultation with Dominica, the importance of appropriate sources of financing for developmental investment. The Industrial Development Corporation and the Agricultural Industrial and Development Bank had also been able to attract some foreign investment and to provide local entrepreneurs with encouragement to engage in more agricultural production and manufacturing. The Dominica authorities should be encouraged to continue their efforts in that area.

The efforts of the authorities to improve public sector savings should enhance the investment strategy, Ms. Lundsager considered. However, as her chair had stated in the past, Dominica's overall adjustment strategy, particularly as it related to investment goals, would most appropriately be based on development financing. In that respect, she noted the significant role taken by the World Bank in developing Dominica's investment strategies and she urged the continuation of that role. Her hope was that the program under the new stand-by arrangement could be completed in a way that allowed Dominica to find longer-term and steady sources of development assistance.

Mr. Ismael remarked that he was broadly in agreement with the thrust of the staff appraisal and that he had no difficulty in supporting the proposed decision. He was satisfied with the progress made by Dominica in rehabilitating its economy through the determined implementation of the adjustment program under the three-year extended arrangement with the Fund. The economy had recovered to a sustained positive rate of growth from the devastation of the hurricanes in 1979 and 1980. Substantial achievements had also been made in correcting internal and external imbalances; he took particular note of the progress made in reducing the rate of inflation, as well as the impressive curtailment of the current account deficit of the balance of payments.

Despite impressive gains, however, Mr. Ismael continued, Dominica's economy continued to suffer from various difficulties emanating from the rising protectionist trends in its trading partner countries and from the policy limitations imposed by membership in the Eastern Caribbean Central Bank. Those difficulties necessitated continued efforts toward adjustment in order to consolidate the gains made so far in strengthening the economy, efforts that should center on raising domestic savings and expanding exports. Domestic savings had remained very low and had even been negative in the past; the savings performance of the Central Government had been particularly discouraging, and an all-out attempt should be made to improve it, by undertaking the measures suggested by the staff, namely, to reduce expenditures and costs and to avoid slippages. In that respect, he welcomed the authorities' intention to seek a new wage agreement with government employees that would limit the annual increase in wages to no more than 5 percent for the period of the agreement.

The maintenance of external competitiveness was vital for the rapid growth of the Dominica economy, Mr. Ismael observed. The sharp appreciation of the Eastern Caribbean dollar, Dominica's currency, was worrisome. Since the scope for making appropriate exchange rate adjustments was limited by the country's membership in the ECCB, the authorities had to take stronger alternative measures on the incomes front in order to prevent the further erosion of external competitiveness. Dominica's present exchange arrangements needed to be made more flexible, and he had been heartened to learn that the authorities had taken the initiative to expedite the joint review being undertaken by the ECCB of the common exchange rate of its member countries.

Mr. Prowse observed that Dominica, one of the small tropical island economies in which he took a special interest, nevertheless had a per capita income of almost SDR 1,000. Thus, with 80,000 people, it was not among the poorest of those economies. Yet Dominica had two important distinguishing characteristics: it was a Caribbean island, which was helpful in certain respects to its external trade, and it was a member of a currency union operated by the Eastern Caribbean Central Bank on the basis of the Eastern Caribbean dollar, a more relevant characteristic in terms of the Fund's immediate analysis. An outstanding feature that Dominica's economy shared with other tropical island economies was its dependence on concessional assistance. That fact had to be kept constantly in mind in assessing Dominica's balance of payments position, as well as in considering the discrepancy between gross domestic savings, which represented only 3.9 percent of GDP, and gross domestic investment, which accounted for 26 percent of GDP. Therefore, he agreed entirely with the view expressed by the staff in its appraisal that "Dominica's economic growth will hinge on its ability to raise domestic savings and private investment." It was notable that the authorities had made some efforts to encourage private investment, with perceptible benefits.

Dominica's achievements under the extended arrangement were also commendable, Mr. Prowse continued. As Mr. Leonard had stated, within the framework of a small island economy, Dominica was close to self-sustaining growth. It was remarkable that the Central Government was projected to have a surplus on its current account in 1984/85; that the current account of the balance of payments was expected--perhaps somewhat optimistically--to show a surplus in 1984 although it had recorded a deficit of EC$7.6 million in 1983; that real growth had been accelerating yearly since 1982, reaching about 4 percent; and that inflation was reported to be about 4 percent. The country's macroeconomic policies seemed to be working, although it was clear from the letter of intent that the authorities did not consider the process of recovery and adjustment to be complete.

What he had missed in the staff report was an attempt to place the program in the context of the request for the stand-by arrangement, Mr. Prowse said. The shift to a surplus in the overall balance of payments forecast in the medium-term scenario, as noted on page 11 of EBS/84/134, would have as a counterpart repayments to the Fund and a modest accumulation of foreign assets, which was perhaps the purpose of the program. Yet on page 13, the staff went on to state that the financial program for fiscal year 1984/85 sought an improvement in fiscal performance to support the investment effort. Again, on page 21, it was noted that the stand-by arrangement would assist Dominica in obtaining financial assistance from other sources; and it was of course important for countries like Dominica to be able to reassure donors that their policies, as part of a program under a stand-by arrangement, were on the right track.

As Mr. Leonard had commented, the program for which the support of a stand-by arrangement had been requested was directed to Dominica's longer-term requirements, envisaging continuing high levels of investment and related imports, Mr. Prowse remarked. It was significant for a stand-by arrangement to be associated with such objectives. He could also endorse Mr. Leonard's view that Fund support was seen as an important endorsement of the Government's policies. His own assessment was that the very existence of the program and the stand-by arrangement, rather than the amount that could be drawn under it, was the critical factor. Dominica might well not need to draw under the stand-by arrangement; its external debt was not at present a problem, and debt service was projected to peak at about 12.5 percent of exports of goods and services in 1984, tapering down to about 9.5 percent in 1989. Thus, it might even be possible to construe the drawdown of the stand-by arrangement as a means of financing that small part of the proposed sizable increase in capital outlays by the public sector that would not be covered by grants or concessional credit from abroad; alternatively, it might be argued that Fund financing would allow the ECCB to avoid the consequences of what he regarded as a questionable foreign exchange policy. Without the stand-by arrangement, Dominica would presumably wish to draw against the reserves of the ECCB, which would be disadvantageous to its members as a group.

The Eastern Caribbean dollar--the currency of the seven members, including Dominica, of the Eastern Caribbean Central Bank or currency union--had been pegged to the U.S. dollar at the same rate since July 1976, Mr. Prowse observed. As a result, Dominica's real effective exchange rate had appreciated 20 percent in the three years to the end of 1983, and roughly 35 percent in just over five years. It was surely unusual for the Fund to support such an exchange rate appreciation, first by granting an extended and then a stand-by arrangement. He had therefore been disappointed at the failure of the staff to address the underlying issues; by the same token, he welcomed the review that the ECCB members were undertaking of some of those issues. He hoped that by the time of the mid-term review under the arrangement or upon its conclusion, the Executive Board could also take a look at the matter.

Despite the comprehensive staff papers on membership of currency unions, which had been convincing in some respects, he nevertheless continued to have difficulties with the currency arrangements of the ECCB, Mr. Prowse remarked. It was obvious that pegging the Eastern Caribbean dollar to the U.S. dollar subjected that minor currency to fluctuations resulting uniquely from fluctuations in a major currency. Moreover, the high rate of appreciation of the real effective exchange rate of the Eastern Caribbean dollar resulting from the fixed relationship between the two currencies ignored the fact that not all of Dominica's trade was carried out with countries using the U.S. dollar. Dominica had significant exports to non-U.S. dollar areas, as well as potential for tourism.

Of course, there were also some important advantages to membership in a currency union, Mr. Prowse went on. But the scope for autonomous monetary policy was limited, both in terms of determining the growth of the money supply and in fine-tuning interest rates. In that respect, he asked the staff for an explanation of its reference on page 17 of the staff report to the development of a regional interest rate strategy, and the likely implications for Dominica. He would submit that Dominica's relationship with the ECCB was having adverse effects not only on the external position of the country, but on the allocation of resources; by being locked into an overvalued exchange rate, the domestic terms of trade were also being distorted. The impact on the domestic income of export industries was all too familiar; indeed, the largest manufacturing enterprise in Dominica had recently reduced the number of its employees by 60 percent, although other special factors were partly responsible for the loss of employment.

More specifically, Mr. Prowse inquired whether the staff had considered the possibility of pegging the Eastern Caribbean dollar to a basket of currencies rather than to a single currency, and if so, against what basket. The subsequent question was under what conditions discretionary adjustments in the value of the Eastern Caribbean dollar should be made. For purely expositional reasons, it could be argued that Dominica might not have needed to seek the support of the Fund, had it been able to follow a different exchange rate policy over the past eight years. The member might also have been in less difficult circumstances; after all, Dominica had one of the more successful economies in the region. He looked forward with great interest to the completion of the ECCB study of the regional exchange rate, which he hoped would reveal the costs and the benefits to the member countries, and more particularly, how the use of resources under stand-by arrangements with the Fund affected the overall position of the ECCB. The crucial issue would be the time it would take the member governments to complete the subsequent joint review of exchange rate policies. Would the results of that review be made available to the Fund during the life of the stand-by arrangement, and would the staff keep Executive Directors fully apprised of its status?

In conclusion, Mr. Prowse stated, although the institutional framework within which Dominica was operating was perhaps not the most beneficial, he supported the authorities request for a stand-by arrangement, in the hope that the strength of the economy, the soundness of the authorities' policies, and their endorsement by the Fund through the existence of the program would pull the country through its difficulties.

Mr. Suraisry noted that the Dominica authorities had been able to implement fully the 1981 extended arrangement with the Fund: all the macroeconomic indicators had improved, and the economy had performed well. The main economic weaknesses were to be dealt with in the program under the one-year stand-by arrangement, which would help to consolidate the gains achieved under the preceding program. The performance criteria were adequate, and the review clauses were appropriate; he could therefore support the stand-by arrangement.

The overall fiscal deficit was expected to widen under the Central Government's fiscal plan for 1984/85 as a result of a sharp increase in capital spending, Mr. Suraisry noted. Although he agreed with Mr. Prowse that such financing would always loom large in the balance of payments of island economies, dependence on it was inadvisable, and the authorities should reduce their capital outlays over the medium term to a more sustainable level. He had been encouraged by the medium-term scenario, which projected an overall central government deficit of 3.5 percent of GDP at the end of the decade. The efforts made by the authorities to increase revenue were commendable, but the prospects for further improvement might be limited; thus, it was all the more important for the authorities to take a cautious stance with respect to expenditure. The continued improvement of the management and general efficiency of public enterprises should reduce the budget burden, as indeed it had been doing over the past several years.

The civil service wage agreement, covering the period up to the end of 1984, had contributed to the success of the extended arrangement, Mr. Suraisry continued. The maintenance of such an incomes policy was essential in order to reduce the fiscal imbalance and encourage competitiveness, as the authorities were aware; he hoped they would be able to adopt a similar stance in the years ahead.

Serious efforts had been made to strengthen and promote the activities of the private sector, and to increase its contribution to GDP, Mr. Suraisry went on. Further improvements in the public finances, leading to the release of credit to the private sector, would assist those efforts, as would the lessening of the main constraints on production and investment, which was the aim of the investment program for 1983/84-1985/86. In the midst of that activity, however, it would be essential to avoid duplicating projects in other Caribbean countries and to give considerable weight to economic viability. Dominica was already finding it difficult to sell its manufactured goods, both outside the protected markets of the Caribbean Community, as well as in CARICOM countries. Although as the staff had suggested, an appropriate exchange rate adjustment might solve Dominica's problems in competing on CARICOM markets, as those markets were already flooded with goods produced by other CARICOM member countries, it would not in his judgment be the ultimate solution. A more fundamental approach consisting, among other things, of regional economic planning, economic cooperation among members, and project viability was essential.

The staff representative from the Western Hemisphere Department noted that the leaders of the Caribbean countries had recently met and agreed to set up a technical committee to review proposals to restart the CARICOM Multilateral Clearing Facility, and to seek assistance outside the region in order to make the facility operational. The committee was expected to make its recommendations in the course of the coming three or four months.

As the sole exporter of bananas from Dominica, the Banana Growers Association assumed certain export costs, the staff representative explained. Packaging was a major expense, and the Association also provided both technical assistance and inputs to farmers. In order to cover those costs, the Association took a share of banana export prices; although its share had been on a rising trend, farmers had received a larger share in 1983, and were likely to continue to do so in the future, based on existing policies. Furthermore, the Banana Growers Association had improved its packaging technique; it was buying some inputs from cheaper sources; and it had also raised the quality of its management. Those factors should tend to lower some of the Association's operating expenses in future.

The stand-by arrangement with the Fund would enable Dominica to deal with the balance of payments problem that it still faced by adopting policies to expand and to diversify its export base while trying to reduce its use of nonconcessionary financing, the staff representative explained. The process of adjustment admittedly took time, and the Fund's role was seen as one of smoothing the process. Also, the Fund had a significant role to play in facilitating a larger inflow of financing to Dominica. It might be expected that during the program period, Dominica would in fact make more repurchases than purchases.

As noted in the staff report, the exchange rate of the Eastern Caribbean dollar had restrained the growth of certain exports, particularly of agricultural products, the staff representative continued. The exchange rate had also had an effect on the competitiveness of Dominica's exports of manufactured goods outside the region; so far, exports of manufactures within the region had been expanding. The study to be undertaken by the ECCB on the appropriateness of the exchange rate and the conduct of overall exchange rate policy by its members was expected to be ready by the end of 1984 for review by the Monetary Council in January 1985. Executive Directors would certainly be kept informed. If the Eastern Caribbean dollar had been pegged to a basket of currencies, rather than to the U.S. dollar, Dominica might have been in a slightly better situation.

On October 1, 1983, when the Eastern Caribbean Currency Authority had been replaced by the Eastern Caribbean Central Bank, the ECCB had assumed certain additional powers relating to interest rates, the staff representative from the Western Hemisphere Department explained. The ECCB could fix the interest rate for deposits as well as for lending; it also had the power to make those rates uniform across countries or to tailor them to the circumstances of individual countries. Although no decision had yet been taken, a common interest rate policy was under review, one of the objectives of which would be to avoid capital flows among member countries, a problem experienced in the past.

The Deputy Director of the Exchange and Trade Relations Department observed that the staff was working on the assumption that Dominica would draw under the stand-by arrangement. Modest surpluses were projected in the overall balance of payments but the staff had been guided by the long-standing policy of the Fund on balance of payments need, which took into account not only the general balance of payments position of a member but the level of and developments in its reserves. As a member of the Eastern Caribbean Central Bank, Dominica did not have an unlimited right to draw down its reserve position within the currency union. Thus, the staff had been guided by the continued fragility of Dominica's external situation, as well as by the fact that Dominica's own reserves were close to zero, and by its subjection in the recent past to severe natural shocks and other disturbances requiring speedy access to foreign exchange. Consequently, Dominica was likely to draw under the stand-by arrangement, if only to build up its own reserves on a modest scale. He felt sure that it had not gone unnoticed by Executive Directors that a significant part of the arrangement was within the first credit tranche.

Mr. Leonard remarked that attention had rightly been focused on the great weakness of Dominica, and of other similar island economies, namely, the need for concessionary finance. Fortunately, it seemed possible for Dominica to reduce its reliance on such sources of finance in the future. For many countries, the longer-term possibilities could not be foreseen, but the likelihood was that any solution would come about incrementally. Meanwhile, without the concessionary financing that was at present being made available to so many island economies, their standards of living would have to fall.

In considering the relevance of the stand-by arrangement for Dominica, Mr. Leonard continued, it was necessary to have regard not simply to one specific aspect of development in the islands but to the general process of adjustment and development. The Fund existed to help countries when they ran into balance of payments difficulties in the normal course of managing their economies. For Dominica, it was normal that economic development should be a major consideration; the related need for investment-generated imports was a potential source of balance of payments difficulties. After a long period of adjustment, the country was anxious to embark on an ambitious development process, and the program for 1984/85 was a stage in that process, which could be upset by any number of unforeseen events. In providing a stand-by arrangement, the Fund would help Dominica to proceed at a pace that might not otherwise be possible in the normal development of its economy.

In conclusion, and as an illustration of the good relationship between the Fund and a member country, Mr. Leonard mentioned that the Prime Minister, introducing her budget speech, had said that although there had been some misunderstanding of Dominica's relationship with the Fund, it had been one of the few countries to successfully complete a three-year extended arrangement. The Fund had not dictated to Dominica what it should do, the Prime Minister had said, because it had known what to do and had set about doing it with determination and honesty. What was important, in her view, was that the Fund had approved of the adjustment strategy.

Mr. Suraisry recalled that he had asked how the member countries of protected markets, like Dominica, intended to avoid the problem of project duplication. If there was no economic coordination among the members of such economic communities as CARICOM, the outcome was likely to be competitive devaluations or the loss of productive capacity. The staff representative from the Western Hemisphere Department responded that the Dominica authorities were aware of the need to export outside the regional market if the export sector was to become a leading growth sector, as they intended. Apart from recognizing the need to be competitive, the authorities were taking measures to encourage private sector activities as well as to reorient public sector investment in order to divert exports to nontraditional markets. In that context, one of the most important considerations in deciding on any particular investment project was the contribution it would make to expanding the country's export capacity, and whether or not the expansion would take place within or outside the region. Dominica's own Department of Trade had been strengthened to enable it to promote exports outside the Caribbean region.

The Chairman remarked that a competitive exchange rate was of course essential if the output of investment projects was to be sold on international markets. It would be inappropriate to concentrate on small domestic and protected markets.

The Chairman made the following summing up:

> Executive Directors agreed with the main elements of the staff appraisal in the report for the 1984 Article IV consultation with Dominica.
>
> Following the devastation caused by hurricanes in 1979-80, the Government of Dominica embarked on an economic recovery

program which was supported by a three-year arrangement under the extended Fund facility, from February 1981 to February 1984. Directors remarked that Dominica's economic performance under the extended arrangement had been satisfactory with respect to growth, inflation, and adjustment. Real GDP had recovered, and the domestic inflation rate had been reduced substantially. Directors noted the substantial curtailment of current expenditures, which fell by more than 10 percent of GDP over the period FY 1979/80 to FY 1983/84. They noted that dissaving by the Central Government that had prevailed at the beginning of the program under the extended arrangement had been virtually eliminated. As a result, the overall fiscal deficit had been reduced, notwithstanding the rise in capital outlays for the restoration of infrastructure and the rehabilitation of agriculture. During this period, most of the Government's capital spending was financed by external grants and concessionary loans, and the Government's use of nonconcessionary financing was reduced. Dominica's balance of payments performance improved and its external debt service ratio remained relatively low.

Directors stressed that in the period ahead Dominica needed to consolidate the recent economic gains and to pursue policies aimed at achieving vigorous and sustained economic growth based on higher domestic savings, investment, and exports. They encouraged the authorities to continue their efforts to increase public sector savings, particularly through the exercise of restraint over expenditure. They welcomed the recent restructuring of the banana industry and stressed the importance of adequate producer prices in that sector.

Directors commended the authorities for creating a favorable climate for private investment in Dominica through policies that fostered a stable industrial environment, helped to improve the country's infrastructure, and served to moderate the rise of wage costs. They urged the authorities to continue their efforts to encourage private investment. In this context, they noted the substantial reduction in the rate of wage increases for civil servants during the extended arrangement compared with the preceding period, but they emphasized the need for continuing efforts in this area to avoid adverse consequences for the public finances and the profitability of investment in the country.

Directors referred with concern to the recent rise in the real effective exchange rate of Dominica's currency, the Eastern Caribbean dollar, reflecting primarily the appreciation of the U.S. dollar to which the common currency is pegged. This development, and the difficulties faced by the economies of the Caribbean region, impeded the growth of Dominica's foreign earnings. It was noted in particular that at the present exchange rate Dominica's manufactured exports could not compete in markets outside the Caribbean Community. In view of the constraints on exchange rate policy arising from Dominica's membership in the Eastern Caribbean Central Bank, it was particularly important that costs be kept under strict control in order to enable Dominica to compete actively in traditional as well as new markets. In this context Directors welcomed Dominica's initiative in requesting the ECCB to examine the appropriateness of the level of the Eastern Caribbean dollar and the conduct of exchange rate policy for Dominica and other members of the ECCB. In view of its importance, it was suggested that the staff give more emphasis to the exchange rate issue in the mid-term review.

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

The Executive Board then took the following decision:

Stand-By Arrangement

1. The Government of Dominica has requested a one-year stand-by arrangement beginning July 18, 1984 in an amount equivalent to SDR 1.4 million.

2. The Fund approves the stand-by arrangement set forth in EBS/84/134, Supplement 1.

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

Decision No. 7758-(84/110), adopted
July 18, 1984

3. BOLIVIA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Bolivia (SM/84/141, 6/20/84; and Cor. 1, 7/12/84). They also had before them a report on recent economic developments in Bolivia (SM/84/100, 5/10/84; and Cor. 1, 6/21/84).

The staff representative from the Western Hemisphere Department noted that on page 12 of SM/84/141, it was stated that with the 100 percent wage increase, effective March 1984, the average real wage had been restored to its level one year previously, in March 1983, when the indexation of minimum wages had been introduced. However, the final agreement reached in early July between the Government and the Labor Union had made the wage and salary increase retroactive to April rather than to March, as had been envisaged at the time of the consultation discussions. On that basis, real wages in March 1984 were some 45 percent below those in March 1983. Even though the final agreement had raised wages by 130 percent in 1984, the average real wage during the second quarter of 1984 had been about one third below that of the same period in the previous year, reflecting the very high inflation rate registered in that quarter in the present year: prices had risen by 63 percent in April, 47 percent in May, and 4 percent in June.

Mr. Delgadillo made the following statement:

My authorities would like to express their appreciation to the staff for an excellent set of documents produced in connection with the 1984 Article IV consultation with Bolivia. In general, they concur with the thrust of the papers and believe that they broadly reflect the financial and economic situation of the country.

As Directors are aware, Bolivia is currently facing very difficult economic circumstances. These are manifested mainly by a sharp drop in economic activity, high levels of inflation, an increase in the unemployment rate, a significant reduction in real wages, a dramatic fall in investment, and a continued weakness in the balance of payments. The origins of this deterioration can be traced to a combination of extremely adverse external factors and political events that prevented the adoption of needed domestic policies.

With few exceptions, prices for Bolivia's main exports continued to remain depressed in the international markets during the period under review. The price of tin declined from US$7.60 a pound in 1980 to US$5.74 in 1982 and increased only to US$5.86 in 1983. Similarly, negative trends were recorded for other minerals, such as tungsten, antimony, lead, and copper. This year, prices are not expected to show any important recovery.

The surge in interest rates is another important external factor that exerted a noticeable impact on the country's finances. Since April 1981, when a refinancing agreement was signed with 128 creditor banks, the average interest rate for the servicing of Bolivia's debt to the banks has been over 15 percent a year. In 1984 interest payments alone on total outstanding public debt including arrears and deferments are projected to amount to 40 percent of total export receipts for the year. Of this, approximately 60 percent represents interest to foreign commercial banks.

Although in the past the country enjoyed a relatively easy access to external financing from both private and official sources, thereby maintaining the country's capacity to import, in the last few years a reversal of this trend has taken place, abruptly limiting external capital inflows. In addition, since 1982 Bolivia has had difficulties in obtaining timely payments for its natural gas exports, thus aggravating the shortage of foreign exchange. Gas sales abroad constitute one of the most important sources of foreign earnings, accounting for over

50 percent of total exports in 1983. Before the end of that year, overdue receipts for this item represented about US$330 million or nearly 43 percent of total annual exports. In March 1984 an understanding in the form of a schedule of payments was reached with Argentina; thereafter, several partial payments were received and new arrears accumulated. Total unpaid debt to Bolivia for this item was still US$171 million by June 1984, an amount which is in the process of being settled. The delays in these export receipts contributed to the fiscal deterioration by depriving the Treasury of considerable revenue.

Furthermore, factors outside the control of the authorities included natural disasters that produced heavy damage to the agricultural sector. This sector is of crucial importance in terms of its contribution to GDP (16 percent in 1983) and to the level of employment (45 percent). During the agricultural year 1982/83 an extraordinarily severe drought in the Altiplano caused serious damage to subsistence agriculture in some of the country's most populated areas. Moreover, floodings in the eastern part of the country damaged commercial agriculture and cattle raising. These climatic disorders affected one third of the country's geographic area and about one third of its population; thus the 22 percent drop in the overall agricultural production recorded in 1983 is almost entirely a reflection of those natural disasters.

The external scenario just described is by no means the sole cause of today's economic and financial problems. My authorities are well aware that domestic factors have also contributed to the gradual deterioration of the economy. Over time, important decisions on policy actions were unduly delayed; many measures were adopted but perhaps fell short of what was needed or were not fully implemented or appropriately supplemented. Political instability also had an important bearing on the economic situation of the country. Frequent changes of authorities contributed to delays in the adoption of measures and to greater uncertainties about the authorities' intentions on policy matters.

Notwithstanding the Government's efforts to correct the economic imbalances since November 1982, the process of adjustment has been particularly difficult and painful and has been further aggravated by a climate of labor unrest. The present economic instability and the attempts to resolve it have also led to a fast turnover of members of the economic team.

More recently, by mid-April, in recognition of the urgent need for a comprehensive stabilization program, the authorities adopted an important package of measures which is well described in the staff report. In the area of public finance, the measures aimed at drastically reducing the 1984 overall fiscal deficit to more manageable levels. Several revenue measures to improve the fiscal performance were introduced, including (a) the prices of hydrocarbon derivatives were increased by up to 500 percent; (b) electricity and transportation rates were raised by 300 percent and 200 percent, respectively; (c) subsidies for basic commodities were further reduced; (d) prices of agricultural and livestock products were liberalized; and (e) presumed costs of the mining sector were lowered to allow for higher effective tax yields. In addition, an instruction was issued to reduce public entities' expenditures. Investment outlays in Bolivia have been drastically reduced from 12 percent to 5 percent of GDP between 1976-79 and 1983; therefore there was virtually no room for further curtailment. As the staff pointed out, in terms of GDP the full effect of the fiscal reforms would imply a reduction in the overall fiscal deficit from 18 percent in 1983 to 15 percent in 1984, thereby avoiding an increase to 40 percent in the absence of the April package. My authorities share the staff's view that sufficient savings need to be generated by the public sector, if this sector is to play the most important role in fostering economic development. They are also aware that additional steps are needed to strengthen the fiscal position in 1984/85 and beyond. Accordingly, a revised budget for the rest of the year and a projected budget for 1985 are under active consideration, including a number of proposals to increase revenues and to restrain the overall growth in public expenditures. However, specific proposals on this matter need to be submitted to Parliament, since tax-related measures and the annual budget require congressional approval. The correction of structural deficiencies in public finances is of great concern to my authorities. Much needs to be done in the context of an overall plan to correct present rigidities. To assist in these and other efforts, the Government has sought technical assistance from the Fund.

Developments in the monetary area during 1982/83 were heavily influenced by the fiscal performance and were translated into a substantial acceleration in the expansion of bank credit as a consequence of increasing financing to the public sector. At the same time, credit to the private sector was substantially reduced in real terms.

My authorities are of the view that a flexible approach to interest rate policy would be important to stimulate financial savings. Pursuing this objective, interest rates were doubled to 150 percent for loans in local currency. Nevertheless, their real levels remain highly negative. My authorities also concur with the staff's assessment that the existence of a number of rigidities in the form of regulations being applied at present to interest rates, reserve requirements, and taxes on financial transactions do not contribute to an efficient and smooth functioning of the financial system; therefore they intend to correct such rigidities. The April measures included the resumption of dollar-denominated loans for specific purposes and the indexation to the U.S. dollar of all complementary, retirement, and housing funds.

On the incomes policy front, considerable efforts have been made recently to rationalize the wage indexation scheme adopted in March 1983. Moderate wage increases are essential to avoid further expansion in fiscal expenditures, in the absence of a corresponding rise in revenue, and to preclude the additional fueling of inflation with a consequent fall in real wages. Therefore, the authorities intend to pursue restrained income policies, to the extent possible considering the relentless social unrest. According to recent information, real wages fell by 50 percent between March 1983 and May 1984, reflecting mainly higher rates of inflation recorded in the last three months.

During 1982/83, Bolivia's external sector continued to be confronted by many difficulties. Foreign trade in relation to GDP experienced a serious setback in this period, particularly on the import side. In both 1982 and 1983 total imports accounted for only 50 percent of the level recorded in 1981. The dramatic decline in imports has had an adverse impact on global output to the extent that it affected the availability of spare parts, equipment, and raw materials. In addition, scarcity of imported essential goods contributed to the inflationary process. Because of foreign exchange shortages and the low level of imports, there were large trade surpluses in 1982 and 1983. However, the current account deficit registered deficits equivalent to 2 percent of GDP during the same years, mainly due to high interest payments abroad.

On exchange rate policies, important steps have been adopted by the authorities to ameliorate the exchange rate system of Bolivia. The abolition of the two-tier exchange rate mechanism in favor of a unified exchange rate in 1982 and the devaluations of November 1982 and 1983 constitute a first step toward a more flexible exchange rate policy. The package of measures introduced in April 1984 included a devaluation of the peso from $b 500 to $b 2,000 per U.S. dollar and a substantial liberalization of the exchange rate system. My authorities have indicated that, particularly in a highly inflationary environment, it would be counterproductive to maintain an unrealistic level for the peso and they remain committed to a flexible exchange rate policy. However, they have to give adequate consideration to domestic political factors in order to maintain the delicate social balance.

As in other countries, external debt is one of Bolivia's most sensitive economic and political issues. As indicated by the staff, at the end of 1983 total outstanding public external debt represented 55 percent of GDP, and for 1984 debt service payments, including arrears and deferments, will be equivalent to over 100 percent of exports of goods and nonfactor services, reflecting higher interest rates and a decline in export earnings. Also, servicing of this debt constitutes a large share of the overall public sector budget.

Bolivia's external debt burden will be unsustainable in the forseeable future, unless further renegotiations lead to a significant improvement in both the terms and conditions on its commercial debt. Moreover, given that prospects for export performance in the short run are unfavorable and external financing remains limited, the level of foreign exchange available for imports is extremely low, thus preventing any reactivation of the Bolivian economy. Therefore, there will be no alternative but to seek better and more imaginative solutions to the external debt problem. Also, to solve the difficult economic situation and reactivate the economy, additional concessionary funds from bilateral and multilateral organizations are urgently needed.

The authorities have attached a high priority to debt service payments to international financial organizations such as the Fund, the World Bank, and the Inter-American Development Bank. To date, Bolivia does not have arrears with these institutions, although some delays have occurred in the past due to difficulties in collecting export proceeds.

Regarding this year's inflation rate, my authorities are not as pessimistic as the staff might seem to be in their report. Of course, if one takes into account the inflationary impact of the April measures to project price increases for the rest of the year, the result is impressive. Available figures indicate that from January to May this year, the cumulative rate of inflation was 291 percent, with increases of 62 percent in April and 47 percent in May. However, in June 1984 the inflation rate decelerated to 4 percent. Needless to say, price developments in the coming months will depend mainly upon additional actions in the fiscal, exchange rate, and monetary areas.

In short, Bolivia is at present confronting the most serious financial and economic crisis of the last 25 years. After long delays in the adoption of necessary decisions, the civilian Government which took office in October 1982 has been able to adopt long-needed strong economic measures in spite of growing social turmoil. The exercise of democracy, after many years of restrained political activities, has strongly raised demands and expectations among organized labor groups who seek to influence the Government to adopt policies favorable to their economic and social goals. Each round of economic measures has therefore triggered widespread strife and resistance by the national labor union, particularly last April, because of the severity of the measures adopted at that time, preventing the orderly implementation of the adjustment measures. My authorities are aware that much remains to be done on the long path of restoring internal and external balances and are committed to adopting the necessary actions when feasible. However, in view of the critical circumstances and peculiar features currently surrounding the Bolivian economy, the authorities consider that only a concerted effort, comprising domestic agents, interested international organizations, foreign banks, and friendly governments, can start alleviating present difficulties. It was in this context that the United Nations sponsored a conference for the coordination of financial assistance to Bolivia in Washington last May. It is hoped that this type of action will bear fruit in the near future.

My authorities have reiterated their willingness to cooperate closely with the Fund in finding solutions to the present economic and financial difficulties of the country, and they hope that a financial arrangement will be negotiated in the coming months. Meanwhile, broader and longer-term support from the Fund in the form of experts and other types of technical assistance will be enormously valuable in helping the authorities to prepare the needed statistical base conducive to the formulation of a viable economic program. My authorities are grateful to management and the staff for this assistance.

Mr. Kafka remarked that Bolivia was in a very difficult situation. A new Government was making--for the first time in many years--serious efforts to adjust the Bolivian economy. The Fund must do all in its power to help it. A few facts would suffice to illustrate the seriousness of the situation. GDP per capita had declined by almost 25 percent in three years; the overall fiscal deficit had reached nearly 20 percent of GDP, because of both a fall in revenues and a rise in expenditures, although the information for June provided by the staff representative was favorable; inflation and unemployment were high; external debt obligations had reached 90-100 percent of exports; and the crisis in Latin America, quite apart from the general economic crisis in the world, had hit Bolivia particularly hard.

The external deficit of the current account had been maintained, on a cash basis, at 2 percent of GDP in recent years, Mr. Kafka continued, largely due to Bolivia's inability to finance imports and to a postponement of debt service; at the same time, exports had been no more than stable. Despite the overvaluation of the real effective exchange rate, the Government had not been able to obtain support for a second major devaluation. The country had nevertheless made efforts to keep its external payments current; it was commendable that debt service payments had been increased in line with the increase in debt, despite the stagnation of exports. In addition to needing urgently to implement a comprehensive adjustment program, it was essential for Bolivia to have an appropriate rescheduling of its debt. However, it would not be very helpful if the banks maintained their 1981 posture; at that time, they had restructured Bolivia's debt at a usurious cost, of almost 4 percent above the London interbank offered rate (LIBOR), as shown in Table 23 of the report on recent economic developments.

In the absence of a very flexible exchange rate policy, Mr. Kafka observed, a noninflationary wage policy was a prerequisite for any comprehensive policy of economic adjustment. The Bolivian authorities should be encouraged to put such a policy into effect as quickly as possible; he noted that they had moved in that direction. He agreed with the staff that priority should be given to dealing with the deterioration of public sector finances. The courageous emergency measures taken by the President of Bolivia in April 1984--that would have reduced the expected overall public deficit in 1984 from 40 percent to 15 percent of GDP if implemented--had yet to be fully adopted. Meanwhile, new problems had accumulated. The question was to find some types of taxation that, even under present conditions, could be made to yield a significant increase in revenue. Since 1979, the tax revenue of the Central Administration had declined by 4 percentage points of GDP--a fall in revenue of over 40 percent.

Since January 1984, Mr. Kafka remarked, Fund missions had spent a total of two and one-half months in Bolivia, where they had effectively supplemented the assistance of the resident representative. But the Fund needed to do even more. Bolivia should be encouraged to request major technical assistance, either from the IMF or from other international organizations, in order to generate the basic information the Government required to formulate its adjustment plans and to enable it to begin early negotiations on a financial arrangement with the Fund.

Mr. Pickering said that he shared the concern about the seriousness of the current economic situation in Bolivia. Of the many areas of weakness in the economy, the poor performance recorded in 1983 in government finances, despite the introduction of measures in November 1982 and in 1983 as well, was particularly disappointing. Clearly, that was the result in large part of an inability to increase tax revenue as expected and the failure to control expenditure. With the worsening of the situation, the need for vigorous measures had become even more vital. He urged that quick action be taken to approve the budget for 1984 so that more appropriate fiscal measures could be put in place as soon as possible.

The large financing requirement of the public sector was the major factor contributing to spiraling inflation, Mr. Pickering considered, and it was perhaps the most important signal that something was seriously wrong in the economy. Also, strains on Bolivia's financial resources were crowding out the private sector from the credit market; for example, credit to the private sector had dropped by one half in real terms in 1983, resulting in a weakened financial position for that sector. The growth of government expenditure to 23.3 percent of GDP in 1983 from 13.9 percent in 1981 might reflect the most pressing aspect of the fiscal problem. There was not only an urgent need to slow down the growth of total spending, but a need to alter the mix of expenditures toward the financing of badly needed capital investment. Modifications in wage policy were also required to help control current expenditures and reduce inflationary pressures. On the revenue side, he urged the authorities to continue their efforts to broaden the tax base and to strengthen tax administration. In addition, careful consideration should be given to such proposals as putting specific taxes onto an ad valorem basis and indexing tax liabilities to inflation.

A tighter monetary policy stance would have to be adopted by the authorities if inflationary pressures were to be significantly reduced, Mr. Pickering observed. As he had already noted, a reduction of the public sector deficit would be of major help in that respect. However, he also encouraged the authorities to phase out interest rate ceilings, which appeared to be a grave disincentive to the domestic savings that were sorely needed to finance productive investment.

The devaluation of the peso in April had been a positive step, Mr. Pickering remarked, and the authorities should press ahead with their intention to make frequent adjustments in the exchange rate. In the current inflationary environment, such flexibility was imperative to ensure international competitiveness and to move toward a more satisfactory balance of payments position. Moreover, as the staff had pointed out, an appropriate exchange rate would have a favorable effect on the fiscal position because public sector revenues were highly dependent on exports and on taxes on international trade.

He supported Bolivia's request for technical assistance from the Fund relating to fiscal, monetary, and external debt policy, Mr. Pickering stated.

He regretted not having been able to take a positive view of the current stance of policy in Bolivia, Mr. Pickering said. He emphasized that the thrust of the economic plan announced by the authorities in April was most encouraging. The plan should be implemented as quickly as possible because it would constitute a significant move toward overcoming some of the economic difficulties facing the country. However, given the magnitude of the imbalances to be corrected, the authorities would have to take new initiatives. The measures needed to be bold and implemented without delay, but they should be considered as only initial steps in tackling important problems over the medium term. He urged the authorities and the labor federation to reach some sort of accommodation that would lead to the implementation of an effective adjustment program, which hopefully the Fund could support.

Mr. Moerke remarked that the staff report for the Article IV consultation demonstrated convincingly that Bolivia was facing a serious crisis. The economy was in total disequilibrium, with external and internal imbalances having reached unprecedented magnitudes. Tables 1 and 4 provided information, which needed no further interpretation, about the rather unsatisfactory developments relating to external debt, economic growth, prices, savings, and investment. The report on recent economic developments analyzed comprehensively the reasons for the emergence of the crisis: confronted with difficult external circumstances, changing governments had not succeeded in carrying out needed policy actions because of the unsettled social and political situation.

While it might be easy to agree on the present ills of the Bolivian economy, Mr. Moerke remarked, it was much more difficult to prescribe the right medicine to cure them. The Government had announced in April a broad package of measures to prevent a further economic and financial deterioration, which had rightly concentrated on reducing inflation, strengthening the foreign sector, and reactivating the economy. The measures were to include action on all economic fronts--fiscal, exchange rate, monetary, and income policies. While he had some sympathy with the staff in its view that bolder actions might be called for to deal with the crisis, he nevertheless believed--as no doubt did the staff--that the announcement of the package was an encouraging development.

He commended the authorities for the adoption of that package which, if fully implemented, would make a significant step toward reducing the external and internal imbalances, Mr. Moerke considered. He had noted, for example, that the overall deficit of the nonfinancial public sector for 1984 would be reduced to about 15 percent of GDP from an estimated 40 percent of GDP in the absence of corrective measures. There could be no doubt about the need for comprehensive adjustment measures over an extended period. The staff in its appraisal had outlined the necessary actions, and he supported its recommendations.

However, Mr. Moerke continued, he had been somewhat disturbed by several references in the staff report that led him to believe that the social and political situation was still unsettled. First, there was the Government's loss of control over public expenditure and the operations of public entities. Second, large economic groups had refused to pay taxes. With a lack of social consensus, it would be unrealistic to expect any coherent and comprehensive strategy to be implemented with the necessary determination. A worsening of the situation was not unlikely, unless the Government, labor unions, and business could reach the urgently needed social consensus.

To help Bolivia, Mr. Moerke stated, the Fund's assistance should be twofold. First, technical assistance should be provided. He had noted from the staff report that the flow of information had been increasingly unreliable; before a coherent and comprehensive adjustment strategy was drawn up, substantial improvements in the availability and quality of economic data were necessary. He would fully support any request for technical assistance in all necessary areas. Second, negotiations with the authorities on a short-term adjustment program should take place only when the staff was convinced that the political and social environment would permit the effective implementation of a strong adjustment program. The authorities should have demonstrated, prior to any decision on a Fund program, that they had fully regained control of economic policy.

Ms. Bush noted that it was difficult to assess the prospects for economic adjustment in Bolivia. Experience showed that a strong political commitment and the ability to effectively implement policy decisions lay at the heart of successful adjustment efforts. Yet the staff had mentioned political opposition and frequent changes in personnel. Despite those difficult circumstances, in April, the Bolivian Government had begun a new attempt to address its grave economic problems. She hoped that it would persevere in that effort, and that eventually, agreement could be reached on a comprehensive program of adjustment that would merit the financial support of the Fund.

In three major areas of economic performance--growth, price stability, and balance of payments equilibrium--serious problems existed, in large part as a result of a dramatic worsening of the fiscal balance, Ms. Bush continued. Real growth had been negative for three years--real per capita growth had been even more negative--and inflation had risen dramatically.

The heart of Bolivia's economic problems was to be found in the growth of the public sector deficit, as the staff had indicated, Ms. Bush remarked. In fact, future economic growth was greatly at risk as the result of the near disappearance of private investment, which had been a mere 1.7 percent of GDP in 1983, owing in considerable part to the preemption of credit by the public sector. Similarly, the domestic savings ratio had fallen from an average of 19.4 percent of GDP in 1973-77 to only 3.6 percent of GDP in 1983. Small public savings in 1979 had turned into massive public dissavings, equal to 12.4 percent of GDP in the past year.

Between 1979 and 1983, the ratio of the public sector deficit to GDP had risen by about 10 points, about 8 1/2 points of which were due to a worsening of the position of the Central Administration, Ms. Bush commented. A fall in the revenue ratio by about 4 points, and a rise in the current expenditure ratio of about 7 1/2 points, had been only partly offset by a 3 point cut in capital expenditures. The financial position of the public enterprises had been weakened by delays in adjusting prices of their goods and services and in adjusting the exchange rate. It was a significant weakness, since those enterprises were said to account for about four fifths of Bolivia's exports. Despite those grave weaknesses, government policy was stated as calling for the public sector to play a major role in economic development, with that role to increase over time, and an increased role was contemplated for labor participation in the management of public enterprises. While the Bolivian authorities might choose such a strategy, a successful economic development effort would depend on more efficient and improved economic and financial management than had been exhibited in recent years.

The rapid growth of credit to the public sector had resulted in a crowding out of the private sector, which had suffered from a large decline in credit in real terms due to the rapid acceleration of inflation since 1982, Ms. Bush noted. A positive step had been taken with the recent creation of the Monetary Board, with broad responsibilities in the monetary, fiscal, foreign exchange, and other financial areas. Also, the steps taken to increase interest rates for savings and time deposits to as much as 110 percent and 140 percent, respectively, were moves in the right direction. Still, an attack on inflation itself was the key to the restoration of financial stability.

As for the balance of payments, the collapse of both exports and imports was striking, Ms. Bush remarked. For example, on a 1978 base, the volume of exports in 1983 had fallen by 23 percent and imports by 38 percent. In value terms, the export level had been falling for the past three years. Somewhat surprisingly, a worsening in the terms of trade, which had occurred in 1981 and 1982, had not been an important cause of balance of payments weakness. It was the failure to adjust the exchange rate to preserve Bolivia's competitiveness and to maintain the financial position of the exporting public enterprises that had contributed to the balance of payments problem. The devaluation of April 1984, if it was allowed to become fully effective, would make an important contribution to restoring competitiveness. More important, in the long run, was the need for continuing exchange rate flexibility and a deceleration of inflation itself.

Her authorities were fully aware of the tight political constraints the Bolivian authorities had faced in dealing with their economic problems, Ms. Bush said. Welcome measures had been taken in April 1984 and the aims of reducing the public sector deficit and of adopting realistic pricing policies for goods, wages, capital, and foreign exchange were appropriate. But as the staff had pointed out, there was still an urgent need to implement those adjustment measures fully, to adapt them to changing circumstances, and to supplement them in order to create a comprehensive adjustment program. It would be a politically difficult process, but the alternative, of failing to act, would have even graver consequences. She fully supported Bolivia's request for technical assistance and urged the Bolivian authorities to develop a public consensus in support of economic adjustment and to persevere with the follow-through measures necessary to make it succeed.

Mr. Portas stated that the economic crisis facing the Bolivian authorities clearly required the prompt and forceful implementation of a major and viable stabilization program. Further delays could only aggravate an already critical situation. The urgent need for the adoption of a comprehensive adjustment program was fully recognized by the current Administration, as demonstrated by the series of strong policy measures adopted in 1983, and, most recently, by the policy package announced in April 1984. However, progress in implementing those policies had been greatly constrained by the combined impact of unfavorable external factors and limited support from the labor sector. That in turn had resulted in political instability, which had added further to the difficulties of adopting timely adjustment policies.

In those serious circumstances, a constructive role by the Fund was crucial, Mr. Portas considered. One essential aspect of that role was to support the authorities' adjustment effort by alleviating the social pressures triggered by each round of economic policy in the past. The strategy embodied in a viable adjustment program obviously should take into account the already fragile sociopolitical setting of the Bolivian economy. Such a strategy might have to involve recognition by the authorities of the need for a painful but unavoidable sacrifice in terms of a loss in real income, although the adjustment program should not fail to pay due regard to the impact of the adjustment burden on the low income sectors of the population. While the range of policy options available to the authorities was very limited, it was essential to give full consideration to policy measures that would minimize the cost of adjustment in different social sectors. In that respect, a more equitable tax structure could perhaps be integrated in the already planned comprehensive fiscal reform.

The need for explicit recognition of those elements in the design of a viable program was evident from the failure of past adjustment attempts, Mr. Portas commented. From the outset, the probability of success would depend not only on the firm determination of the Bolivian authorities to carry out the program, but on the support of all involved sectors of the economy. Mr. Delgadillo had raised that essential aspect of Bolivia's adjustment effort in his statement.

The Fund had already initiated its support by providing technical assistance to create the necessary statistical basis for a viable economic program, a first step that he welcomed, Mr. Portas added. He also welcomed the staff's identification of those areas in which comprehensive structural changes were needed to improve the efficiency of the public sector and the financial system; there should be no further delays in implementating the urgently needed corrective measures or the negotiation of a viable program. In particular, he joined the staff in urging the authorities to carry out the fiscal measures contemplated in the 1984 budget as a first step toward stopping a further deterioration of the public finances.

The likely success of the adjustment program would be greatly enhanced if appropriate support was forthcoming from bilateral and multilateral financial institutions, Mr. Portas observed. With respect to the latter, the World Bank in particular could be of great assistance to Bolivia in both providing technical assistance and granting financial support for sound development projects. In that respect, he wondered what the World Bank's current stance was; it would be highly beneficial for Bolivia, given the dramatic fall in investment expenditures during the past few years, to receive financial support from the World Bank.

In short, Mr. Portas concluded, the Bolivian authorities would have to carry out a strong adjustment effort so as to generate the required confidence at home and abroad. For the adjustment to be successful, a more cooperative attitude was called for by all parties concerned.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/109 (7/17/84) and EBM/84/110 (7/18/84).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/17 through 84/19 are approved. (EBD/84/187, 7/11/84)

Adopted July 17, 1984

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/154 (7/16/84) is approved.

APPROVED: April 11, 1985

LEO VAN HOUTVEN
Secretary