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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/107

10:00 a.m., July 16, 1984

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
J. de Groote	
B. de Maulde	X. Blandin
	M. Teijeiro
	M. K. Bush
	M. Lundsager, Temporary
M. Finaish	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
	L. Leonard
	G. W. K. Pickering, Temporary
A. Kafka	C. Robalino
G. Laske	
G. Lovato	N. Coumbis
R. N. Malhotra	
Y. A. Nimatallah	J. E. Suraisry
	S. El-Khouri, Temporary
J. J. Polak	
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
	E. I. M. Mtei
M. A. Senior	J. L. Feito
J. Tvedt	A. Lindø
N. Wicks	T. A. Clark
	Wang E.

J. W. Lang, Jr., Acting Secretary
R. S. Laurent, Assistant

Also Present

Administration Department: R. Tenconi, Director; D. A. Anderson, T. Cole, M. A. DeLuca, A. D. Goltz, G. E. Gondwe, J. D. Huddleston, J. G. Keyes. African Department: R. J. Bhatia, Deputy Director; O. B. Makalou, Deputy Director; E. A. Calamitsis, F. d'A. Collings, T. T. Gibson, M. G. Gilman, S. Schiavo-Campo, R. T. Stillson, P. C. Ugolini, J. C. Williams. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; E. H. Brau, M. O. Tyler. External Relations Department: D. M. Cheney, M. Stuart. Legal Department: J. K. Oh, J. V. Surr. Middle Eastern Department: C. Sassanpour. Treasurer's Department: D. Williams, Deputy Treasurer; R. Noë, G. Wittich. Western Hemisphere Department: E. Wiesner, Director. Bureau of Computing Services: J. R. McKee. Bureau of Language Services: P. P. Guilmard. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, L. K. Doe, W. Moerke, A. Steinberg, A. Vasudevan. Assistants to Executive Directors: R. L. Bernardo, J. Bulloch, M. Camara, M. B. Chatah, C. Flamant, I. Fridriksson, V. Govindarajan, D. Hammann, H. Kobayashi, S. Kolb, E. Landis, E. Portas, T. Ramtoolah, M. Rasyid, Shao Z., A. J. Tregilgas, M. A. Weitz.

1. MADAGASCAR - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the first review of the stand-by arrangement for Madagascar (EBS/84/133, 6/19/84; and Cor. 1, 6/27/84).

The Deputy Director of the African Department noted that the Malagasy authorities had recently informed the staff that Madagascar had met all performance criteria as of end-April as well as the criterion relating to the net reduction in external arrears for end-June. In addition, pursuant to the intentions expressed in paragraph 4 of the letter dated June 8, 1984 from the Minister of Finance, the authorities had announced on July 11 a list of manufactured products, the prices of which were no longer subject to government controls.

The staff paper had stated that an adjustment in the exchange rate for the Malagasy franc was due by the end of June, the Deputy Director continued. In keeping with the understandings under the program with the Fund, the Malagasy franc had been further depreciated in two steps by a total of 3.9 percent in June, a figure corresponding to the rate of inflation during the first quarter of 1984. Finally, on June 29 an understanding had been reached among commercial banks that permitted the previous draft agreement with Madagascar concerning the rescheduling of debt to all banks to be finalized.

Mr. Tshishimbi made the following statement:

About three weeks ago, I reported to the Board that Madagascar was making significant progress in implementing the 1984 adjustment program for which the Fund has provided financial support. As the staff report on this first review of the program confirms, developments in all sectors--production, investment, public finance, and balance of payments--are in line with the projections for the year. In view of the severe damage caused by the cyclone "Kamisy" in early April 1984, the prospects for the attainment of the objectives of the program are all the more encouraging.

The most adverse impact of the cyclone was felt in the agricultural sector, where on a preliminary basis about 150,000 tons of incremental paddy production were destroyed. The manufacturing and services sectors are expected to be less affected. The authorities have undertaken, with the cooperation of the World Bank and various other international institutions, a thorough assessment of the extent of the damage caused by the cyclone and its impact on production as well as on government accounts and balance of payments accounts.

In the agricultural sector, the program had envisaged an extensive reform of the marketing system and an upward adjustment of producer prices. As the staff reports, in the pilot area of

Lac Alaotra, where the state enterprises SOMALAC had a monopoly on the purchase of paddy, competitive bidding has been introduced, and auction sales involving private intermediaries and other state enterprises have taken place. As a result of these changes, the trading price of rice in the area has risen substantially, bringing the regulated minimum price of rice to the figure initially agreed on at the introduction of the program. Other regions are devising similar marketing systems to be introduced later in the year. On the import side, the Malagasy authorities have limited rice imports to 91,000 tons, in compliance with the program's target for the year 1984. However, in view of the damage caused by the cyclone, additional imports might be required. Nevertheless, before deciding on such imports, the authorities will consult with the staff in the course of coming reviews.

Price incentives have also been introduced for other agricultural products. The wholesale price of edible oil, for instance, has been raised by more than 20 percent to FMG 850 per liter. The producer price for coffee has been raised by 18 percent to FMG 330/kg. As the staff points out, the authorities had adopted increases higher than those required in the program, thus signaling their intention to provide sufficiently remunerative incentives to stimulate production.

In the industrial sector, the Government intends to pursue the implementation of the price decontrol policy adopted in the initial program. The Government's objective is to free the price of industrial goods representing at least 70 percent of value added in that sector, including textiles, shoes, cigarettes, cement, and condensed milk. The control procedures on the prices of the remaining controlled goods--mainly necessities such as sugar, bread, soap, and medicines--will be made more flexible. By a decree of July 11, 1984, the authorities have freed the price of at least 30 percent of industrial products as provided for in the program.

The staff has also reported on the progress of the discussions between the authorities and the World Bank on a public investment program covering 1984-87. The Malagasy authorities are aware of some reservations expressed by the Bank regarding a small number of industrial projects and have agreed with the staff that further feasibility studies, with external assistance, would be conducted before putting these projects into operation.

Mr. de Maulde commented that the staff paper demonstrated the commitment of the Malagasy authorities to the success of the program; indeed, they had had an excellent record of policy implementation under the program. A number of steps had been taken in exchange rate, marketing, and pricing policies; encouraging results were beginning to be achieved.

After the 15 percent devaluation of the Malagasy franc in March 1984, the authorities were fulfilling their commitment to maintaining a flexible exchange rate policy, for which they were to be commended, especially after two small devaluations that had recently taken place, Mr. de Maulde noted. In pricing and marketing policies, the measures carried out represented a dramatic and sweeping change from the previous practice of state regulation. In particular, the price of paddy was now market determined at rates that should provide adequate incentives to farmers, to the extent that they could buy basic consumer goods with the increased income accruing from paddy sales.

In the real sector, despite the adverse consequences of the cyclone "Kamisy," the original target of 1 percent real growth in GDP might well be exceeded, Mr. de Maulde went on. Moreover, budgetary operations had been kept so closely under control that, for the first time in many years, a cash surplus--amounting to FMG 14 billion--had been registered in the first quarter of 1984. As a consequence, domestic arrears would be completely eliminated by the end of the year. Those developments had had a beneficial effect on the evolution of credit and the money supply that was certainly related to the significant slowdown in the rate of inflation that had also taken place in the first six months of 1984. It was therefore not surprising that Madagascar easily had met all of the performance criteria through the end of April and that the program with the Fund was on track.

Madagascar was doing well, and it would have done even better had more financing been available, Mr. de Maulde considered. More financing would have translated into more imports, which would have greatly enhanced the supply response currently under way. At present, the supply response was restrained both by a lack of spare parts and raw materials and by a lack of consumer goods. Higher producer prices were not the only condition for an increase in agricultural production, another condition being the availability of basic consumer goods for farmers.

Mr. Polak said that he found it satisfactory to learn that the program remained on track despite the April cyclone and uncertainties about the disbursement of aid. He was also glad that inflation had slowed and that the overall objectives for 1984 would probably be achieved. The setting of some indicative targets would be useful in circumstances in which it was not yet possible to set more definitive performance criteria for the rest of the year.

On more technical points, he was not certain whether the staff had succeeded in what it had called its aim of assessing the appropriateness of the 1984 adjustment program, Mr. Polak continued. Such an assessment would seem more the job of the World Bank. The staff paper also mentioned an understanding in the World Bank that certain investments would not become operative until their viability had been determined; he did not understand why such a topic, which would seem the preserve of the World Bank, had been included in a letter of intent by the authorities to the Fund.

As to the ending of price controls, a World Bank condition for industrial sector credit to Madagascar, Mr. Polak continued, one good solution might be to allow enterprises to raise formally controlled prices if there were no objection from the Government within 30 days. Such an arrangement would relieve the Government of actually having to approve price increases while discouraging it from blocking such increases. In conclusion, he hoped that the next review would provide guidance for the remainder of the stand-by arrangement.

Mr. Pickering said that his authorities were in broad agreement with the staff report and recommendations. As the full implementation of the stand-by arrangement had been delayed by a cyclone, he supported the proposal to delay the establishment of performance criteria for end-September and end-December until the August review. The setting of indicative targets provided an important benchmark, and he would look for full explanations of any deviation from the indicative ceilings at the time of the August review by the Board.

Policy implementation to date had been satisfactory, Mr. Pickering concluded. He was glad that the authorities had initiated important measures affecting producer prices, agricultural prices, and industrial pricing policy as well, and also that they had taken proposed exchange rate measures as planned. Early completion of the World Bank review of the public investment program would pave the way for rationalizing government investment. Finally, he attached importance to the elimination of domestic and external arrears as soon as possible.

Mr. Clark observed that while he recognized the difficulties that had arisen in the aftermath of the April cyclone, he hoped that they would not weaken the authorities' adjustment efforts. So far, the 1984 program had been proceeding satisfactorily: encouraging progress had been made on the supply side, the authorities had continued to maintain flexibility in the exchange rate, and had fulfilled all the performance criteria. A quantitative assessment of the cyclone damage should be possible by September.

Table 1 of EBS/84/133 showed that there was little room for maneuver within the 1984 budget if the overall deficit were to be contained to 5.5 percent of GDP, Mr. Clark went on. Current expenditure was already estimated to be 3.5 percent higher than originally projected under the program, a rise that was fortunately offset by higher than expected revenue from the export levy during the first quarter of 1984. For the remainder of the year, the authorities would be well advised to consider compensating unavoidable additional expenditures resulting from the cyclone within the existing budget. Although recognizing that that approach would be constrained by the need to keep the economy moving, he would be interested in hearing any ideas that the staff or Mr. Tshishimbi might offer on which elements of the budget could provide scope for further adjustment. At a minimum, it would be necessary to monitor planned expenditures closely. It would also be important to resist pressures that might emerge for further wage increases. If there were some slippage in the deficit, it would be important for any additional borrowing to be financed by noninflationary means.

Paragraph 2 of the proposed decision gave three reasons for the delay in setting performance criteria for domestic credit and external debt: aftereffects of the cyclone, delays in agreeing on debt relief, and delays in agreeing on exceptional balance of payments assistance, Mr. Clark noted. If he had interpreted it correctly, the reference to exceptional balance of payments assistance related to uncertainties about how much of any additional government expenditure resulting from the cyclone would be financed by aid. He had been puzzled by the phrase "delays in agreeing on debt relief," which he supposed was a reference to negotiations with commercial banks mentioned by the Deputy Director of the African Department. He would also be grateful for confirmation by the staff that paragraph 2 of the proposed decision in no way undermined the assurances given the Board in April that a sufficient amount of external finance had been secured to enable the stand-by arrangement to proceed. More generally, there was a question whether it was not rather odd for performance criteria to be set so close to their effective date. It was scarcely conceivable that criteria would be set in August that seemed unattainable in September.

On the public investment program, Mr. Clark welcomed the understandings reached between the authorities and the World Bank, described in paragraph 3 of their letter of June 8. On another topic, he would have liked to see more progress toward decontrolling industrial prices, but a start had been made, and a timetable for decontrolling the remaining prices would be set during the November review. In addition, he welcomed the authorities' intention to limit imports of rice for 1984 out of their own foreign exchange resources to the level already attained. Finally, he was encouraged by the staff's assessment on page 7 of EBS/84/133 that the short-term effects of the cyclone on Madagascar's balance of payments had been relatively unimportant. He also noted the staff's finding on page 2 that there was no need at present for change in the main medium-term trends described in EBS/83/235 (11/2/83).

Mr. Laske expressed support for the proposed decision. The cyclone that had struck the island appeared to have caused serious damage to the economy; appropriate performance criteria were difficult to determine before the extent of the damage could be accurately assessed. For that reason, he could go along with the proposal to define performance criteria for the remainder of the stand-by arrangement only in the August review. The repercussions of the cyclone would have to be dealt with out of domestic savings to the extent that they could not be covered by external grants. To make such a move feasible without greatly delaying the adjustment under way, he would urge the authorities to begin to identify the possibilities of expenditure cuts in other areas. He would consider it unfortunate if the authorities were to take refuge from a higher budget deficit in a more expansionary monetary policy, as that would unnecessarily slow down progress in correcting the economy's serious imbalances.

Although only a brief period had elapsed since the inception of the program, the Fund staff had been able to provide indications that developments in the real economy, in the financial sphere, and in the balance of payments were probably in line with the objectives of the program, Mr. Laske noted. In the real economy, marketing systems for agricultural commodities had been improved, with adequate incentives now being given to producers. The decontrol of industrial prices should be extended to commodities whose prices were still subject to official control and regulation. As the public sector investment program benefited from cooperation with the World Bank, he had noted with interest that the World Bank had urged the authorities to review some investment projects of doubtful economic value before putting them into operation. Nevertheless, perhaps the completion of those projects should be delayed, thus freeing scarce resources for investments of unquestionable merit.

Like other speakers, Mr. Laske continued, he was puzzled by the wording of paragraph 2 of the proposed decision, which stated that performance criteria could not be established "because of uncertainties arising from the effects of the recent cyclone 'Kamisy,' together with delays in agreeing on debt relief and exceptional balance of payments assistance." The stand-by arrangement had entered into operation in April 1984 after agreements on debt relief and special balance of payments assistance had been reached. The proposed decision ought to express uncertainties about the timing of the disbursement of such assistance, because the staff report actually mentioned such uncertainties, although not uncertainties with regard to debt relief. Perhaps the wording of the decision should be amended.

The optimistic tone of the staff appraisal might well be justified in view of the authorities' apparent determination to press ahead with the required adjustment, Mr. Laske concluded. What he had missed in the staff appraisal, however, was any indication of what effects the uncertain disbursement of the aid promised by the donors' group would have on the expected progress in adjustment, especially as it related to the balance of payments, to the working off of external arrears, and to the hope for strengthening international reserves. He invited the staff to elaborate on the consequences of those uncertainties regarding the disbursement of aid and the effects on the balance of payments, especially for the public sector budget and also for the formulation of ceilings on credit to the Government.

Ms. Lundsager observed that, although it did not meet the original expectations, the review of Madagascar's program indicated that the authorities had taken the agreed-upon measures and had met the performance criteria so far. Therefore, she supported the proposed decision.

The stand-by arrangement called for a reduction in the fiscal deficit to 5.5 percent of GDP, by restraints on government expenditure, Ms. Lundsager noted. She supported that approach but observed, however, that both revenue and expenditure had increased in Malagasy francs following the devaluation; she would have preferred to see tighter controls over expenditure, especially government wages. Unfortunately, not enough time had elapsed since the April cyclone for the staff to determine the additional government expenditure that might result. Although there had been a tax surplus early in 1984, she feared that, given Madagascar's strained economic position, additional financing for expenditures greater than currently planned might be extremely difficult to obtain from domestic or foreign sources. Could the staff clarify whether the authorities would undertake additional expenditures, make reductions in other areas, or carry out increased borrowing? She urged them to control government expenditures.

Positive developments were apparent in many other areas, including the higher price of rice, Ms. Lundsager continued. She supported the authorities' decision to continue with the system of sales by auction that had led to profitable rice production and was also pleased to note that the authorities had both increased prices for other agricultural products and widened the scope of price decontrol for industrial goods. In addition, she supported World Bank involvement, especially in the assistance given in setting priorities.

Finally, Ms. Lundsager said that she welcomed the continued flexible management of the exchange rate, as shown by the devaluations on June 21 and July 2, which demonstrated the authorities' commitment to maintaining relative prices. In addition, the devaluations indicated to donors and creditors that adjustment was taking place. Control over the budget would complete the program.

Mr. Mtei said that he supported the proposed decision. Although Madagascar had been unable to draw until April 16, 1984 under the stand-by arrangement approved on December 21, 1983, the authorities had persevered to keep the program on track: all the agreed measures under the program had been implemented, and the performance criteria had been met. The prospects for realizing the broad objectives of the program were also good, despite the cyclone "Kamisy," the effects of which were yet to be fully evaluated. Various international organizations, including the World Bank, were involved in assessing the full extent of the damage; uncertainty about the effects of the cyclone had prevented the staff from setting firm performance criteria for the remainder of 1984. He hoped that, in reaching agreement on performance criteria, the staff would exercise the necessary flexibility, taking full cognizance of the financing needs, both domestic and external, occasioned by the cyclone. He did not think it realistic to tie those emergency expenditures to provisions in the current budget, as suggested by some Executive Directors, although it would be ideal if it were possible.

The problem of external arrears was being compounded by external interest payments, which were expected to be 9.4 percent higher than originally programmed, on account of soaring international interest rates, Mr. Mtei continued. The burden imposed by the rise on economies like that of Madagascar could not be overemphasized and required due attention from those countries whose policies were major determinants of international interest rates. He noted the resolve of the Malagasy authorities to reduce and eventually eliminate not only external arrears but also domestic arrears. The authorities' acceptance of a performance criterion for arrears during the second half of 1984 was indicative of their resolve.

Agricultural producer prices were sufficiently remunerative, and a decision had been made to decontrol most prices in the industrial sector, Mr. Mtei observed. The resulting price incentives would have salutary effects not only on output but also on the balance of payments. Furthermore, he hoped that the discussions between the authorities and the World Bank staff on the public investment program for 1984-87 would lead to a rational process of project selection.

Although he appreciated the benefits that could derive from exchange rate action, the staff should be a little more careful in recommending such adjustment, Mr. Mtei considered. Otherwise, the staff might be seen as too eager to pull the devaluation trigger. In particular, he was not sure whether it was appropriate to link the size of exchange rate changes solely to quarterly increases in the cost of living. According to such a yardstick, almost all members of the Fund would need to adjust their exchange rates downward every quarter. The benefits of such competitive exchange rate depreciation were far from clear.

In conclusion, adjustment and financing must go together if the effective adjustment were not to be disruptive of the economic and sociopolitical fabric of society, Mr. Mtei said. Therefore, he strongly urged the donors to be quick in their disbursement of aid to Madagascar, which was particularly crucial in view of the devastating effect of the recent cyclone.

Mr. Ismael observed that the cyclone disaster, severely affecting the northern part of Madagascar, together with delays in reaching agreement on debt relief and exceptional balance of payments assistance, had made it impossible at present to set the performance criteria for the second half of 1984, as required in the stand-by arrangement. Nonetheless, he had no difficulty in agreeing to the waiver regarding performance criteria and in supporting the proposed decision. According to the staff paper, the latest financial developments and measures taken by the authorities indicated that the current program had remained firmly on track. All the performance criteria appeared to have been met, and the overall objectives of the program were expected to be realized. He was not sure with how much confidence Executive Directors could accept that optimistic assessment, because the staff had made no attempt in the paper to indicate whether the cyclone damage would have significant effects on the achievement of the program targets. For instance, the paper projected continued adherence to financial discipline in order to assure a further reduction of the fiscal deficit to 5.5 percent of GDP, but that was one major area in which the impact of the cyclone damage might be felt to have required increased relief expenditures. He invited the staff to provide further indications of the significance of that impact.

In the monetary sector, the target rate for the expansion of broad money had been set at 19 percent for 1984, compared with a decline of 2 percent in 1983, Mr. Ismael observed. He understood that the more rapid expansion was consistent with the expected improvement in the balance of payments position and with the greater need for liquidity by private sector businesses consequent to price liberalization measures. Those developments indicated, however, that the inflation rate for 1984 would be no lower than in 1983, and might even be higher, an impression supported by the fact that the increase in projected nominal GDP was expected to be higher than in 1983 despite the similar real growth prospects of about 1 percent. He would appreciate comments by the staff on that topic, in the light of both the presumptions of the program and the latest price developments.

He had noted with satisfaction that the authorities had continued to manage the exchange rate flexibly, Mr. Ismael continued. The Malagasy franc had already been depreciated by 15 percent in March and by 2 percent in early July, depreciations that had appeared sufficient to maintain Madagascar's external competitiveness. However, interest rates that had continued to be mostly negative in real terms were a subject for serious concern and would be covered in the next review, perhaps within the broader context of liberalization measures in the banking sector. Nevertheless, the authorities should accelerate their efforts toward promoting a more liberal interest rate policy in order to stimulate private savings, hold down the rate of inflation, and increase economic efficiency.

Finally, Mr. Ismael commended the authorities for the measures taken to liberalize marketing and to adjust producer prices for rice and some other agricultural products so as to assign a bigger role to market forces. It was also reassuring to note from Mr. Tshishimbi that the authorities, on July 11, had freed the prices of goods representing at least 30 percent of value added in the industrial sector, as provided for under the program. Those steps were important in increasing efficiency and incentives for production and exports. He encouraged the authorities to continue liberalizing the remainder of industrial products, as envisaged in the program, particularly with respect to the still controlled 70 percent of value added.

Mr. El-Khouri expressed agreement with the staff appraisal and support for the proposed decision. It was encouraging that the adjustment policies envisaged under the stand-by arrangement were being implemented on schedule. Producer prices for a number of agricultural products had been raised to increase incentives for production, and the marketing system for rice was being implemented as planned. The prices of industrial products accounting for 30 percent of value added had been decontrolled, as provided in the program. Budgetary policies were generally on track, and the authorities were pursuing a flexible exchange rate policy.

Uncertainties did exist that could complicate the task of attaining the objectives of the program, Mr. El-Khouri went on. First, there were uncertainties regarding the timetable for the receipts of aid expected as a result of the donors' meeting in Paris in April. Perhaps the staff could explain whether there might be a shortfall in the aid to be received by Madagascar during the program period. Even more important were the uncertainties regarding the effects of the cyclone "Kamisy" on the economy, which were still to be evaluated.

In view of those uncertainties, it was understandable that the quantitative performance criteria for the second half of 1984 could not be set during the first review of the program, as had been originally intended, Mr. El-Khouri recalled. Therefore, he could agree with the authorities' request that the performance criteria be set during the second review under the stand-by arrangement. But the cyclone had introduced a new element into the program. In case the effects of the cyclone turned out to be severe, the question arose whether the authorities would be able to implement additional measures to ensure that the program's objectives were met. For instance, if additional budgetary expenditures and imports were required that could not be financed from additional aid, would there be scope for reducing other expenditures and imports? Perhaps the staff could comment on the room for maneuver available to the authorities in implementing the program. Finally, he hoped that the staff would impress on the authorities the need for a longer-term strategy regarding the production and export of cloves, in the light of the Board's earlier discussions of a request by Madagascar for a purchase under the compensatory financing facility.

Mr. Salehkhou observed that the staff report contained some good news about the implementation of various policies under the program and the performance of the Malagasy economy. Economic and financial developments during the first half of 1984 were particularly welcome in view of the multiple difficulties that had prevented full implementation of the previous arrangements with the Fund and in view of the devastation brought by the cyclone. He had noted with satisfaction that, even after the cyclone had badly affected rural infrastructure, housing, and agricultural production--although a definitive assessment of the damage had not been completed--available evidence indicated that the broad objectives of the 1984 program should be realized. However, the severity of the cyclone had created a number of uncertainties that did not permit the adoption of formal performance criteria. Thus, he had no difficulty in supporting the authorities' proposal that performance criteria for the period after June 1984 should be delayed until after the August review, when the actual effect of the cyclone would have been assessed. The adoption of indicative targets was fully appropriate and ensured that no relaxation in carrying out the program would occur in the absence of formal performance criteria.

He shared the staff's assessment of Madagascar's performance under the program during the first months of 1984 and the prospects of its successful implementation on domestic financial developments, Mr. Salehkhou said. Despite a number of upward revisions in budgeted current and capital expenditure, the overall budget deficit would probably remain at the level originally estimated under the program, owing to an increase in revenues induced by the recent devaluations and the new measures introduced in 1984. The increase in expenditures was mainly due to the depreciation of the Malagasy franc and a small increase in government workers' salaries. It also reflected higher than expected interest payments that should result from the increased international rates and from somewhat unfavorable terms of rescheduling.

Unless the cyclone damage turned out to be much greater than expected by the staff and the authorities, balance of payments developments in Madagascar should also be in line with the original objectives of the program, Mr. Salehkhou predicted. Higher export prices for coffee had helped to offset lower earnings from other imports as well as the increase in external interest payments, and the completion of the rescheduling exercise, although on less favorable terms than expected, would enable Madagascar not only to fill the external financing gap but also to increase its international reserves.

With respect to policy implementation under the program, Mr. Salehkhou noted that significant progress had already taken place, particularly in agricultural producer prices, which had been progressively raised. He also welcomed the acceleration in the decontrol of industrial prices--in cooperation with the World Bank--and the introduction of substantial flexibility in the pricing of goods whose prices were still controlled. In conclusion, he supported the proposed decision.

Mr. Malhotra commented that he had been happpy to note from the staff report that progress under the program had been satisfactory. Therefore, he could support the proposed decision. He would suggest only that the staff should take the impact of the cyclone into consideration in setting performance criteria later in the year.

The Deputy Director of the African Department explained that recently, not only in Madagascar but also in many other countries where problems had been more difficult and performance more problematic, the staff had attempted to monitor programs by conducting more frequent reviews. The efforts of the staff had been directed at the specific topics that had to be addressed instead of giving an overall review of the economy in each of what was often a series of review papers.

As for the usefulness of setting performance criteria in August for the month of September, the Deputy Director noted, the staff had not discussed such ceilings with the Malagasy authorities as close to the performance date as it might appear. For instance, the ceilings for July had been discussed with the authorities in May, and those for September would be discussed in July; about two months elapsed between the discussion and fixing of the ceilings.

A question had been posed by Mr. Polak whether, in the letter of intent, the authorities should have included criteria or commitments relating to price decontrol or the investment program, as such matters normally fell within the jurisdiction of the World Bank, the Deputy Director continued. It was true that the staff relied on the World Bank to provide an assessment of the investment program. As noted on page 11 of EBS/84/133, the World Bank was seeking to discuss three aspects of the investment program with the Malagasy authorities: first, the overall financial constraint; second, the policy content behind the public investment program; third, the specific criteria governing the selection of projects. The staff would think that, in establishing financial criteria and working out an adjustment program, a significant factor would be the overall financial constraint; therefore, to some extent reference to investment programs under different scenarios would appear to be justified. The Fund staff had asked the World Bank staff to help in determining whether, within that global framework, the kind of projects included in the investment programs conformed to criteria that the World Bank staff would accept. Again, the specific performance criteria had been included in the letter of intent within the context of overall financial constraints. If, after completion, those projects had to begin operation, losses would be incurred, with consequences for the budget. The Fund staff had wished to be certain that the understanding with the World Bank paralleled the understanding reached with the Fund, so that the overall investment program would not be jeopardized.

The Fund had a direct interest in price decontrols, to the extent that the program had to take into account both demand management and supply response, the Deputy Director observed. For the previous two years, demand management had been the major emphasis of the program, and the time had come for some emphasis to be put on the supply side as well. The staff had felt that price decontrol was an essential element of the program, and had relied on the World Bank to undertake a study and identify the products whose prices should liberalized. Upon completing its study, the World Bank had said that it expected the authorities to liberalize about 30 percent of value added in industrial products before it could begin negotiations on a new structural adjustment loan. The Fund staff had not wished to treat such an important supply aspect of the program before those negotiations began. Furthermore, by having undertaken to decontrol some prices, the Malagasy authorities to some extent could induce the World Bank staff to negotiate a structural adjustment program as early as possible, thereby perhaps avoiding the considerable delays that sometimes occurred.

It should be borne in mind, the Deputy Director said, that over the past three or four years, everything had gone wrong for Madagascar, from natural disasters to domestic policies. In the past six months, every policy implemented had been on target.

Several Directors had suggested that if there were additional expenditures because of the cyclone, the Malagasy authorities should try to offset them by reducing other expenditures, the Deputy Director continued.

In particular, Mr. Pickering had said that he would expect a full explanation if any deviation occurred from the indicative ceilings mentioned in the letter of intent. In response, it would be unfortunate not to distinguish indicative ceilings from performance criteria. The staff did indeed expect national authorities not to exceed indicative ceilings, and to some extent, therefore, it tended to be conservative in setting such ceilings until the full facts became known. If, during a subsequent mission, the assumptions had not been fully borne out by the facts, the staff would appreciate having some flexibility. He hoped that the staff would not be held to indicative ceilings as performance criteria.

In the budget, the authorities had been making as much progress as was possible while maintaining stability in the economy, the Deputy Director remarked. Notwithstanding the 15 percent price inflation recorded in 1983, the increase in prices in 1984, following the 15 percent depreciation, had been only 3 percent. It would be difficult to justify cutting current expenditure further. Indeed, if interest and other fixed charges were excluded, there would be almost no margin left for expenditure cuts. The staff's preference would be to try to look for additional sources of revenue, provided that expenditure was not financed from abroad. It was likely that larger receipts would be forthcoming because of the impact of the depreciation, which the staff had not yet taken fully into account. There was also the possibility of reducing domestic capital expenditures if the need arose.

The exchange rate policy being followed had been formulated to apply during the period of the present program only, the Deputy Director pointed out. The staff would discuss future exchange rate policy with the authorities when the time came to work out a new program. In 1983, the exchange rate of the Malagasy franc had been greatly overvalued, but the authorities had not wished to correct the entire overvaluation in one or two steps. Therefore, a formulation had been devised whereby, over the program period, a series of depreciations would bring the exchange rate into some kind of equilibrium. To the extent that the rate of inflation remained within the range of 15-20 percent, the current exchange rate policy would be appropriate, particularly in the light of the recent 4 percent devaluation, which underscored the authorities' commitment to that policy.

Several Executive Directors had asked whether the financing gap for 1984 had been filled, the Deputy Director recalled. Mr. Laske was correct in supposing that the staff had been referring to the timing of the aid that had been promised, not to the amount actually disbursed. There had been some delay owing to a dispute between two groups of commercial banks--one group representing secured loans, another representing general-purpose loans--about preferential treatment. The staff had not known whether the group to be given preferential treatment would receive a down payment or how much it would be. At present, all those problems had been resolved. The staff was even confident that the reserve target, which involved some increase in reserves, would be attained.

The staff did not believe that the rate of inflation in Madagascar in 1984 was going to be higher than in 1983, the Deputy Director of the African Department said. Given the performance of the economy in the first four months of the year, inflation might well turn out to be lower than expected, particularly as the rate of expansion of the money supply had been declining consistently during the past year. The increase in velocity could not induce inflation beyond a certain limit, and although rates of interest in real terms were lower than the rate of inflation, the staff was encouraging the authorities to raise them. With the liberalization of prices, enterprises were no longer able to argue that their costs, fixed by the authorities, did not allow them to raise prices. Thus, the staff should have a certain leeway to suggest that the authorities should in turn increase real interest rates. Finally, the banking system had to be thoroughly reviewed; the staff hoped to focus attention on the use of monetary policy.

Mr. Polak explained that he had not meant to suggest that the staff paper was too brief, but that it was too early to conduct a substantive review of recent developments in the Malagasy economy.

Mr. Tshishimbi agreed with the Deputy Director of the African Department that the authorities' room for maneuver would be quite limited if the assessment of the damage caused by the cyclone indicated the need for additional expenditures. Thus, the authorities hoped that, if the damage had been as severe as some feared, outside assistance might be forthcoming. Probably any adjustment would come from the revenue side rather than the expenditure side.

As to whether the performance criteria had been set too close to the effective date on which they became operational, Mr. Tshishimbi said that the greater the number of performance criteria included in the program, the shorter the period between the different reviews would be. Indeed, setting too many performance criteria led to a situation in which reviews took place before enough time had passed for the economy to respond to the new measures taken since the previous review.

He shared the concern expressed by Mr. Polak and Mr. Laske about the wisdom of the Fund's including in letters of intent matters dependent on World Bank staff work, Mr. Tshishimbi remarked. While agreeing it was useful to encourage cooperation between the two institutions, he considered that the Fund did put itself in something of a straitjacket by including in the letter of intent all of the performance criteria based on an assessment by the World Bank. In conclusion, he agreed with Mr. de Maulde that, had the amount of financial assistance given to Madagascar been a little higher, the good economic performance that had been welcomed by Executive Directors would have been even better.

The Deputy Director of the African Department suggested that, in paragraph 2 of the proposed decision, the phrase "delays in agreeing on debt relief and" should be replaced by a reference to "the time needed to ascertain the phasing of receipts in respect of." In addition, at the end of paragraph 2, the phrase "(iii) external debt" should be deleted and replaced by two phrases referring to "(iii) domestic arrears, and (iv) external arrears."

The Executive Board approved the decision, as amended. The decision was:

1. Pursuant to paragraph 4(c)(i) of the stand-by arrangement for Madagascar (EBS/83/255), as amended by paragraph 3(b) of Executive Board Decision No. 7650-(84/42), adopted March 19, 1984, understandings regarding the policies and measures that Madagascar would pursue, including the specification of performance criteria for the remaining period of the arrangement, were to have been reached during the first review of the program to be completed before May 31, 1984.

2. Madagascar has consulted with the Fund as required by the cited paragraph 4(c)(i) of the stand-by arrangement, but, because of uncertainties arising from the effects of the recent cyclone "Kamisy," together with the time needed to ascertain the phasing of receipts in respect of exceptional balance of payments assistance, it was not feasible to establish performance criteria for the remaining period of the stand-by arrangement with respect to (i) total credit, (ii) net credit to the Government, (iii) domestic arrears, and (iv) external arrears.

3. The Fund waives the requirement that during the first review understandings be reached on the performance criteria for the remaining period of the arrangement listed in paragraph 2 above. Such performance criteria will be established during the second review of the program to be completed before August 31, 1984. Madagascar will not make any purchases under the stand-by arrangement after August 30, 1984 until these performance criteria have been established, or after such performance criteria have been established, while they are not being observed.

4. The letter dated June 8, 1984, from the Minister at the Presidency of Madagascar in charge of Finance and Economy shall be attached to the stand-by arrangement as representing further understandings reached with the Fund, and the letter dated November 21, 1983, attached to the stand-by arrangement as modified and supplemented by the letter and memorandum of February 23, 1984, is further modified and supplemented by the letter dated June 8, 1984. Accordingly:

(a) Paragraph 4(a) of the stand-by arrangement shall be amended to include the following additional performance clauses:

(iv) the target for the reduction of external payments arrears through net cash payments as described in paragraph 5(f) of the letter dated June 8, 1984, or

(v) the target for the elimination by the Government of domestic payments arrears as described in paragraph 5(g) of the letter dated June 8, 1984....

(b) Paragraph 4(d) of the stand-by arrangement shall be amended to read as follows:

(d) during the entire period of this stand-by arrangement, while Madagascar has any overdue financial obligations to the Fund, or if Madagascar....

5. The Fund finds that no additional understandings are necessary because of the inability to establish certain performance criteria during the present review of the program for the remaining period of the stand-by arrangement and that Madagascar may make purchases under the stand-by arrangement until August 30, 1984.

Decision No. 7753-(84/107), adopted
July 16, 1984

2. EXECUTIVE DIRECTOR - REPORT BY CHAIRMAN

Meeting in restricted session, Executive Directors considered a report by the Chairman on recent developments regarding the continued absence of an Executive Director.

3. STAFF COMPENSATION REVIEW AND RECOMMENDATIONS FOR 1984 ADJUSTMENT

The Executive Directors, meeting in restricted session, considered the Managing Director's recommendations for the 1984 staff compensation review (EBAP/84/122, 6/4/84; Sup. 1, 6/26/84; and Sup. 2, 7/13/84). They also had before them a paper prepared by the Staff Association Committee concerning the 1984 staff compensation review (EBAP/84/137, 6/28/84) and a paper on recent recruitment and retention experience (EBAP/84/121, 6/4/84).

Executive Directors agreed to continue 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/84/106 (7/13/84) and EBM/84/107 (7/16/84).

4. JOINT COMMITTEE ON REMUNERATION OF EXECUTIVE DIRECTORS - EXTENSION OF GOVERNORS' VOTING PERIOD

The Executive Board approves the proposal to extend the period of voting on the Resolution submitted to the Board of Governors with the Report of the Standing Joint Committee on Remuneration of Executive Directors through July 25, 1984, as set forth in EBAP/84/120, Supplement 2 (7/13/84).

Adopted July 13, 1984

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/84/140, Supplement 1 (7/12/84) is approved.

APPROVED: April 3, 1985

LEO VAN HOUTVEN
Secretary