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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/147

10:00 a.m., October 9, 1984

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	K. Celebican, Temporary
	X. Blandin
	J. Delgadillo, Temporary
	M. Lundsager, Temporary
M. Finaish	
H. Fujino	T. Yamashita
	B. Goos
J. E. Ismael	
	L. Leonard
	J. R. N. Almeida, Temporary
G. Lovato	
R. N. Malhotra	
	J. E. Suraisry
J. J. Polak	
	H.-S. Lee, Temporary
G. Salehkhou	O. Kabbaj
	E. I. M. Mtei
	J. E. Rodríguez, Temporary
	A. Lindå
	J. Bulloch, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present:
African Department: R. J. Bhatia, Deputy Director; O. B. Makalou, Deputy Director; N. Abu-zobaa, E. A. Calamitsis, C. N. Egwim, T. T. Gibson, M. G. Gilman, S. Schiavo-Campo, R. T. Stillson, J. C. Williams. Exchange and Trade Relations Department: S. Kanesa-Thasan, M. O. Tyler. Legal Department: J. M. Ogoola. Advisors to Executive Directors: D. Hammann, A. Steinberg, A. Vasudevan. Assistants to Executive Directors: I. Angeloni, M. Camara, C. Flamant, N. U. Haque, G. D. Hodgson, H. Kobayashi, K. Murakami, E. Olsen, J. K. Orleans-Lindsay, T. Ramtoolah.

1. MADAGASCAR - 1984 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1984 Article IV consultation with Madagascar, together with a proposed decision concluding the 1984 Article XIV consultation, and the second review under the stand-by arrangement (EBS/84/195, 9/12/84; and Cor. 1, 9/19/84). They also had before them a report on recent economic developments in Madagascar (SM/84/218, 9/25/84; and Cor. 1, 9/28/84).

The staff representative from the African Department stated that on September 22 the Malagasy Government had revalued the Malagasy franc by 1.1 percent in local currency terms. That revaluation was in strict conformity with the flexible exchange rate policy agreed upon under the stand-by arrangement whereby the authorities would adjust the exchange rate quarterly on the basis of the previous quarter's increase in the consumer price index (CPI). A review mission was scheduled to visit Madagascar in the following week and would, inter alia, review the movement in the consumer price index, which had declined by 1.1 percent in the quarter March-June 1984.

Mr. Alfidja made the following statement:

> Over the past ten months, the Executive Board has had the opportunity to undertake several reviews of developments in the economy of Madagascar. The latest staff report, EBS/84/185, indicates that the Malagasy authorities are making substantial progress toward overcoming many of the obstacles that thwarted their adjustment efforts to correct the internal and external economic imbalances and to reverse the deterioration in overall economic performance experienced during 1980-82. Growth of real GDP is now positive. The budget deficit has been reduced further, accompanied by an increase in gross domestic savings and a substantial deceleration in inflation. The current account deficit has also continued to decline. However, the overall balance of payments position continues to be under pressure, and the external debt situation remains a subject of major concern to the Malagasy authorities.
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> The signs of a turnaround in economic recovery became evident in 1983 when real GDP expanded moderately by 1 percent, reflecting a 2.4 percent increase in agricultural output. Notwithstanding the adverse effects of the cyclone Kamisy of April 1984, it is expected that the producer pricing and liberalization measures for agricultural marketing, already in place, together with better supply of inputs and extension services will help to maintain agricultural growth in 1984. Thanks to measures taken to rehabilitate existing industrial capacity and improved supply of imported materials and spare parts, industrial output is expected to expand. As a result, a further expansion in real GDP of about 2 percent is likely to be achieved in 1984.

Domestic financial developments also show that the authorities have made further progress in reducing the budget deficit in relation to GDP, from 8.8 percent in 1982 to 6.7 percent in 1983. The present indications are that the target reduction to 5.5 percent of GDP for 1984 could be achieved. Expenditure restraint, particularly of the public sector wage bill and improvements in administrative procedures are major components of the fiscal adjustment effort. In terms of GDP, total expenditure declined in 1983 and is projected to decline further in 1984. As a result of discretionary revenue measures introduced in 1983, including a new unified duty on petroleum products, new excise taxes, and a new system of payment of company taxation, budget revenue increased significantly that year. Furthermore, partly as a reflection of the depreciation of the Malagasy franc, tax receipts on traditional exports also rose substantially in 1983.

Monetary and credit developments during the past two years have been broadly consistent with the reduction in the Government's financial requirements, the pressures on the balance of payments, and the tight liquidity position of the banking system. The reduced government demand for bank credit should permit an expansion of credit to the private sector, consistent with the expected increase in economic activity. The report of the comprehensive auditing of the national banks under way will be examined by the Malagasy authorities for appropriate action, if necessary.

In the external sector, the medium-term scenario outlined in the staff report highlights the very limited scope for a rapid reduction of the large imbalances in the external account. Over the past four years, Madagascar's exports have virtually stagnated and imports have steadily declined, thus contributing to the continued reduction in the current account deficit (excluding interest). However, the authorities' flexible implementation of the import program has meant that the share of equipment and consumer goods in total imports has been reduced while that of raw materials, intermediate goods, and essential inputs necessary for sustaining the economic recovery has been increased, in conformity with their policy to rehabilitate and increase the utilization of existing productive capacity. The reduction in imports is also a reflection of the authorities' commitment to cut back on rice imports in conformity with their medium-term objective of being self-sufficient in rice production.

Turning now to performance under the current stabilization program, the indications are that Madagascar has continued to make steady progress in its implementation. As the staff report on this second review confirms, all undertakings under the program have so far been implemented. All performance criteria have been observed.

> In support of their adjustment efforts, the Malagasy authorities have followed a flexible exchange rate policy. They are satisfied that, as indicated in the staff report, no further understandings with the Fund staff are necessary concerning their exchange rate policy and the banking system.
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> In the context of the authorities' efforts to deal with the structural problems of the economy, they have consulted the World Bank on a public investment program to be presented to the Consultative Group meeting in November 1984. To ensure that Madagascar's emerging recovery does not falter under the heavy burden of the external debt, their adjustment efforts need the massive support of the international financial community. The difficult outlook of the Malagasy economy for the medium term has strengthened the determination of the authorities to consolidate the gains achieved so far and encouraged them to persist in their endeavors. Success in these undertakings cannot be achieved without the exceptional assistance from donors and creditors.

Mr. Blandin remarked that the staff's statement in EBS/84/195 that Madagascar had made substantial use of Fund resources seemed contradictory to its observation that as of August 31, 1984 Fund holdings of Malagasy francs subject to repurchase were equivalent to only 141 percent of quota. Furthermore, he did not agree with the staff that the Fund-organized Aid Donors' meeting of April 5-6, 1984 had been successful. In his view, the amount of balance of payments assistance pledged at the meeting had been insufficient and, consequently, the supply response to the authorities' welcome reorientation of economic policy had been limited and they had been forced to compress imports further. While he welcomed the close cooperation of the Fund and the Bank on major issues of concern to Madagascar's adjustment and development effort, he was concerned that the World Bank had been slow to extend to Madagascar nonproject assistance, which had amounted only to $1 million thus far.

The progress made by the authorities toward adjustment would not easily lead to progress toward development if imaginative solutions to the external debt problem were not found, Mr. Blandin considered. Adjustment was well under way and the economic policy approach had shifted from demand restraint to more fundamental reform. The overall budget deficit had been reduced by 1.5 percentage points of GDP in 1984, and government savings were likely to be positive in 1985, after several years of negative savings. As a result of the fiscal discipline, monetary expansion had been kept well below target. As for the banking system, he was not as concerned as the staff that 38 percent of total loans of the commercial banks had been classified as high risk. To what extent did that figure reflect the large accumulation of claims on the state enterprises? A general consolidation of those claims, together with the continued pursuit of a more realistic pricing policy, might restore the financial viability of some of those enterprises in such a way that they would be better able to repay their obligations to the banks. Could the staff comment further on that matter?

Substantial progress had been made on the supply side of the economy, Mr. Blandin observed. The extension of a more flexible pricing policy--initially limited to the agricultural sector--to the industrial sector was a welcome development, particularly as it had enabled the World Bank to grant an industrial sector credit of $40 million. Those resources should help the authorities to restore the productive capacity of viable enterprises and, hence, increase exports or import substitutes, thereby improving Madagascar's debt service capacity in the medium term.

Nevertheless, Madagascar's outstanding external debt was of such a magnitude that, even with appropriate policies in place, the resumption of economic development and servicing of debt would be difficult, Mr. Blandin commented. The country's future debt service capacity depended on economic growth and export volume, both of which required an appropriate level of imports. Some thought should be given to finding new and imaginative solutions to Madagascar's problems. An opportunity to do so would occur at the November 28-30 meeting of the Consultative Group for Madagascar, which would discuss various scenarios being prepared by the World Bank. It would be interesting to see whether the reversal of the dates of the meeting of donors' and the Paris Club meeting--and the change in chairmanship of the Consultative Group--would increase the overall amount of aid pledged to Madagascar. In conclusion, he supported the impressive efforts made by the Malagasy authorities.

Mr. Mtei indicated his broad agreement with the staff appraisal. He commended the authorities for their successful implementation of all measures adopted under the stabilization program, their observance of the quantitative performance criteria, and the significant gains made in reducing domestic financial imbalances. Even more important, the decline in economic activity had been halted, and there were indications that recovery, although slow, could be well under way. In fact, were it not for the burden of the heavy external debt service payments, which would dominate the balance of payments situation over the medium term, it could be said that sustainable economic growth had been achieved.

There was no room for relaxation of the adjustment effort, Mr. Mtei considered. The authorities would need to maintain a delicate balance between policies aimed at restraining domestic demand and those aimed at promoting growth. They had been successful in reducing the rate of inflation and the budget deficit. Although the policy of domestic demand restraint had reduced the volume of imports for the third consecutive year, the recovery in economic activity had been broadly unaffected because of the marked change in the composition of imports. He was concerned that a further compression of imports could jeopardize the foundations of the recovery, but the authorities might be forced to cut imports further given their heavy debt obligations.

Clearly, cooperation with creditors and aid donors would be necessary if Madagascar was to restore economic growth, while discharging its foreign obligations in a timely manner, Mr. Mtei considered. Substantial concessional external assistance and continued debt relief were essential to enable the country to maintain a level of imports that would ensure economic growth. Could the staff or Mr. Alfidja indicate whether the response from the international community had been positive?

The two final purchases under the arrangement--of SDR 6 million each--would be made upon the completion of the third review and observance of the end-September performance criteria, and upon satisfaction of the end-December performance criteria, respectively, Mr. Mtei noted. As the latter date had already passed, would the authorities be allowed to make the first of the final drawings as long as the stipulated performance criteria had been satisfied? In his view, the third review, scheduled so soon after the second review, might not serve a useful purpose. The budgetary policy and import program for 1985, scheduled to be discussed in the third review, could be tied to the final drawing.

Mr. Suraisry indicated his broad agreement with the main points in the staff appraisal and his support for the proposed decisions. The authorities' success with respect to inflation, the current account, and the overall budget deficit was encouraging. The projected economic growth for 1985 was particularly noteworthy, and he commended the authorities for their achievements. Nevertheless, the economy was still faced with a number of problems: the balance of payments was under pressure, the outstanding debt was high, and inflation and the overall budget deficit should be reduced further. Continued adherence to the present adjustment policies was necessary if lasting success in those areas was to be achieved and confidence in the Malagasy economy was to be strengthened.

The authorities were already moving in the right direction in many areas, Mr. Suraisry considered. In the productive sector, the prospects for increased agricultural output were better than in the past, although further efforts were necessary, in particular, to introduce a more flexible pricing policy and improve the financial position of the state enterprises. He welcomed the authorities' intention to review the general operations of the state enterprises with a view to increasing their profitability and efficiency.

On monetary policy, the proportion of commercial bank loans classified as high risk was a cause for concern and represented a real challenge to the monetary authorities, Mr. Suraisry remarked. Those loans could complicate monetary policy and added an element of uncertainty about economic performance in the future. He welcomed the comprehensive review of monetary policy, which he hoped would result in increased competition among the banks. The technical capabilities and management of the commercial banks should be improved.

On the external side, he was pleased to note that economic activity had largely been insulated from the compression in imports, Mr. Suraisry stated. However, any further cut in imports was likely to affect economic activity, a fact that underscored the importance of continued external financing and adherence to the adjustment effort. He welcomed the authorities' intention to give higher priority in allocating credit to the financing of imported inputs.

The medium-term outlook was discouraging given the substantial debt service ratio, Mr. Suraisry observed. Madagascar had no choice but to continue with the adjustment effort and to prevent any slippages in economic performance. He welcomed the authorities' close cooperation with the Fund thus far.

Ms. Lundsager stated that the cyclone in April 1984 had caused significant damage. However, foreign assistance, which had largely covered the related financial expense--representing just under 0.5 percent of GDP--and continued implementation of planned economic policies had kept the program on track. Performance criteria and targets had been met with some room to spare.

She agreed with the thrust of the adjustment effort, Ms. Lundsager said. Investment, directed toward the rehabilitation of the existing infrastructure, was increasingly financed out of domestic savings, as shown by the increase in the national savings rate from 4.8 percent of GDP in 1982 to a projected 7.8 percent of GDP in 1984. Wage increases would be constrained below the expected rate of inflation in 1984. On the fiscal side, the budget deficit was projected to be 5.4 percent of GDP in 1984, slightly less than originally targeted; all domestic arrears would be eliminated by year end; and although nominal expenditure as a proportion of GDP had been higher than previously projected, revenues had also been higher than expected. Finally, the real depreciation of the Malagasy franc so far in 1984 had increased the competitiveness of exports and import substitutes. She encouraged the authorities to continue the quarterly exchange rate adjustments, even beyond the completion of the current program.

Comprehensive policy changes were planned for the public sector enterprises, Ms. Lundsager noted. She fully endorsed the goal to increase private investment in the parastatals and encouraged the authorities to complete the audits and policy changes necessary to make those enterprises desirable investments. Did the staff have any details on those changes? While the required adjustment effort had resulted in some inescapable reduction of imports, imports of raw materials and intermediate goods had not been affected. Furthermore, the increases in rice prices had led to increased domestic production of rice in 1984, limiting the need for imports. She hoped that those successes, combined with the modest increase in GDP in 1984, would encourage the authorities to continue with their structural reform.

The growth in credit in 1984 appeared to be appropriate in light of developments in 1983, Ms. Lundsager commented. However, credit demand by the private sector had been weak thus far in 1984, and although the authorities believed that it would remain low, they wished to leave room for private sector expansion should demand for credit in that sector recover in the remainder of the year. She endorsed their approach and hoped that they would remain in close consultation with the Fund. If there were a short-term increase in the demand for credit, the economy might not be able to satisfy rapidly the resulting demand for real resources. She welcomed the fact that credit to the public sector would be lower than the indicative ceiling presented in the staff paper on the first review of the stand-by arrangement. On a related point, the staff had stated in the body of the staff report that many interest rates were positive in real terms, whereas the tables indicated that they remained slightly negative, given the expected annual rate of inflation for 1984. Could the staff clarify further the current situation, particularly with respect to inflation, given the most recent report that consumer prices had fallen in the third quarter of 1984?

Referring to the medium-term outlook presented in Table 6 of the staff report, Ms. Lundsager agreed with the staff that imports could not be reduced further without jeopardizing growth and development and that Madagascar needed additional concessional assistance. A continuation and strengthening of the current policy mix were the best means of generating additional donor support. However, if that assistance was not forthcoming from creditors and donors, Madagascar might have to take further adjustment measures. In conclusion, she supported the proposed decisions.

Mr. Goos recalled that when the Executive Board had discussed the first review under the stand-by arrangement at EBM/84/107 (7/16/84) the staff had observed that everything had gone wrong--from natural disasters to domestic policies--for Madagascar in the previous four years. However, in the past six months, all policies had been implemented on target. Clearly, the economic policy changes made by the authorities under the Fund-supported program had had beneficial effects on Madagascar's economy. Significant progress had been made in reducing internal and external imbalances; inflation was slowing; and real growth seemed to be gaining momentum. Those developments left no doubt that it would be in the country's best interest to continue pursuing stabilization efforts on the basis of the recommendations contained in the staff report. He could therefore endorse the proposed decisions.

However, a note of caution regarding the quantitative performance criteria for monetary developments was called for, Mr. Goos considered. While the planned expansion of broad money appeared appropriate, the implied increase in credit to the private sector by almost 30 percent was generous given the declining trends in credit expansion in the first half of 1984 and in the rate of inflation. He agreed with the authorities that the uncertainties surrounding private credit demand must be considered when formulating appropriate credit policies, but he felt that the authorities would be well advised to act flexibly and cautiously in that area in order to avoid rekindling inflationary pressures. Furthermore, by maintaining positive real interest rates, the risk of increasing inflationary expectations could be reduced. Could Mr. Alfidja or the staff provide further information on recent developments in monetary policy?

Looking beyond the short term, Madagascar's economic situation appeared to be difficult, particularly with respect to its external accounts, Mr. Goos commented. Even with appropriate domestic policies, Madagascar's debt service capacity would remain too limited to deal with its high indebtedness. Consequently, the resolution of the debt problem in cooperation with donors and creditors was crucial for the country's economic prospects. It was equally important, however, that the authorities continued to tackle the various underlying structural problems, the resolution of which clearly required increasing involvement of the World Bank and other development institutions. In conclusion, as the reporting of statistical data was unsatisfactory, with the exception of data reported by the Central Bank, he encouraged the authorities to request further technical assistance from the Fund.

Mr. Malhotra stated that he broadly agreed with the thrust of the staff report and endorsed the proposed decisions. Economic developments in the past 18 months demonstrated the success of the changes being made in Madagascar's economic policies. GDP had risen modestly in 1983 and 1984, in spite of a cyclone in April 1984. Gross domestic savings had risen by about 3 percent since 1982, to 7.8 percent of GDP in 1984. The rate of inflation had declined from 31.5 percent in 1982 to a projected 16 percent in 1984. The budget deficit and the current account deficit of the balance of payments were expected to decline in 1984. The pricing and marketing of paddy and other crops had been liberalized significantly, while prices of many industrial goods, accounting for about 30 percent of industrial value added, had been decontrolled. Furthermore, the real effective exchange rate had depreciated between May 1982 and June 1984. All of those welcome developments were in line with the objectives of the adjustment effort.

The heavy debt service burden was the main problem that would overshadow the economy for several years to come, Mr. Malhotra considered. In that respect, developments in the real sector would be of crucial importance. There was considerable scope for increased production in the agricultural sector if greater attention were paid to agricultural inputs and extension services. Similarly, while he noted the authorities' efforts to consolidate investments in the parastatal sector, continued attention must be directed to improving the operations of the public sector enterprises, particularly in view of the deteriorating quality of the banking sector's claims on public enterprises. He agreed with the staff that following the completion of the audit of the banking sector, substantial measures should be introduced to improve the efficiency of that sector. He endorsed the view that a major effort should be made to restructure Madagascar's debt, but additional financial assistance would be necessary. Special and imaginative measures must be taken to improve economic performance.

Mr. Polak remarked that the authorities were to be commended for having finally agreed to accept the staff recommendations and introduce measures to reduce the budget deficit and increase bank credit to the private sector. Furthermore, he welcomed the introduction of a flexible exchange rate policy and a more market-determined pricing policy. The actions taken by the authorities had led to modest growth and a slight reduction of the trade deficit, and he encouraged them to continue on the present adjustment path.

In spite of the improvements on the domestic side, the external situation remained tenuous, particularly given the high debt service ratio, Mr. Polak observed. Considerable financial assistance by donors and creditors was needed. The World Bank had an important role to play in Madagascar's development, and the Fund should continue to provide financial assistance and advice to the authorities.

Mr. Ismael stated that the encouraging developments during 1983/84 had rebuilt the Fund's confidence in the authorities' determination and ability to bring the economy back on track. Financial discipline, reorientation of policies, and appropriate measures in several key areas had led to the continued reduction of the domestic financial imbalances and the creation of more favorable conditions for a resumption of economic growth and monetary stability. Notwithstanding the significant progress, the medium-term outlook remained bleak in view of the increasing debt service burden. The projected increase in the debt servicing capacity of the economy until 1989 was barely sufficient to cover interest payments on existing debts and on those arising from future capital inflows, leaving a sizable financing gap each year within that period.

He agreed with the staff's recommendation regarding an appropriate strategy for the authorities to follow in the coming years, Mr. Ismael continued. They should accelerate the process of adjustment along the lines of the recent reorientation of economic policies. Madagascar would need additional financial support from the international community in order to resolve its debt problem. While the Fund should continue to support the country in its stabilization efforts, the World Bank and other development institutions should assume an increasingly active role.

The removal of rigidities in production and trade should be accelerated in order to stimulate growth and increase the competitiveness of the economy, Mr. Ismael considered. The recent liberalization of some industrial prices was a step in the right direction, as was the trend toward market-determined producer prices for rice and some other important agricultural commodities. Price liberalization had had only a limited impact on inflation in 1983 and 1984, a fact that he hoped would encourage the authorities to speed up the decontrol of prices of other industrial goods and abolish monopolies in the marketing of agricultural products.

Another major task confronting the authorities was the general policy review of the public enterprises, Mr. Ismael noted. In view of the predominance of the parastatals in the economy and their generally weak financial condition, their rehabilitation would be crucial to enhancing economic efficiency, growth, and external competitiveness in general.

He welcomed the comprehensive audit of the commercial banks to be completed by the end of October 1984, particularly as the present structure of the banking system might be incompatible with the recent liberalization of pricing and marketing policy, Mr. Ismael said. Most lending rates and several deposit rates had become positive in real terms owing to the increases in the minimum deposit and lending rates, combined with a slowdown in inflation. Nevertheless, the Central Bank continued to rely primarily on elaborate quantitative credit controls--a direct and crude monetary policy instrument--and the authorities should perhaps focus instead on more traditional instruments, including liquidity ratios and rediscount policy, that would be more consistent with the objective of removing rigidities in the financial sector.

Since further adjustment efforts in Madagascar would be directed more toward removing structural rigidities in various sectors of the economy, the increasing role expected to be assumed by development institutions, particularly the World Bank, was appropriate, Mr. Ismael stated. Assistance from the World Bank would be especially needed in such areas as the financial and operational management of state enterprises. The authorities' efforts to restructure the economy would play a crucial role in mobilizing concessional long-term financial assistance, which was necessary to resolve Madagascar's debt problem. In conclusion, he supported the proposed decisions.

Miss Bulloch stated that the authorities were to be commended for the adjustment measures implemented under the present program, which had begun to yield encouraging results in terms of reducing the imbalances in the economy and reviving economic growth. But the heavy burden of external debt that remained underlined the importance of sustaining the adjustment effort to increase gradually the economy's debt servicing capacity and maintain the confidence of creditors and donors. She agreed with the staff that increased emphasis should be placed on the resolution of underlying structural problems and hoped that the authorities would press ahead with action in the areas listed in the first paragraph on page 25 of EBS/84/195. She looked forward to the discussion of the third review under the present stand-by arrangement, which was expected to include the timetable for reducing the remaining price controls. The Fund had a continuing role to play in Madagascar through technical assistance, policy advice, and financial support. Close collaboration between the Fund and the World Bank would also be important. Concerning the banking system's exposure in the state enterprise sector, what would be the effect on the fiscal deficit if the Government took over public sector liabilities or provided interim finance for individual enterprises as had been suggested by the staff? Finally, she endorsed the staff appraisal and supported the proposed decisions.

Mr. Salehkhou indicated his broad agreement with the staff appraisal and his support for the proposed decisions. Madagascar's economic performance in 1983 and 1984 had been generally satisfactory, and the overall objectives and quantitative targets of the Fund-supported program had been met. The authorities' success was particularly encouraging in view of the difficulties experienced in implementing the three previous Fund-supported arrangements and the adverse impact of the cyclone.

In spite of the large imbalances that continued to affect Madagascar's economic and financial development and the difficult medium-term prospects, tremendous progress had been made, Mr. Salehkhou observed. Modest real economic growth had been restored in 1984, the rate of inflation had declined sharply, and the fiscal and external deficits had been curtailed significantly. The financial imbalances would have been reduced further had interest payments on external debt not been substantially higher.

The favorable economic performance was due largely to the reorientation of Madagascar's economic policies and the authorities' determined implementation of all measures under the Fund-supported adjustment program, Mr. Salehkhou observed. It was encouraging that the performance criteria for June 1984 had been met and that although the uncertainties relating to the cyclone had made it impossible to set performance criteria for the second semester, performance had remained within the indicative targets.

Nevertheless, improvement in the economy's medium-term prospects had been modest and even under the staff's favorable assumptions regarding adjustment, real growth, and exports, the authorities' room for maneuver would remain severely limited by their external debt obligations, Mr. Salehkhou noted. While the economy's debt servicing capacity should improve somewhat over the next five years, it would "barely match interest payments on the presently scheduled debt and on additional normal capital inflows." Furthermore, an improvement in the debt servicing capacity was largely dependent on the realization of projected levels of imports and real economic growth and the continued pursuit of strict adjustment policies. The substantial reduction in imports in previous years had adversely affected growth. Although some of the decline in imports might be related to the authorities' attempts to eliminate unproductive public investment, imports had clearly dropped below the minimum level compatible with the overall objectives of adjustment.

The staff had appropriately emphasized the need for the authorities to concentrate on structural adjustment, particularly in the agricultural sector where higher producer prices and increased competitiveness had already yielded encouraging results, Mr. Salehkhou observed. He agreed with the staff that the World Bank should provide the authorities with the necessary expertise and financial assistance to bring about structural change in that sector, rehabilitate and streamline the public enterprises, and establish a realistic investment program. It would be equally important for the Fund to strengthen its technical and financial assistance to Madagascar. Although structural changes would be crucial in strengthening the gains achieved in the past two years, the country's major constraints in the medium term were related primarily to the balance of payments disequilibrium and the external debt burden.

The staff representative from the African Department stated that the reference in the staff report to Madagascar's substantial use of Fund resources should be considered in the context of the country's previous and future use of Fund resources. The present stand-by arrangement was the fourth in a series of such arrangements, under which SDR 141 million had been drawn. Additionally, Madagascar's medium-term outlook was such that the country would have to continue making use of Fund resources for years to come; by referring to the substantial use, the staff had not wished to prejudge the possible size of any future stand-by arrangement.

The staff had considered the aid donors' meeting organized by the Fund in April 1984 to have been successful because the balance of payments assistance required to fill the gap under the stand-by arrangement had been obtained, the staff representative indicated. On a related point, he would submit that the success of a donors' meeting was related not to who chaired the meeting but to the performance of the country in question. He reminded Directors that at the time of the spring 1983 Consultative Group meeting, Madagascar's performance had been, at best, mixed. He hoped that the Consultative Group to meet in Paris at the end of November 1984 would lead to a more favorable response on the part of both the aid donors and the Paris Club in view of Madagascar's good performance over the past year.

The staff did not consider it appropriate to make the final purchase of SDR 6 million available at the conclusion of the present review because the purpose of the third review was to reach an agreement with the authorities on the budgetary policy for 1985, the staff representative remarked. If the Executive Board were to agree to Mr. Mtei's suggestion for an earlier disbursement, the staff would not have any input into the 1985 budget, which would be submitted to Parliament before the end of December 1984.

To the best of the staff's knowledge, the state enterprises were not in arrears to the Government, the staff representative commented. If anything, the proportion of commercial bank loans classified as high risk had been underestimated. More precise figures would be available after the completion of the bank-by-bank audit. On a related point, the staff considered that only those high risk loans that were directly attributable to the policies of the Government should be taken over by the Government, although those loans would admittedly be difficult to identify. The transfer of high risk loans from the commercial banks to the Government would not have an expansionary impact on the economy, assuming that other credit policies remain unchanged. Although it was inappropriate to try to quantify the effect on the fiscal deficit, he estimated that if all the high risk loans were transferred to the Government, the deficit would increase by approximately 0.5 percent of GDP. No definite information was yet available on the possible reorganization of the state enterprises; clearly, the World Bank would have many suggestions to make to the authorities in that area.

Interest rates on term deposits of less than 6 months and on certificates of deposit of 6-12 months were still negative, the staff representative from the African Department commented. However, effective minimum rates were higher than the nominal rates because interest was prepaid and net of taxes, and deposit rates overall were probably on the positive side. Before further adjusting the present interest rate policy, the authorities wished to evaluate its impact on the liquidity and profitability of state enterprises after the reorganization of that sector. The authorities would not consider using the more traditional, less administrative methods of monetary control until the bank-by-bank audit had been completed, an appropriately cautious approach. Finally, the difficulties associated with the reporting of data to the Bureau of Statistics had to some extent been overcome. A few weeks previously, the Malagasy authorities had responded to the Bureau's questionnaire.

Mr. Alfidja remarked that the authorities were successfully implementing the adjustment program under the Fund-supported stand-by arrangement. The Fund had played, and would continue to play, an important role in the debt rescheduling process. Madagascar would obviously need further technical and financial support from the Fund and other multilateral institutions.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal for the 1984 Article IV consultation with Madagascar. They warmly commended the authorities for their success in implementing the adjustment program and for the progress made since the last consultation discussion in reducing the financial imbalances that had emerged in the early 1980s.

Directors observed that in 1984 the fiscal deficit would be slightly less than the program target of 5.5 percent of GDP, representing a very commendable adjustment since 1982 when it had amounted to 8.8 percent of GDP. This continued success has provided the foundation for the necessary adjustments of monetary and credit policies and, in turn, has led to the impressive reduction in inflationary pressures within the Malagasy economy and for an encouraging increase in domestic savings. At the same time, the erosion of real GDP was halted and the economy has begun to grow again, although at a very modest pace.

Directors agreed with the assessment that the fiscal and monetary policy aspects of the current adjustment effort were yielding satisfactory results and that such policies needed to be sustained. In addition, Directors put great emphasis on the need for structural adjustment with a view toward fostering faster growth of the economy. The basic framework for the required structural adjustment effort has already been laid in the current program. In this regard, Directors commended the authorities for pursuing appropriately flexible pricing and marketing policies and for scrupulously implementing the flexible exchange rate policy as agreed in the current program. Directors strongly urged the authorities to continue to follow an appropriately flexible approach in the future, which should take into account needed import liberalization. Such flexible pricing and exchange rate policies were seen as conducive to restoring the international competitiveness of the Malagasy economy and, thus, to facilitate the resumption of acceptable rates of economic growth.

Directors welcomed the decision to raise the minimum interest rate on deposits held by individuals. They noted that as a consequence of the success in reducing inflation, many deposit interest rates had become positive in real terms, and hoped that a more comprehensive action on interest rates would be taken, especially in light of concerns about the projected growth of credit to the private sector.

Directors also encouraged the authorities to continue efforts to restructure and reorient the banking system and to permit a more market-oriented approach to credit flows.

In supporting the staff's emphasis on the resolution of underlying structural problems, Directors placed strong emphasis on the need to increase the role of the World Bank and other development institutions in Madagascar in addition to further Fund involvement through both advisory and financial support. They noted that the World Bank was planning a second Consultative Group meeting, which is scheduled for November of this year. A convincing public investment plan agreed by the World Bank would facilitate the mobilization of financial support from bilateral and multilateral donors and creditors over the medium term. Given the resource constraint, Directors stressed that the authorities should continue their emphasis on rehabilitation of existing capacity and complementary investments, including the restructuring or closure of unprofitable state enterprises.

Directors agreed that the massive overhang of external debt and the consequent high debt service ratio would be a severe constraining factor in Madagascar's balance of payments for the foreseeable future. They noted that even with the successful implementation of the agreed stabilization program, which had led to a substantial adjustment of the external current account, excluding interest payments, Madagascar's existing and projected debt servicing capacity would be barely sufficient to cover interest payments for many years.

Directors agreed that the current policy stance of the authorities, which had been effectively and courageously implemented thus far, would need to be applied on a sustained basis and that it should be supplemented with sizable inflows of external concessional assistance from both bilateral and multilateral sources, as well as supplemented with generous and imaginative debt relief arrangements.

It is expected that the next Article IV consultation with Madagascar will take place on a 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 Madagascar's exchange measures subject to Article VIII, Section 2, and in concluding the 1984 Article XIV consultation with Madagascar, in the light of the 1984 Article IV consultation with Madagascar conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Madagascar maintains restrictions on payments and transfers for current international transactions as described in EBS/84/195 and SM/84/218. The Fund welcomes the intention of the authorities to progressively remove exchange restrictions in the context of the adjustment program supported by the current stand-by arrangement. In the meantime, the Fund grants approval for their retention until March 31, 1985.

Decision No. 7818-(84/147), adopted
October 9, 1984

Review Under Stand-By Arrangement

1. Pursuant to paragraph 4(c) of the stand-by arrangement for Madagascar (EBS/83/255, Supplement 1), as amended by paragraph 3(b) of Executive Board Decision No. 7650-(84/42), adopted March 19, 1984, and by paragraph 3 of Executive Board Decision No. 7753-(84/107), adopted July 16, 1984, Madagascar has consulted with the Fund in order to reach understandings with the Fund regarding the policies and measures that Madagascar will pursue with respect to exchange rate policy and the banking system, and to establish performance criteria regarding (i) total credit to the economy, (ii) net credit to the Government, (iii) domestic payments arrears, and (iv) external payments arrears for the remaining period of the arrangement.

2. The letter dated July 31, 1984, from the Minister at the Presidency of the Republic of Madagascar in Charge of Finance and Economy shall be attached to the stand-by arrangement for Madagascar (EBS/83/255, Supplement 1) and the letter dated November 21, 1983, attached thereto as modified and supplemented by the letter and memorandum of February 23, 1984, and the letter of June 8, 1984, shall be read as further modified and supplemented by the letter of July 31, 1984.

3. Accordingly, the limits referred to in paragraph 11 of the letter of November 21, 1983 and paragraph 5 of the letter dated June 8, 1984, on total credit to the economy, net credit to the Government, the targets for the reduction of external payments arrears through net cash payment and the elimination of domestic payments arrears, shall be those referred to in paragraphs 3(a), (b), (d), and (c), respectively, of the letter of July 31, 1984.

4. The Fund finds that no additional understandings are necessary concerning exchange rate policies and the banking system, and that Madagascar may proceed to make purchases under the stand-by arrangement.

Decision No. 7819-(84/147), adopted
October 9, 1984

2. RWANDA - 1984 ARTICLE IV CONSULTATION - POSTPONEMENT

The Acting Chairman proposed that the Executive Board should waive the three-month rule and extend the period for completion of the consultation with Rwanda until October 15 to enable the Managing Director to be present for the Executive Board's discussion.

The Executive Board thereupon took the following decision:

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1984 Article IV consultation with Rwanda to not later than October 15, 1984.

Decision No. 7820-(84/147), adopted
October 9, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/146 (10/5/84) and EBM/84/147 (10/9/84).

3. MALAYSIA - TECHNICAL ASSISTANCE

In response to a request from the Governor, Bank Negara Malaysia, for technical assistance, the Executive Board approves the proposal set forth in EBD/84/260 (10/3/84).

Adopted October 5, 1984

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of Mr. de la Herrán as Assistant to Mr. Pérez, as set forth in EBAP/84/204 (10/2/84).

Adopted October 5, 1984

5. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 84/67 are approved. (EBD/84/255, 10/1/84)

Adopted October 5, 1984

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/207 (10/4/84) is approved.

APPROVED: July 11, 1985

LEO VAN HOUTVEN
Secretary