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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/160

10:00 a.m., November 5, 1984

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

Executive Directors	Alternate Executive Directors
A. Alfidja	W. B. Tshishimbi
	J. K. Orleans-Lindsay, Temporary
	D. C. Templeman, Temporary
	M. Lundsager, Temporary
	H. G. Schneider
	X. Blandin
	C. Flamant, Temporary
M. Finaish	
H. Fujino	
	B. Goos
J. E. Ismael	
	G. W. K. Pickering, Temporary
A. Kafka	
	A. S. Jayawardena
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	B. Jensen
	E. M. Taha, Temporary
P. Pérez	G. Ortiz
	A. A. Scholten, Temporary
	A. V. Romuáldez
	O. Kabbaj
	E. Olsen, Temporary
N. Wicks	T. A. Clark
S. Zecchini	N. Coumbis
Zhang Z.	Wang E.

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

Also Present

African Department: A. D. Ouattara, Director; S. E. Cronquist, A. B. Diao, K. G. Dublin, C. Enweze, A. Jbili, B. R. H. S. Rajcoomar, M. Sidibé. Asian Department: M. J. Fetherston. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; E. H. Brau. Fiscal Affairs Department: J. Diamond, T. Hatayama, K. M. Meesook. IMF Institute: A. Samba, Participant. Legal Department: Ph. Lachman, J. M. Ogoola. Research Department: M. Goldstein, O. E. G. Johnson. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. Wright, Deputy Secretary. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. A. Ajayi, G. R. Castellanos, L. K. Doe, D. Hammann, S. M. Hassan, J.-C. Obame, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: J. R. N. Almeida, I. Angeloni, V. Govindarajan, N. Haque, G. D. Hodgson, J. M. Jones, H. Kobayashi, S. Kolb, A. Koné, D. J. Robinson, Shao Z.

1. EXECUTIVE DIRECTORS

The Chairman welcomed to the Board Mr. Mtei, Mr. Nebbia, Mr. Pérez, and Mr. Zecchini as Executive Directors and Mr. Abdallah, Mr. Jensen, Mr. Ortiz, and Mr. Romuáldez as Alternate Executive Directors.

2. PEOPLE'S REPUBLIC OF THE CONGO - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with the People's Republic of the Congo (SM/84/223, 10/11/84; and Cor. 1, 10/25/84). They also had before them a report on recent economic developments in the Congo (SM/84/238, 10/25/84).

Mr. Alfidja remarked that thanks to the large inflow of revenue resulting from the rapid expansion in oil production in the late 1970s, the authorities in the Congo had been able to implement an investment program containing a number of infrastructural projects--particularly the construction of new roads--that were essential for the development of the non-oil sector of the economy and for the process of diversification away from the oil sector. More recently, greater emphasis was being placed on directly productive investments, particularly in agriculture and forestry.

The Congolese economy had experienced an impressive rate of growth, averaging 18 percent a year between 1979 and 1982, due mainly to the rapid expansion of activities in the oil sector as well as construction, public works, services, and trade, Mr. Alfidja continued. The contribution of agriculture to that development had been well below potential, owing mainly to weaknesses in methods of agricultural production, the exodus of labor to the urban areas, and drought, while the sluggish performance of the forestry sector had been due to a weak world demand for timber and difficulties in gaining access to new forest areas. The authorities were thus working hard under a rehabilitation program to expand the production of export crops such as cocoa and coffee and it was expected that in order to facilitate access to the exploitable forests in the north their efforts to overcome transportation difficulties would significantly improve the production of timber.

The authorities were aware that the economic and financial difficulties confronting the country called for corrective measures, Mr. Alfidja indicated. One of the many areas requiring urgent attention was the public enterprises sector, where the need to find solutions to financial and managerial problems was urgent. In recognition of that need, the authorities had changed the management of a number of enterprises in 1983, and in May 1984, they had authorized the Agence Transcongolaise des Communications--which handled most domestic transportation--to increase its tariffs by about 34 percent. Increased participation by the private sector, especially in agriculture and forestry, also was being encouraged. The authorities had emphasized that progress in restructuring the public enterprises was likely to be slow, but they were determined to continue their efforts to address the problems.

Another important area of concern was the fiscal sector, Mr. Alfidja observed. The overall balance in government financial operations had shifted from a small surplus in 1981 to a deficit during the following two years. Despite the scaling down of the investment program and the effort to improve tax administration, the effect of the decision to accelerate the execution of the investment projects, together with the sluggish growth in revenue, had led to an unsatisfactory fiscal outturn. The Government thus intended to pursue policies that would increase the share of non-oil revenue in total revenue in the medium term. On the expenditure side, the authorities agreed that educational and recruitment policies thus far had placed a heavy burden on public finances and should therefore be re-examined; however, they believed that the difficulties in reversing those policies should not be understated. In any event, in the future they intended to stress policies that would generate employment and help develop a small business sector in order to absorb school graduates. The modern private sector also would be encouraged to offer employment opportunities to those graduates.

As part of the effort to reduce current outlays, a study financed by the World Bank was under way to assess the extent of recurrent costs of investment projects and to make recommendations for their reduction, Mr. Alfidja said. A compensation scheme for settling government claims on the state enterprises would be more vigorously enforced, and in the area of money and credit, the authorities had recognized the need for strengthening the available credit control instruments in order to make credit policy generally less accommodating.

On the basis of preliminary estimates, it was clear that the current account had strengthened slightly, thanks to improved export performance, Mr. Alfidja noted. The terms of trade, however, had deteriorated markedly in 1983, reflecting the decrease in oil prices and the continued weakness in the export price of some other commodities. The external debt service ratio had remained unchanged at about 25 percent during 1982 and 1983. The Congolese authorities were concerned about the deterioration in the external position and were closely monitoring developments there. In conclusion, the authorities believed that their efforts at diversifying the economy away from the oil sector, coupled with their commitment to rehabilitate the state enterprises, would help to achieve self-sustained growth in the non-oil sector and would have a favorable impact on the domestic and external positions.

Mr. Blandin observed that the Congo's current difficulties were similar to those experienced by Gabon at the end of the 1970s, difficulties that had warranted the adoption of an adjustment program supported by purchases under the extended Fund facility. Like Gabon, the People's Republic of the Congo was an oil producing country that had overestimated its oil revenues and had embarked on an ill-conceived and overextended investment program. That would not in itself have been cause for concern if the program had been made up of viable and productive projects designed with a view to increasing the debt servicing capacity of the country;

unfortunately, the bulk of those projects had been concentrated in infrastructure, mainly the construction of roads and buildings, which tended to generate very little revenue and only over a long period of time. In the absence of tight and centralized management of the external debt, those projects, moreover, had been partly financed with commercial loans whose maturities and interest rates were out of line with the type of financing generally required for infrastructural investments. In addition, because there was no link between investment programming and the budgeting process, the recurrent expenditures associated with the investments had tended to be underestimated; the additional resources required to prevent the projects from falling apart shortly after their completion would constitute a heavy burden on the budget.

Given the already bleak picture, a large and inefficient public enterprises sector--which constituted a major drain on public finances--and the absence of a sound employment policy in the civil service, all the ingredients for a serious financial crisis were in place, Mr. Blandin remarked. Not surprisingly, just such a crisis had occurred in the Congo over the past two years--one with a soaring budget deficit and the emergence of sizable payments arrears. The external repercussions of those financial difficulties had been felt quickly, with the debt service ratio already having risen to a level that was cause for serious concern. Clearly, the situation was not sustainable, and the authorities recognized the need to adjust their policies in order to reduce present imbalances. In that regard, he had noted with interest, that the authorities had decided to scale down the 1984 investment program from CFAF 172 billion to CFAF 115 billion. However, given the constant nature of capital expenditures, the final outcome might well prove higher than the target.

In general, the scaling down of the investment program was only a first step in the right direction, Mr. Blandin considered. Further action was necessary to put the economy back on track toward balanced and sustainable growth. Appropriate additional actions had been delineated clearly in the staff report and should be adopted; however, they would be more likely to bear fruit in the short run if they were included in the framework of a comprehensive and well-designed adjustment program supported by Fund resources. The authorities were apparently not yet prepared to enter into such a program, an attitude that, unfortunately, could lead to an increase in the present imbalances. They should carefully assess the current situation--including the evolution of the world oil market--and give further thought to the possibility of an adjustment program supported by the Fund.

Mr. Templeman observed that, relative to most of its neighbors, the People's Republic of the Congo had a high per capita income, and the wealth of energy resources provided the authorities with the flexibility to finance development in such a way as to expand the non-oil productive sector in order to offset the expected decline in the contribution of oil to GDP. Thus far, however, they had not taken full advantage of that opportunity: the revenues generated by oil exports had been used mainly to finance an all-encompassing public sector, and insufficient attention had been paid to efficient resource allocation. The result of that over-ambitious approach had been budget deficits averaging in the past two years more than 10 percent of GDP, current account deficits in the past three years of more than 20 percent of GDP, foreign debts equivalent to 75 percent of GDP, unpaid bills at home and abroad, and depleted foreign exchange reserves.

According to the staff, the Government was beginning to come to grips with the changes in the world oil markets of the past two years, Mr. Templeman continued. However, it was not clear that the policy measures discussed in the course of the Article IV consultation would be sufficient to reverse the deterioration in the external accounts. Rehabilitation of the state enterprises--which represented a drain on the economy--was certainly needed; and, as a first step, price decontrol and reduced hiring were called for so as to permit a more appropriate price/cost structure. Following that, consideration also might be given to the sale of some viable enterprises to the private sector.

Another problem was the central government deficit, which as shown by the accumulation of domestic arrears, had been unfinanceable in several of the past few years, Mr. Templeman commented. Current and capital expenditures had increased rapidly, reaching about 50 percent of GDP in 1982 and 1983. Table 1 in Appendix IV of the staff report showed that current expenditures were estimated to drop slightly in 1984 but still might be more than 25 percent of GDP. If the public savings necessary for financing investment were to revive, the Government must reduce its spending on wages and education as well as search for other areas to pare back current expenditures.

Public investment in the future rightly would be geared toward expanding the productive sectors such as agriculture and forestry, with reduced emphasis on overly ambitious infrastructure development, Mr. Templeman said. World Bank advice in that area should help the authorities to reorient their economy away from an overdependence on the oil sector; however, the World Bank apparently was recommending an even lower level of investment spending than the authorities were presently planning, and he urged them to heed the World Bank's advice. With a more restrained fiscal policy, the authorities could pursue a more active monetary policy, which should set interest rates on deposits high enough to compensate adequately for inflation.

Given the high debt/GDP ratio, the soft oil market, and the mounting debt service payments, the medium-term external outlook was not promising, Mr. Templeman observed. Debt on commercial terms was at present 40 percent of public sector external debt. He agreed with the authorities that commercial borrowing might be justified for high-yield investments--such as in the oil sector--but it appeared that commercial loans had been used to finance general imports and service transactions and thus had not contributed to expanding the Congo's ability to make future debt service payments. He urged the authorities to manage their domestic economy more cautiously and to avoid additional recourse to nonconcessional resources for general balance of payments financing. Steadier demand management would at the same time permit a reduction in external arrears, making the Congo more creditworthy. Finally, he commended the authorities for having maintained an exchange system free of restrictions on payments and transfers even when faced with a low level of official reserves.

Mr. Mtei indicated that he was in broad agreement with the staff appraisal, which suggested that the performance of the Congolese economy, while comparing favorably with performance in other developing countries, had slowed considerably in the past two years. Real GDP growth had dropped from 24 percent in 1981 to 3.6 percent in 1983, reflecting adverse developments in the oil sector, inefficient operations in manufacturing output, and declining agricultural and forestry production. At the same time, of course, inflation had decelerated from 11.7 percent in 1982 to 8.8 percent in 1983.

An important factor contributing to the emergence of domestic and external imbalances in the Congo had been the expansionary fiscal policy prompted by the rapid rise in revenue from the oil sector, Mr. Mtei continued. With the unanticipated decline in the growth of oil sector resources, the Government's investment plan had proved too ambitious and had led to increased foreign borrowing on commercial terms. Moreover, the use of borrowed resources to finance basic infrastructural projects with long gestation periods had resulted in mismatching between maturity of loans and expected yields, leading to repayment difficulties and accumulated arrears. In the circumstances, there was a clear need to review the investment program with an eye to curtailing its size and to shifting the emphasis to more productive projects. He thus welcomed the authorities' decision to redirect resources toward more productive sectors and to scale down the investment budget generally.

The authorities' concern regarding the social implications of a major shift in public sector employment policy was understandable, Mr. Mtei said. However, it was important to limit the Central Government's current expenditure and improve the financial performance of the public enterprises. He urged the authorities to give serious consideration to the staff's recommendations in that regard. There was also a need to reduce government dependence on bank financing, not only to limit the growth of credit but also to accommodate private sector demand and to direct a larger proportion of bank credit to productive areas. In that connection, the authorities had agreed to use the reserve ratio and an active interest rate policy to strengthen credit controls. In passing, he observed that the rehabilitation of the public sector enterprises and the strengthening of their financial performance was necessary, not only to reduce the fiscal imbalance but also to promote the non-oil sector of the economy. Recently adopted measures aimed at improving the management of some enterprises were steps in the right direction, and he welcomed the authorities' commitment to a viable parastatal sector. Finally, the Congo's external payments position remained under pressure as a result of an increase in the debt service burden and uncertainties regarding oil production and prices and made it necessary for the authorities to accept a more cautious approach to borrowing.

Mr. Goos stated that he too was in general agreement with the staff appraisal of the Congolese economy. More particularly, he found the emphasis on the need to adjust the investment program and to improve the financial situation of the state enterprises to be well taken. It was satisfying to hear that the authorities were aware of the risks involved and that they already had made significant cuts in the investment budget; it was unfortunate, however, that they had not been similarly responsive to the staff's recommendations on price controls and current public sector expenditures, including public sector employment policies. Decisive measures in all those areas were clearly called for in view of the rapid buildup of foreign debt and the steep increase in the debt service ratio in recent years. A continuation of those developments that had already led to external arrears would be worrying; in that context, he had been surprised not to find in the staff report any comprehensive medium-term scenario of the sort that would have shed more light on the sustainability of the present policy stance.

While he shared the staff's concern about the importance of preserving the Congo's borrowing capacity, he had some difficulty with the statement on page 12 suggesting that "access to international capital markets would become even more important in the medium term, especially if oil prospects become less favorable." The remark was somewhat ambiguous, inasmuch as it could be understood as an invitation to step up borrowing if revenues from oil deteriorated further. Given the already high indebtedness of the Congo, such an interpretation was not appropriate. Instead of linking the country's borrowing requirements to oil prospects, it would be better to suggest that access to international capital markets should be more dependent on a country's debt servicing capacity and, hence, on the foreign exchange generating power of existing and new investments. In conclusion, he commended the authorities for maintaining a liberal exchange and trade regime, and he supported the proposed decision.

The staff representative from the African Department observed that the staff had attempted to produce a comprehensive medium-term scenario but had been unable to do so because of a lack of information, particularly from the oil sector. Still, it was clear that unless investment and fiscal policy were changed and the state enterprises were reformed, prospects for the economy would be relatively bleak. It was to be hoped that by the time of the next consultation, the staff would be in a better position to make a more detailed assessment of medium-term prospects.

The sentence on page 12 of the staff report--to which Mr. Goos had referred--had been intended as a judgment that the authorities should have resorted to borrowing on commercial terms over the past few years only to finance high-yield projects of the sort that would help to preserve their borrowing capacity in the future, the staff representative noted. In the past, the authorities had been able to mobilize loans from the financial markets whenever oil prospects had been favorable; but if those prospects were to deteriorate, as they had in 1983, it would become difficult for the authorities to borrow, a possibility that demanded an effort to retain borrowing capacity for the future.

Mr. Alfidja said that he had made it clear in his opening statement that the Congolese authorities were in agreement with a number of the recommendations made by the staff. In that context, he had found Mr. Blandin's comments on some of the Congo's infrastructural projects to be somewhat harsh. Wherever development projects existed, there would always be some that would fall into the category of "white elephants," the blame for which could not always be placed on the authorities of the country undertaking the project. Still, he took Mr. Blandin's criticism as constructive, and he was certain that the Congolese authorities would consider the advice seriously.

It was true that the authorities were not at present involved in negotiations for a comprehensive adjustment program, Mr. Alfidja continued. That did not mean, however, that they were not aware of the nature of the difficulties confronting them or that they would have any a priori reservations about undertaking such a program--as they had done in 1977 and in 1979--if that was considered warranted.

The Chairman made the following summing up:

> Executive Directors were in agreement with the thrust of the views expressed in the staff appraisal in the report for the 1984 Article IV consultation with the People's Republic of the Congo. They noted with concern that the authorities' policy response to the turnaround in the oil market had not been as swift and comprehensive as called for by the situation. Fiscal policy remained expansionary and, as a result, the Congo's budgetary and external positions had weakened considerably, and substantial arrears had been incurred. Investment spending had been concentrated on infrastructure, and progress in developing the non-oil productive sector had been limited. Moreover, notwithstanding large subsidies, the economic and financial performance of the state enterprises remained poor. Directors therefore underscored the urgent need to scale down the investment program and reorient its sectoral allocation so as to give the necessary priority to the directly productive economic sectors. Toward that end, they urged an early completion of the review of the development program.
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> Directors also emphasized that the rehabilitation of the state enterprises was crucial to the achievement of self-sustained growth of the non-oil sector and they stressed the need to adopt and effectively implement strong corrective measures designed to bring about a fundamental improvement in the performance of those

enterprises. In particular, reductions in hiring, flexible employment and pricing policies, and improved management appeared essential.

Directors stressed that the necessary containment of the growth of public spending required that current spending be curtailed and that a greater effort be made to mobilize domestic resources. Also, coordination of budgetary and monetary policies should be improved, and realistic interest rate policies should be adopted.

Directors remarked that the external current account deficit had become unsustainable and that the rapid growth in external borrowing, especially borrowing on commercial terms, was imposing a dangerous burden on the fiscal and external positions. Consequently, they called for great restraint in the contraction of external debt and encouraged the authorities to adopt policies designed to eliminate official external payments arrears. They commended the authorities for maintaining an exchange system which is free of restrictions.

In sum, Directors urged the authorities to adopt and implement, without delay, a comprehensive set of measures to restore internal and external equilibrium and to strengthen the base for the noninflationary growth of the non-oil productive sector of the economy.

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

The Executive Board then adopted the following decision:

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with the People's Republic of the Congo, in light of the 1984 Article IV consultation with the Congo conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that the Congo continues to maintain an exchange system which is free of restrictions on payments and transfers for current international transactions.

Decision No. 7832-(84/160), adopted
November 5, 1984

3. SIERRA LEONE - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Sierra Leone (SM/84/222, 10/10/84). They also had before them a report on recent economic developments in Sierra Leone (SM/84/234, 10/23/84).

The staff representative from the African Department remarked that since the issuance of the staff report (SM/84/222, 10/10/84), another mission had visited Freetown to conduct a review of recent changes in Sierra Leone's exchange arrangements. Prior to the establishment of those new arrangements, the staff had discussed with the authorities possible modifications and adaptations of the export incentive scheme that would facilitate the completion of the program review; however, the authorities instead had established a new exchange system, which was based on the operations of the Precious Metals Marketing Company (PMMC) and its related Foreign Exchange Committee (FEC) and which had adverse implications for the current program supported by a one-year stand-by arrangement. Specifically, the new system represented the introduction of a multiple currency practice, undermined the enforcement of surrender obligations for exports of diamonds and gold, institutionalized the arbitrary fixing of the exchange rate in the parallel market, and distorted the efficient allocation of foreign exchange. It also had resulted in an open-ended budgetary subsidy arising from increasing government recourse to the parallel market for foreign exchange, so that the budgetary and credit targets for the remainder of the program period no longer were attainable; the external sector targets of the program also had gone substantially off track. Given those slippages, the staff had recommended to the authorities that the program should be terminated and that efforts should be focused instead on the negotiation of a possible new Fund-supported program. The staff had also informed the authorities that a major reform of the exchange arrangements would need to be implemented as a basis for such a program.

Mr. Mtei made the following statement:

> The adjustment program implemented during the course of 1983/84 by the Sierra Leonean authorities has yielded positive results in a number of important areas: recent estimates indicate that the budget deficit relative to GDP declined by 5.6 percentage points, from a peak of 13.5 percent in 1982/83 to 7.9 percent in 1983/84; bank financing for the budgetary deficit has been reduced as a result of efforts aimed at mobilizing resources from the private sector; the deficit on the current account of the balance of payments narrowed from 9.5 percent in GDP in 1982/83 to 7.1 percent of GDP in 1983/84; the growth rate of the money supply dropped substantially--a welcome sign in an environment of high inflation--and a number of debt rescheduling agreements were concluded with both private and official creditors.

Despite these achievements, it is clear that serious problems persist, particularly the perennial shortage of foreign exchange, which places Sierra Leone in the uncomfortable position of maintaining a high level of external arrears but not being able to make timely payments on its debt obligations. The shortage of foreign exchange has also precipitated a substantial compression of imports, which continued into 1983/84. As a consequence, output in the manufacturing sector has declined because of insufficient spare parts, equipment and raw materials; and inadequate supplies of consumer goods have contributed to keeping inflation high.

The authorities are convinced, therefore, that the adjustment efforts must be continued. In this connection, it should be noted that the direction of policy, as suggested below, shows clearly that the Government's commitment to the program has not weakened. The delay in reaching understandings on exchange rate policy with the staff is due to a difference of opinion on a crucial matter, rather than to the lack of political will to act. The authorities are hopeful that the issue will be resolved in due course, as they are willing to continue working with the Fund in seeking solutions to their economic and financial problems.

The authorities believe that, in order to establish the basis for sustained economic growth--which has been stagnant in recent years--it is essential that proper attention be given to policies aimed at correcting structural deficiencies in the economy and encouraging productive investment. To this end, a medium-term plan is being formulated and is scheduled to become effective in the near future. The top priority area focused on in the plan is agriculture, the single most important economic sector in Sierra Leone, accounting for about 26 percent of total investment expenditure during the plan period. Mining is also a priority sector, with an allocation of 13 percent of expenditure. It is important to mention that, in view of the limited availability of resources, success of the plan will depend a great deal upon the amount of foreign capital that can be mobilized. It is hoped that multilateral institutions as well as individual donor countries will be sympathetic to the efforts being made by the authorities to improve the real sector of the economy, especially in the face of a high rate of population growth and the current low level of economic activity.

The development of export-oriented activities is one of the concrete examples of the Government's determination to move ahead with its adjustment program. In the agricultural sector, for instance, producer prices were raised substantially earlier this year for coffee, cocoa, ginger, and palm kernels, in addition to the large increases granted in July 1983. The authorities believe that the new price level should encourage farmers to increase output. Meanwhile, they have obtained financial and technical support for agriculture from a number of multilateral development agencies, including the World Bank, which approved a sectoral adjustment loan in the amount of $21.5 million in June of this year. The funds are to be used to increase production of export crops as well as foodcrops, with foreign exchange being made available to finance the importation of fertilizers, machinery, and spare parts. The World Bank is also assisting the Sierra Leonean Government with financial and technical support for integrated rural development projects.

In the mining sector, the authorities are addressing three main problems: the low level of production of diamonds due to the depletion of alluvial reserves; the diversion of diamond sales away from official channels; and the high operational costs experienced by the National Diamond Mining Company (DIMINCO), a company in which the Government holds a 51 percent share. In order to reduce reliance on alluvial mining, plans are proceeding to construct the Kimberlite underground mining project. The project is expected to take about a decade to be completed, but production should start in 1984/85 at a level of 38,000 carats, rising to 147,000 carats in 1986/87. At the same time, a number of incentives have been granted to DIMINCO, the company which would develop and manage the Kimberlite project, including the reduction in the corporate tax rate applicable to the company and waivers of certain taxes for a period of four years. The Government's decision in early 1984 to allow exporters of gold and diamonds to retain their export earnings for use as they see fit has led to a sharp increase in recorded sales of both commodities.

The general stance of fiscal policy remains one of restraint in 1984/85. In particular, the hiring freeze initiated at the beginning of the previous fiscal year has been extended to casual workers, no general salary increases are envisaged, and steps are being taken to improve the financial position of public corporations with a view to reducing their need for transfers from the national budget. As a result of these and other discretionary measures, total expenditure in 1984/85 is expected to rise by only 7 percent from the previous year, which is substantially less than the rate of inflation projected for the period. And the increase in expenditure would have been even lower, were it not for the sharp rise in interest payments.

While exercising expenditure restraint, the authorities are also adopting measures to improve tax collection. To this end, a Customs and Excise Advisory Committee has been established with a mandate to seek improvements in customs valuation and inspection procedures, and a new incentive scheme has been instituted for revenue departments. Moreover, higher taxes have been levied on a number of consumer items, including automobiles.

As a result, the budget deficit in 1984/85 is projected to be equivalent to 6 percent of GDP, almost 2 percentage points below the outcome for 1983/84.

Monetary policy is consistent with the objectives of reducing pressure on the country's balance of payments and containing inflation. Bank financing of the budget deficit is to be reduced further, while efforts are being made to channel credit into productive areas in the private sector. Ceilings on lending rates charged by commercial banks have been eliminated, and deposit rates have been raised by 2 percentage points. The purpose of the adjustment of interest rates is to promote a better allocation of resources and to increase domestic savings. The authorities are aware, however, that real rates are still negative, a fact that has prompted the authorities to approve an additional increase for implementation in 1984/85.

Sierra Leone's balance of payments position continues to be a weak link in the Government's attempt to stabilize the economy. Despite the fact that imports have been reduced considerably over the past few years, the tight foreign exchange situation makes it difficult to reduce external arrears and to make debt payments on schedule. The authorities hope that the recent exchange measures, which have increased export earnings from the sale of gold and diamonds, will help to ameliorate the problem. Meanwhile, committees have been formed in the Bank of Sierra Leone for the purpose of working out ways to limit the retention of foreign exchange earnings in the mining sector.

The authorities expect the balance of payments situation to remain difficult in the medium term. A sizable financing gap is projected for 1985/86, widening to about SDR 100 million in 1987/88, which means that Sierra Leone will need further debt rescheduling as well as an increase in official capital inflows in order to continue the adjustment momentum and the structural reforms in the economy that are now under way.

Mr. Jayawardena, indicating that he was in broad agreement with the staff appraisal, remarked that Sierra Leone was facing a difficult economic situation at present; indeed, it could be described as a major casualty of the world recession and economic crisis. As in other countries, the authorities in Sierra Leone had attempted to cushion the impact of the adverse external situation by adopting domestic policies that had no doubt appeared appropriate at the time but had come to be described, with the benefit of hindsight, as something less than appropriate.

Economic growth in Sierra Leone had slowed since 1978 and had come to a halt in 1981; and activity had yet to recover significantly since then, Mr. Jayawardena observed. Per capita incomes had been on the decline since 1980, assuming that GNP figures had not been understated because of unrecorded parallel market transactions; the fiscal deficit had grown, financed largely by bank borrowings; the exchange rate--pegged to the SDR--had appreciated sharply, compounded by fairly high domestic inflation; payments imbalances had arisen; debt servicing had increased sharply; and external arrears had accumulated. Those changes were typical of developments in a number of countries that had approached the Executive Board for financial assistance in recent years; and, like others, Sierra Leone had sensibly reached understandings with the Fund to correct the difficulties. The one-year program and the compensatory financing facility drawing agreed in February 1984 had followed three previous one-year programs beginning in 1977/78. The most recent program in 1981/82 had been interrupted before its completion, and he was concerned that the current program might meet a similar fate because of differences of view between the staff and the authorities on economic policies.

Agreement had been reached on policies in a number of areas, including a curtailment of the fiscal deficit and a reduction in the current account deficit in the balance of payments; the major remaining disagreement was in the area of the exchange rate, Mr. Jayawardena continued. It was difficult in a country like Sierra Leone--which produced large amounts of diamonds and gold that could easily be smuggled across borders--to establish an appropriate exchange rate, particularly during times of high inflation, import compression, and difficulties with export expansion. In the past, he had been critical of countries that had adopted a dual exchange rate to deal separately with expensive but easily smuggled items, but he was beginning to question the Fund's insistence in all cases on a unitary rate. He was not taking a strong stance on the matter, but he would appreciate some elaboration from the staff or Mr. Mtei on the extent to which disagreements about the exchange rate might make it difficult for Sierra Leone to negotiate a sensible medium-term arrangement with the Fund.

Mr. Goos observed that measures introduced by the Sierra Leone authorities, both before and after the adoption of the present adjustment program, had produced visible improvements in the current account, public finances, and business confidence. Against that background, and given the country's difficult economic outlook and unsatisfactory record with respect to previous Fund arrangements, it was disappointing to hear that the program might have to be terminated because of a relaxation of the adjustment effort. There was no doubt that the overall economic situation in Sierra Leone remained critical, particularly given the high inflation rate and the shortage of foreign exchange; and he endorsed the staff's assessment and recommendations for dealing with both those issues.

The staff had offered ample evidence that additional efforts to reduce the public sector deficit and its bank financing were indispensable, Mr. Goos continued. As shown in Table 1 of the report, the overall government deficit was virtually equivalent to the current account deficit, a relationship that clearly reflected the poor performance of domestic savings in the private sector and lent strong support to the staff's recommendation to increase domestic interest rates without delay.

With regard to the exchange rate, Mr. Goos said that he could understand the authorities' concerns about further fueling inflationary pressures through another devaluation of the leone. However, a recent information notice showed a real appreciation of more than 50 percent since the third quarter of 1983, a development that left no doubt that the exchange rate had become unrealistic and called for a change in the authorities' attitude toward devaluation. In searching through the staff paper for an explanation of the authorities' reluctance to follow the staff's advice, he had discovered the following statement on page 26 of SM/84/222: "...the staff urges the authorities to resist emerging pressures aimed at further complicating and manipulating the exchange rate system in a way that serves sectoral interests rather than being a useful tool to serve national objectives." He would appreciate hearing more on what the staff had meant by its reference to pressures that served "sectoral interests"; he assumed that they were the same pressures and interests that had contributed to the formation of the Precious Metals Marketing Company, an undertaking that, according to the staff, threatened to have "adverse implications for the budget and the exchange system."

On other matters, Mr. Goos observed that the staff report contained apparently conflicting remarks with regard to the way in which agriculture had responded to recent producer price increases. As a result, he was at a loss to know whether or not agricultural output had responded positively, overall, to those price increases. Finally, with regard to prospects for a follow-on program with the Fund, he joined the staff in hoping that any remaining differences of view between the staff and the authorities could be resolved so that another, more viable, program could be negotiated.

Mr. Wicks, endorsing the staff appraisal and proposed decision, remarked that the economic situation in Sierra Leone continued to be difficult. To their credit, the authorities had taken some remedial measures with regard to prices and the exchange rate in 1983, but most of the benefits of those measures had been significantly reduced by the continuing appreciation of the real effective exchange rate. Indeed, that appreciation seemed to have already wiped out the effects of the July 1983 devaluation, and the resulting widening discrepancy between the official and parallel market rates had contributed to the disappointingly sluggish reponse of the output of cash crops to increases in producer prices. It had also increased the incentives to move transactions into the parallel market. His authorities saw as essential the elimination of the parallel market because it would make transactions through the official market more remunerative. The existence of the substantial parallel market seriously complicated economic policymaking, added to the foreign exchange difficulties, and could undermine the authorities' strategy of increasing tax revenues through improved collection efforts.

The gravity of Sierra Leone's situation was underlined by the staff's medium-term projections, which, although based on relatively optimistic assumptions and embodying a less than ambitious rate of reduction of arrears, still painted a bleak picture, Mr. Wicks considered. Debt service ratios averaging nearly 50 percent were projected for 1985 and beyond; and financing gaps averaging more than 40 percent of exports were expected to persist through the remainder of the decade. In the cirumstances, he regretted that the staff had been unable to complete the mid-term review of the program. It was also distressing to note from page 11 of the report that "the authorities' commitment to implement adjustment measures appears to have weakened." Still, he had taken heart from Mr. Mtei's indication that the authorities were convinced that the adjustment effort must be continued.

His own authorities believed that fundamental reforms carried out in the context of a Fund arrangement offered the best hope for Sierra Leone, Mr. Wicks commented. He therefore urged Sierra Leone to heed carefully the staff's advice, particularly that regarding the appropriate level of the exchange rate and the exchange system generally. Like some other countries in West Africa, Sierra Leone was a classic case of a country where collaboration between the Fund and the Bank should be very close; he hoped that during the next Article IV consultation with Sierra Leone, the Executive Board would be presented with more detailed information on what the World Bank was doing in Sierra Leone.

With regard to the exchange rate regime and the parallel market, Mr. Wicks inquired, first, about the macroeconomic consequences of the operations of the newly formed Precious Metals Marketing Company. Second, he noted from Table 5 of the staff report that an outflow of private capital equivalent to SDR 11.8 million was projected for 1983/84 and that a figure of SDR -26.6 million was projected for export earnings retained. He would welcome further explanation by the staff of the nature of those outflows. Also in Table 5, he observed that there was no item listed for "errors and omissions," which seemed to suggest that there were no unrecorded capital outflows from Sierra Leone. He wondered whether that suggestion was accurate or whether the estimate of unrecorded outflows was part of the figure for private capital outflows. In that respect, he wondered what was indicated by the level of the obviously artificial parallel market rate. If temporary capital outflows were passing through the parallel market, it could be argued that the parallel rate was lower than the rate that would reflect trading fundamentals.

Mr. Orleans-Lindsay agreed with others that the adjustment program implemented during 1983/84 had produced commendable results and that signs of improvement in the economic and financial situation in Sierra Leone had begun to emerge. The budget deficit in relation to GDP had been reduced, thus lowering the level of noninflationary financing of the Government's operations, and the rate of monetary expansion had slowed significantly. In addition, the current account deficit had narrowed, following a better export performance resulting from higher international commodity prices, larger volumes of mineral exports, and a recovery in world prices for Sierra Leone's major agricultural exports.

Unfortunately, Mr. Orleans-Lindsay continued, the authorities' commitment to that program had apparently weakened, and the arrangement had been allowed to lapse. It was nonetheless encouraging to note from Mr. Mtei's statement that the authorities' new direction of policy was evidence that their commitment to adjustment in general had not weakened.

A lack of foreign exchange was one of the most serious problems facing the Sierra Leone economy, Mr. Orleans-Lindsay considered. The staff had asserted that the situation was mainly a reflection of the pervasive parallel exchange market, a reflection that was making the diversion of foreign exchange receipts into official channels more difficult. It was unfortunate that some nine months after the unification of the dual exchange rate system in July 1983, the authorities had reintroduced the dual system, thus giving credence to the view that the official exchange rate was overvalued. That development seemed to suggest that the gains from the earlier action had been eroded, since the authorities themselves had encouraged parallel market transactions. In the context of Sierra Leone's medium-term economic prospects--which had been described by the staff as gloomy--the authorities needed to give priority to establishing an appropriate exchange rate system, which should be flexible enough to reinforce already tight measures in the fiscal and monetary areas. It was to be hoped that the authorities would be able to reach understandings on exchange rate policy with the staff as soon as possible and would act promptly to establish an appropriate rate. The measures already taken by the authorities demonstrated that they were determined to continue the adjustment effort to restructure the economy; however, to ensure that the necessary support was forthcoming, they needed to intensify their efforts so that the large financing gap that had emerged in the external sector could be narrowed. In conclusion, and because he was in broad agreement with the staff appraisal, he could support the proposed decision.

Ms. Lundsager said that it was disappointing to learn that the staff and the authorities had been unable to reach agreement on external policies, thus preventing the completion of the mid-term review of the present stand-by arrangement. Measurable progress had been made in the fiscal year ended June 30, 1984, with performance criteria and targets having been met. Notably, the overall government deficit had fallen from 11.4 percent of GDP to 7.9 percent, and the current account deficit had been reduced to 7.1 percent of GDP, a figure less than half the size of the deficits incurred in the years 1978-82. In addition, several upward adjustments had been made in producer prices. Notwithstanding those developments, the official exchange rate remained substantially overvalued, and the parallel market rate continued to thrive. The chart in the information notice (EBS/84/223) clearly showed the real appreciation of the leone since the devaluation in 1983. Nearly the entire effect of that devaluation had been eroded by the combined effects of domestic inflation and insufficient further exchange rate adjustment. The point to be made was that an adjustment program consisted of an array of policies; while demand management policies in the fiscal and monetary areas had allowed the authorities to meet program targets, the constraints on demand might not be strong enough without further exchange rate action to prevent a reversal of recent improvements in Sierra Leone's current account. Table 5 of the staff report showed that deterioration in the capital account had already more than offset the improvements in the current account, especially in the area of private export earnings retained and short-term capital outflows. The relationship of those developments to the overvalued rate of exchange was difficult to dispute. On a related matter, she took note of the authorities' disappointment at the fact that export production had not immediately responded to the 1983 policy changes, including the devaluation and increases in producer prices. Expanded production could not occur instantaneously; supply frequently responded only with a lag to price signals. Unfortunately, with the real appreciation of the leone since 1983, there might not be much supply response at all.

The new Precious Metals Marketing Company might be one avenue through which the Government of Sierra Leone could gain more access to foreign exchange, Ms. Lundsager remarked. However, centralizing power over trade and financial transactions could have the effect of influencing the official exchange rate without allowing for due consideration of the true competitiveness of Sierra Leone's traded goods and balance of payments situation. Like Mr. Wicks, she would appreciate further elaboration on the nature and impact of the new company.

Commenting on the fiscal and monetary policy mix in Sierra Leone, Ms. Lundsager observed that the authorities had implemented the policy measures as planned during the previous fiscal year, although there had originally been some problems in containing the level of government hiring. Despite the previously mentioned improvement in the fiscal situation during 1983/84, the deficit remained high and was contributing to the pressures on the balance of payments. Further measures would be needed to contain the Government's use of resources; such restraints, combined with a policy to generate more private sector savings through positive real interest rates, could increase national savings above the rate of 3.9 percent of GDP in 1983/84.

The Sierre Leone authorities should address the rapidly deteriorating economic situation in Sierra Leone in order to prevent the recent gains from slipping away, Ms. Lundsager said. A determined effort to tackle the growing disequilibrium in the exchange market should bring about improvements in the external accounts, both through the impact on the trade and services account and the impact on private capital flows and financing items. On a related matter, while the authorities had made larger than programmed cash payments to reduce external arrears, the total amount outstanding remained high at SDR 231 million in June 1984. The existence of such arrears made it difficult for Sierra Leone to return to normal trade and financial relations with the rest of the world; hence, it was important for the authorities to maintain a strong adjustment effort that would permit the reduction of arrears and allow Sierra Leone to return to a sustainable external position. In conclusion, and given her agreement with the staff appraisal, she could support the proposed decision.

Mr. Scholten considered it unfortunate that the stand-by arrangement with Sierra Leone would have to be terminated, especially since commendable fiscal adjustments had been made that had undoubtedly required a strong political effort. It was interesting to note in that regard that budgetary plans for the current fiscal year remained impressive; indeed, the target for total nominal expenditure growth of 7 percent, in the face of an expected increase in the GDP deflator of more than 20 percent, seemed very tough, and he would appreciate an assessment of its feasibility.

It was questionable whether any country that had only recently devalued its currency by 100 percent in nominal terms could be expected to maintain a fixed nominal peg for the next 12 months in the face of double digit domestic inflation, Mr. Scholten continued. In Sierra Leone's case, it was clear from the minutes of the Board's previous discussion on Sierra Leone (EBM/84/18, 2/3/84) that "because of considerable pressures exerted on the authorities in operating the dual exchange system, which preceded the unification, there had been little time to devote to the other aspects of economic management." In such circumstances, perhaps the Fund should not have entered into an arrangement where the exchange rate was highly overvalued and where no other specific agreement had been reached to reconsider the matter at the time of the first review. He was inclined to argue that the case of Sierra Leone showed the mistake of leaving the issue of exchange rate policy unresolved at the beginning of an arrangement, particularly when the country's track record on exchange rate policy was not positive.

He had understood from the staff that the "emerging pressures aimed at further complicating and manipulating the exchange rate system in a way that serves sectoral interests" had not been completely resisted by the authorities, Mr. Scholten remarked. In the circumstances, he agreed with the staff that the establishment of an appropriate exchange rate system was a priority matter; however, he wondered what would be considered an "appropriate" system in the particular circumstances of Sierra Leone.

Mr. Taha endorsed the thrust of the staff analysis and supported the proposed decision. Given the ample evidence in the staff papers of the serious structural and financial imbalances facing Sierra Leone, he was encouraged that the authorities in early 1984 had embarked on a stabilization program, supported by Fund resources, aimed at addressing the country's deep-rooted economic problems. The results of the authorities' adjustment efforts through end-June 1984 were commendable; the program had been on track and, in some instances, quantitative performance criteria had been overfulfilled. Nonetheless, the adjustment process had been interrupted, mainly as a result of a failure to agree on policies for the second half of 1984. The fact that the program was inoperative was by itself discouraging; however, in light of the additional information provided by the staff at the beginning of the meeting, it was also cause for concern.

Sierra Leone was already facing serious problems in remaining current in its external obligations, and the immediate prospects for the economy were not promising, Mr. Taha continued. Hence, the authorities needed quickly to reaffirm their commitment to implement strong adjustment policies for the immediate future and over the medium term. Two areas seemed deserving of urgent attention: fiscal policy should be strengthened, and the recent successful effort to contain expenditures in 1983/84 should be continued in order to reduce the budget deficit. It was also important to ensure that fiscal policy was consistent with the goal of improving the balance of payments in the medium term. The reduction in the budget deficit entailed a cut in borrowing from the domestic banking system, which should lessen pressure on the balance of payments; there was also room for further tightening of credit policy.

It would be useful as well for the authorities to build on the substantial previous exchange rate adjustment to improve the incentives of producers so as to promote exports, Mr. Taha observed. Such an approach was particularly important in view of the recent appreciation of the exchange rate. In addition, the authorities should focus as soon as possible on the removal of exchange restrictions and multiple currency practices. Finally, it was to be hoped that they would maintain their adjustment efforts and would be able to reach an agreement with the staff on a new stabilization program in the near future.

Mr. Pickering observed that the program approved in February 1984 had been partially implemented as agreed and had produced a number of positive results. The stand-by arrangement had apparently provided an important framework for helping the Sierra Leone authorities to begin to improve the country's economic and financial situation; unfortunately, the situation at present--particularly with respect to the external accounts--was quite fragile. Producer price increases and the policy underpinnings in the 1984/85 budget represented significant adjustments, but efforts toward continuing adjustment appeared to have stalled. In general, he could endorse the staff's concerns that the gains achieved earlier in 1984 might be reversed if slippages occurred in the monetary and fiscal areas. Also, understandings on exchange rate policy had not yet been completed, and the stand-by arrangement at present was irretrievably off track.

In view of the extent of access granted under the stand-by arrangement approved in February 1984, the expectation of a significant adjustment in all areas--including the exchange rate--had not seemed unreasonable, Mr. Pickering remarked. In that regard, the staff had indicated its preference for a discrete change in the exchange rate; and he wondered what level the staff felt the rate should be and how it should compare with the parallel market rate. One of the weaknesses of the current program might be reflected in the undertaking of the authorities--in the memorandum of understanding agreed to in February 1984--to pursue a flexible exchange rate policy where, in fact, a fixed rate policy had been in place. Perhaps a more flexible mechanism should have been in place before the program had been approved. In that regard, before reaching any new understandings, the authorities and the staff must take account of the fact that inflation was in the range of 50-70 percent in Sierra Leone, compared with a rate of inflation in the United States of about 3-5 percent. In conclusion, he hoped that understandings could be reached soon on a new program.

Mr. Flamant said that he wished to associate himself with the remarks of Mr. Scholten and Mr. Pickering on the subject of the exchange rate.

The staff representative from the African Department agreed with Mr. Goos that the effects of producer price changes on agricultural output had not been clear. Certainly, there had been an increase in palm kernels purchased by the marketing board; however, it had been difficult for the staff to ascertain the impact of producer price increases on coffee, which had been adversely affected by a drought. In the case of cocoa, there had been some response, althought the effect had not been as great as the authorities would have liked. In addition to those somewhat different signals, the staff had had to deal with the problem of smuggling of produce across the border; despite recent increases, producer prices in Sierra Leone remained below producer prices in neighboring countries by as much as 10-20 percent.

In response to Mr. Wicks's questions on presentational aspects of the balance of payments table, the staff representative observed that an "errors and omission" item had indeed been defined and should have been presented as part of short-term capital. On a related matter, the outflow of private capital had taken place as a result of problems connected with the diamond/gold sector and the exchange rate.

Remarking on the macroeconomic effects of the Precious Metals Marketing Company (PMMC), the staff representative recalled that, when the 1984/85 budget had been discussed with the authorities, the staff had come away with the impression that difficulty would be experienced in meeting the budgetary targets. The Government's capital contribution to the Precious Metals Marketing Company had been about 25 percent, or Le 7.5 million, which had not been budgeted at the time; and that amount had to be translated into expenditures with equivalent increases in domestic credit to the Government for 1984/85. Also at the level of the budget, there were two types of transactions under the PMMC for which budgetary appropriations were not provided. One type of transaction arose because the Government, through the PMMC, had increased its foreign exchange at a highly depreciated market rate, a practice that represented an open-ended subsidy that would have to be borne by the budget. It was difficult to know how many transactions would be undertaken during the year; hence, it was difficult to quantify the subsidy, although it was clear that the amount would be very large. The second type of transaction concerned oil and again represented an open-ended subsidy, with implications for the overall deficit and for bank financing.

The Precious Metals Marketing Company also had certain other macroeconomic effects, the staff representative considered. On the external side, those effects were difficult to quantify, but the direction was fairly clear. Because of the modality of surrender requirements under the present system, the inflow of foreign exchange from export earnings had been substantially less than expected. Also, the modality of exchange rate determination as between the PMMC and its related foreign exchange committee was such that the tendency had been to attempt to fix the exchange rate at a level that was higher than the official rate but lower than the parallel market rate, a development that had begun to lead to a third market for foreign exchange in Sierra Leone, with all of the accompanying unfavorable repercussions for the balance of payments. Finally, even though some transactions were taking place at nearly the parallel market rate--which had been reported as highly depreciated--the authorities had been using the official rate of 2.5 leones to the dollar for purposes of customs valuations.

In assessing the parallel market rate, it was first necessary to recognize that the rate played an important role in Sierra Leone, the staff representative remarked. In the mineral sector, official exports of diamonds produced under the Alluvial Diamond Mining Scheme had temporarily come to a halt following the surge in the parallel market rate for foreign exchange in the second half of 1983, and the Diamond Corporation (DICOR)--one of the largest producers and exporters of diamonds in Sierra Leone--had been forced to close its purchasing office in August 1983 as a result of its inability to compete for diamonds at the parallel market rate. Similar developments had affected the production and export of gold; and even agricultural exports had been affected significantly by the parallel market rate. Also, the new Precious Metals Marketing Company had been authorized by the Government to purchase gold at prices that reflected the leone equivalent at the parallel market rate. It was in light of those relationships that the staff had considered the parallel market rate to be an important benchmark, although it was by no means the only benchmark under consideration. The staff had also looked closely at the real effective exchange rate, which had shown a very large appreciation since June 1983. In attempting to maintain flexibility, the staff had recommended in July 1983 a unification of the exchange rate at a level near, but not equivalent, to the parallel market rate.

Recognizing that the parallel market rate might encourage capital flight, the staff had considered with the authorities a number of other types of exchange rate regimes, the staff representative continued. Under one, the appreciation of the real effective exchange rate would be corrected in the first instance; thereafter, the authorities would undertake to peg the leone to a basket of currencies of the sort that would allow, over a period of time, an adjustment for the inflation differential between Sierra Leone and its major trading partners. Another possibility was a modified version of the exchange arrangements introduced in March/April 1984, and a third was a floating exchange rate regime. It was not until the authorities adopted a more flexible exchange rate system than the present one that the staff would be able to tell precisely how much of the depreciation in the parallel market rate could be ascribed to capital flight.

It was true that the exchange rate question had not been resolved at the time the stand-by arrangement had been approved in February 1984, the staff representative noted. On the other hand, at the time the rates had been unified, the staff had urged the authorities to find a rate more representative of that at which transactions had been taking place in the economy. In one sense, the staff had been fortunate enough to have had the benefit of the authorities' dual exchange rate system, under which it had been determined that the rate of 2.5 units to the dollar had been about appropriate. Of course, there had been some pressure on the authorities to contain that rate somewhat but, in the event, the rate had been unified at 2.5 units to the dollar and, at that time, there had been no major difficulties with respect to the exchange rate that had been left unresolved as between the staff and the authorities. It had nonetheless been made clear that even though unification had taken place at a fairly appropriate rate in the staff's judgment, the exchange rate would be reviewed again in the context of the program; and the staff had specifically recommended that the authorities should at some point move away from a dollar peg toward the use of a basket of currencies. It had been with that objective in mind that during the earlier review in March 1984, the staff had left the authorities with some suggestions for correcting the appreciation of the relative exchange rate and moving to adopt a more flexible "currency-basket" approach to exchange rate determination. In the event, an alternative program had been approved, although the requirement of a review remained, and it had been in that area that disagreements had developed.

The question had been raised of whether the Board might have taken a somewhat different view of Sierra Leone's access under the program, given the way the exchange rate had evolved, the staff representative recalled. Because the staff had wanted to maintain some leverage on the exchange rate question, purchases under the program had been substantially back-loaded; indeed, the purchases thus far under the program had amounted to only SDR 19 million out of a possible SDR 51 million.

In reponse to those who had asked the staff to determine an appropriate range of devaluation, the staff representative from the African Department noted that the matter was still being discussed with the authorities, and the staff was not maintaining rigid views. However, it was clear from the discussion on the parallel market rate that the staff would insist on approaches to the exchange rate question that assured an element of flexibility.

The staff representative from the Exchange and Trade Relations Department, responding first to a question by Mr. Mtei, observed that the Excutive Board was not being asked to take a decision to terminate the program. The stand-by arrangement had originally been approved on the basis of a provision that purchases after June 1984 would depend on the fulfillment of performance criteria for end-June and on the completion of the scheduled review, which, it had been decided, would focus mainly on the exchange rate. Since the review had not been completed, Sierra Leone's right to purchase under the arrangement had automatically lapsed.

In answer to a question by Mr. Jayawardena, the staff representative said that he doubted that a dual exchange rate system would be appropriate for Sierra Leone. At present, the agricultural sector--which employed a large segment of the population--produced receipts for the Government at the overvalued official rate, while very few imports of interest to the agricultural sector came in at the official rate; instead, those imports came in at the depreciated parallel rate. Such a structure presented severe disincentives to agriculture. Also, because the parallel market was widespread and applied to virtually all private sector imports, the depreciation in the parallel rate was already fully reflected in the consumer price index. In that respect, there should be no fear that adjusting the official rate would further fuel inflation. In his view, therefore, a flexible exchange rate system would be necessary in any future abandonment of a fixed rate; and that flexibility would have to be coupled with a liberalization of access to the exchange market. If a rationing system were to be maintained at the official market rate, and goods that were essential for the agricultural sector and the industrial sector were not allowed, then a parallel market would again develop, and, as was the case at present, large areas of economic activity in Sierra Leone would slip beyond the control of the Government, thus eroding the revenue base.

Mr. Mtei expressed the hope that the difficulties that had led to a lapsing of the program could be overcome through further discussions between the staff and the authorities. It was his understanding that the authorities had good reasons for objecting to some of the staff recommendations regarding the exchange rate, and he hoped their arguments would be heard and accepted. If some agreement between the authorities and the staff could be reached, consideration should then perhaps be given to reviving the program.

The staff representative from the Exchange and Trade Relations Department replied that discussions between the staff and the authorities were continuing; however, even if an agreement could be reached on the substance of the matter, it was questionable whether it would be wise or even possible to complete a review for the current stand-by arrangement, which would, in any event, end in early February 1985. It might be better to negotiate a new program to deal with the sizable imbalances that existed in the economy.

Mr. Mtei noted that Directors had apparently agreed that the adjustment effort must continue in Sierra Leone, a view with which his authorities had no difficulty. It was clear that the external sector remained weak and that the staff and some Directors believed that the situation called for substantial adjustment of the exchange rate. It was to be hoped that the staff and the authorities could reach an agreement on that matter, paying due regard to all social, political, and economic circumstances.

The Chairman made the following summing up:

> Directors supported the views expressed in the appraisal contained in the staff report for the 1984 Article IV consultation with Sierra Leone. They considered that the adjustment measures taken in the context of the Fund-supported program, including the sharp depreciation of the official rate of the leone in July 1983, the announcement of sizable increases in producer prices, and the

restraint exercised over government expenditures had contributed to a significant improvement in economic and financial performance during the financial year 1983/84. While noting that the quantitative performance criteria of the program for end-March and early June 1984 had been met, Directors were concerned that the initial progress toward adjustment had been eroded in recent months, due to continued high inflation and to the inability of the authorities to agree on implementing additional corrective measures. Directors, taking note of the view of the staff that the program targets had become unattainable, urged the authorities to restore firm control over fiscal and monetary policies and to give priority to a major reform of the exchange rate arrangements.

Noting the close correlation between changes in the public sector deficit and the deficit on external current account, Directors urged the authorities to seek major further strengthening of the fiscal position and to reduce bank financing of the budget. Increases in interest rates would, in their view, assist in raising the level of domestic savings.

Directors focused on the urgent need for the authorities to adopt policies that would correct the severe overvaluation of the leone. They observed that the foreign exchange situation remained critical and that the official exchange rate was far out of line when compared with the exchange rate prevailing in the parallel market, although the parallel market should not necessarily be seen as a perfect yardstick for judging the appropriateness of the rate. In that context, Directors took note of the wish of the Sierra Leone authorities to convey to management their own views on the weight to be given to the parallel market rate in any assessment of the exchange rate.

Directors also noted that the improvement in the current account position was increasingly being offset by higher capital outflows and that the reintroduction of a dual exchange system in March-April 1984 had not been successful in counteracting the attraction of the parallel market.

Directors pointed out that Sierra Leone continued to experience difficulties in meeting external payments and that the level of external arrears on commercial payments remained very high. Accordingly, they urged the authorities to work toward an appropriate market-determined rate as soon as possible and to continue to implement a flexible exchange rate policy thereafter. Directors expressed the view that only on that basis could progress be made toward the continuation of the stabilization effort that was needed to address effectively Sierra Leone's difficult medium-term balance of payments prospects. They hoped that the ongoing discussions between the staff and the Sierra Leone authorities would be fruitful.

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

The Executive Board then adopted the following decision:

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

2. Sierra Leone's exchange system involves restrictions on payments and transfers for current international transactions, including external payments arrears and multiple currency practices, as described in SM/84/222. Sierra Leone continues to maintain bilateral payments agreements with Fund members. The Fund urges the authorities to reduce reliance on exchange restrictions, including the associated multiple currency practices, and to eliminate the bilateral payments agreements with Fund members.

Decision No. 7833-(84/160), adopted
November 5, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/159 (10/31/84) and EBM/84/160 (11/5/84).

4. CYPRUS - TECHNICAL ASSISTANCE

In response to a request from Cyprus for technical assistance, the Executive Board approves the proposal set forth in EBD/84/278 (10/30/84).

Adopted November 2, 1984

5. WESTERN SAMOA - FUND REPRESENTATIVE

The Executive Board approves the recommendation of the Committee on Administrative Policies to establish a resident representative post in Western Samoa, as set forth in EBAP/84/230 (10/29/84).

Adopted November 2, 1984

6. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the proposal to appoint an Assistant to an Executive Director as set forth in EBAP/84/229 (10/29/84).

Adopted October 31, 1984

7. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the proposal to appoint an Assistant to an Executive Director as set forth in EBAP/84/231 (10/29/84).

Adopted October 31, 1984

8. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the proposal to appoint an Assistant to an Executive Director as set forth in EBAP/84/234 (10/31/84).

Adopted November 2, 1984

9. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 84/74 are approved. (EBD/84/276, 10/26/84)

Adopted November 1, 1984

10. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/84/233 (10/31/84) is approved.

APPROVED: August 5, 1985

LEO VAN HOUTVEN
Secretary