NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/187

10:00 a.m., December 19, 1984

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
C. H. Dallara	M. K. Bush
	D. C. Templeman, Temporary
J. de Groote	
B. de Maulde	X. Blandin
M. Finaish	
H. Fujino	M. Sugita
	B. Goos
J. E. Ismael	
R. K. Joyce	
	C. Robalino
	A. S. Jayawardena
E. I. M. Mtei	A. Abdallah
	C. A. Salinas, Temporary
Y. A. Nimatallah	E. M. Ainley, Temporary
	J. E. Rodríguez, Temporary
J. J. Polak	A. Steinberg, Temporary
	A. V. Romuáldez
	O. Kabbaj
	A. K. Juusela, Temporary
N. Wicks	
	N. Coumbis
	Wang E.

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

Also Present

African Department: N. Abu-zobaa. European Department: L. A. Whittome, Counsellor and Director; L. M. Beleza, J. T. Boorman, M. T. Hadjimichael, E. Spitaeller, T. M. Ter-Minassian, M. Xafa, P. M. Young. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; E. H. Brau, J. A. Clement. Fiscal Affairs Department: A. A. Tait, Deputy Diretor; D. C. McDonald. Legal Department: Ph. Lachman, S. A. Silard. Middle Eastern Department: P. L. Clawson, F. Drees, S. H. Hitti, B. A. Karamali, S. Kawar, M. Yaqub. Treasurer's Department: D. Gupta, D. V. Pritchett. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, E. A. Ajayi, G. R. Castellanos, D. Hammann, S. M. Hassan, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: M. B. Chatah, C. Flamant, V. Govindarajan, N. Haque, G. D. Hodgson, H. Kobayashi, S. Kolb, M. Lundsager, R. Msadek, A. Mustafa, Shao Z., A. J. Tregilgas, A. H. van Ee, A. Wood, A. Yasseri.

1. CYPRUS - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Cyprus (SM/84/263, 11/29/84; and Cor. 1, 12/3/84). They also had before them a report on recent economic developments in Cyprus (SM/84/264, 12/4/84).

Mr. Polak made the following statement:

By most of the commonly used indicators, the economic performance of Cyprus in recent years has been quite satisfactory. Growth and employment have been well maintained, while unemployment and inflation have been low. 1/ In all these respects, Cyprus's performance has been better than that of the great majority of members of the Fund. At the same time, international reserves have been maintained at a comfortable level of six months' imports or more.

The primary policy issue for the country is, therefore, not to improve on recent performance, but whether that performance is sustainable. Thus, when the staff expresses its concern on page 10 of SM/84/263 that "the economic performance can be expected to deteriorate further in 1985" because of a projected acceleration in the growth of domestic demand, it clearly deals with the question of sustainability; it refers to the risk that certain tendencies unfavorable to the balance of payments that seem to have begun to emerge in the second half of 1984 might continue into 1985. The crucial variables to watch are therefore the current account deficit, its financing by external debt, and the rising ratio of that debt to GDP.

In the years 1981-84, external debt as a percentage of GDP has increased by almost one half, from 31 percent to 45 percent. The most important proximate cause of this has been the current account deficit, running in the range of 6.3-8.6 percent of GDP in recent years, if the large expenditure on aircraft for 1984 is left out of account. But the underlying economic reason for that deficit has been the persistent budget deficit on the order of 6-7 percent of GDP, as is made clear in the table on page 54 of the report on recent economic developments.

1/ Annual Percentage Increases

	1982	1983	1984 (Provisional estimate)
Real GDP	4.8	3.0	4.9
Employment	0.9	1.8	1.6
Unemployment (rate)	3.1	3.7	3.6
Consumer prices	6.4	5.1	5.6

The crucial element in the question of sustainability will, therefore, be what happens to the government deficit. If it is reduced by, say, 2 percentage points of GDP to 4-5 percent, and assuming competitiveness to be well maintained, the country could reasonably be expected to settle comfortably on something like Scenario A in Table 6 of SM/84/263, where the external debt would not grow faster than GDP, although the ratio would not decline, and the debt service ratio would remain at a sustainable point. If the budget deficit stays in its present range, the country might well move closer to Scenario B--which also includes a less favorable development of exports--leading to continuously worsening indicators of the debt situation. That scenario includes a doubling of the debt service ratio by 1988,1/ and even a substantial movement toward such a scenario would involve major risks.

The staff's basic policy recommendations should be seen against this background. They include the need for a cautious fiscal policy, leading to a reduced public sector deficit. There is some room for reduction on the expenditure side; the tax burden in Cyprus is relatively low, so that there are considerable possibilities for increased tax revenue. The Government will introduce a value-added tax in 1985, which will have a large yield. This fiscal policy should be backed up by monetary policy. It is the monetary authorities' intention to make credit policy for the private sector more restrictive, in line with the mission's recommendations. Another favorable development is the easing in the increase of wages, which is now nearly in line with the increase in productivity.

The validity of the staff's recommendation is not necessarily predicated on precise forecasts for 1985, on which there is some disagreement between the Cypriot authorities and the staff. The authorities believe, for example, that the staff's estimates for the exports of goods and services for 1985 are on the low side, and those for imports for that year on the high side. These differences of view apply also to some extent to the--partially estimated--figures for 1984, for which year the authorities expect a smaller current account deficit than the staff (about 10 percent of GDP, rather than 11 percent of GDP, both figures including imports of aircraft).

With the qualifications mentioned, the authorities agree with the general thrust of the staff's recommendations and want to express their appreciation for the thorough analysis of the Cypriot economy that the staff has presented to the Board.

1/ I have selected from Table 6 the figures for 1988 rather than the final year in the table (1991), because I am concerned about extrapolating too far ahead on the basis of a mechanical, rather than a policy, model. The rather extreme figures shown for 1991 would seem to imply that ever-increasing debt service will be allowed to lead to an ever-increasing government deficit.

Mr. Templeman observed that the managers of a small, open economy like that of Cyprus, a country exposed to large and unexpected external influences, needed to be prepared to deal with a range of economic uncertainties and to have the economic tools to do so. Recent management had produced generally acceptable results in real economic growth, moderate inflation, and a financeable current account position, but a number of structural and institutional weaknesses continued to impede prompt adjustment to changed foreign and domestic conditions. For example, the tax system was in need of reform, subsidies were imposing a burden on the budget, wage indexation created vulnerabilities to inflationary shocks, and interest rate ceilings together with selective credit controls constrained the financing of budget deficits from domestic sources and hindered the efficient mobilization and allocation of savings and investment.

During the past three years, the rate of inflation in Cyprus had been relatively low, owing in part to wage moderation, Mr. Templeman remarked. Continued moderation would be important both to contain the public sector deficit and to avoid a further worsening in the country's unit labor costs vis-à-vis its trading partners, so that the authorities could hold down the current account deficit and limit any further accumulation of foreign debt. He supported their intention to avoid substantial adjustments in contractual wage rates for public and semipublic employees in 1985. He also agreed with the staff that the renewed educational campaign was needed to pave the way for a modification of the wage indexation system in order to contain inflation and improve the effectiveness of policies on the exchange rate, indirect taxes, and administered prices.

As shown in Chart 1 on page 2a of SM/84/263, Mr. Templeman noted, vis-à-vis 14 industrial countries and 7 EC countries, relative unit labor costs in Cyprus had worsened dramatically since 1978, while relative consumer prices adjusted for exchange rate changes had either declined or risen moderately. The combination suggested a squeeze on profits and raised questions about the prospects for the balance of payments. On the other hand, Cyprus's export performance in 1984 had been quite good. Still, there were reasons to wonder whether any fundamental, durable strengthening of the current account had occurred. In fact, when adjusted for the large import costs of aircraft purchases in 1984, the ratio of the current account deficit to GDP was likely to worsen substantially in 1985, unless the authorities accepted the staff's advice to aim at no change in the deficit and also took policy measures, particularly fiscal ones, to bring about such a result.

Two major problems in Cyprus were the structural weaknesses in the fiscal accounts and the resort to foreign borrowing to finance budget deficits in view of difficulties in securing financing from nonbank domestic sources, Mr. Templeman continued. Subsidies accounted for a large part of current expenditures; the prices of grain products had not risen for a decade. If the authorities were to carry out their public investment plan without causing adverse consequences for inflation and the balance of payments, they needed to reduce such current expenditures. Moreover, the authorities could help to narrow the deficits if they carried out reforms involving reductions in tax evasion and avoidance by closing loopholes, together with the adoption of a value-added tax. A reduction in tax evasion on nonwage income would facilitate cooperation from labor in achieving wage restraints.

Development of the country's financial markets, especially through a more flexible interest rate policy and elimination of the distortions arising from selective credit controls, would help to mobilize domestic savings and provide an opportunity to avoid foreign borrowing in order to finance budget deficits, Mr. Templeman remarked. Although the current debt service ratio of about 13 percent was not high by international standards, it had grown rapidly; the ratio of foreign debt to GDP, at about 43 percent by end-1984, had risen by 13 percentage points since 1981. In conclusion, Cyprus had so far escaped the foreign debt problems of a number of developing countries. It could continue to do so by making some fairly modest improvements in economic management.

Mr. Coumbis noted that the real GDP of Cyprus, having grown by 4.8 percent in 1982 and by 3 percent in 1983, was expected to grow by 5 percent in 1984. As measured by consumer prices, inflation had remained low, at about 5.6 percent during each of the past three years; only 3.5 percent of the labor force was unemployed; foreign exchange reserves were equal to six months' imports. However, a few structural problems and financial imbalances might jeopardize the development efforts of the country unless they were tackled in time. For example, tax evasion was widespread, and credit policy was quite inflexible, with a legal ceiling on interest rates and credit ceilings on trade and personal loans.

The overall deficit of the Central Government had widened from 5.9 percent of GDP in 1982 to 7.1 percent of GDP in 1983, Mr. Coumbis observed, while the rate of growth of monetary aggregates had continued to exceed by a wide margin the growth of real GDP. Moreover, the country's deficit on the current account of the balance of payments had widened from 7.2 percent of GDP in 1982 to 8.6 percent in 1983. As a result, external debt had reached some 41 percent of GDP, and the debt service ratio had risen to 13.5 percent of exports from 10.5 percent in 1982. Excluding the purchase of two airplanes, there had been an improvement in both the budget deficit and the current account during 1984, because the authorities had introduced a package of tax measures at the end of the previous year and exports had shown a sharp recovery. According to the staff, however, a deterioration in the financial balances was expected in 1985. Some evidence existed that both current and capital spending had accelerated through the second half of 1984. Moreover, the staff expected the growth of exports to decline to more normal rates. Although disagreeing with some of the staff's assumptions--especially with respect to the growth of exports and to Cyprus's saving and import propensities--the authorities recognized that the country's current account position, trends in public finances, and weaknesses in credit policy might undermine the development effort in the medium term. Thus, they stood ready to take measures on many fronts during 1985 in order to reduce the government deficit and follow a more restrictive credit policy for the private sector, besides keeping real wage increases in line with increases in productivity.

The basic policy issue in Cyprus, as Mr. Polak had noted, was not how to improve but rather how to sustain the results already attained in GNP growth, unemployment, and inflation, Mr. Coumbis remarked. However, the question of sustainability was related to the size of the government deficit. Given the flexibility and adaptability that the Cypriot economy had consistently shown, provided that the authorities acted promptly and decisively among the lines suggested above, it was reasonable to expect that the economy would move as projected by Scenario A in Table 6 of SM/84/263, including a reasonable rate of GDP growth and relative stability without severe external constraints. In conclusion, he agreed with the thrust of the staff appraisal and could support the proposed decision.

Mr. Wicks expressed agreement with the staff appraisal and support for the proposed decision. There had been some useful improvements in the economy of Cyprus during 1984, particularly the 5 percent growth in GDP, higher agricultural exports, and a rise in tourism. As Mr. Polak had pointed out, the economy had performed relatively satisfactorily so far. There remained some underlying weaknesses, however, of which the authorities were well aware, according to page 4 of SM/84/263. It was disappointing that they had as yet taken no action to control the fiscal deficits or to remove the underlying rigidities in the economy. After all, the staff had presented similar diagnoses and prescriptions during its past three reports for Article IV consultations with Cyprus. Thus, the urgency of the need for action was increasing.

Favorable trends observed in early 1984 were already reversing, and a deterioration in the external and fiscal balances was in prospect for the year as a whole, Mr. Wicks went on. The four alternative scenarios presented by the staff showed some looming external constraints toward the end of the 1980s. Although he recognized that some of the areas in which early policy actions should be taken were politically sensitive, he agreed with the staff that, if action were postponed, it would have to be even more rigorous when taken later.

Fiscal policy would play a central role in the adjustment effort, Mr. Wicks considered. To protect the country's creditworthiness and attractiveness to foreign investors over the medium term, the authorities should reduce the high and rising fiscal deficits, but the 1985 budget provided for a deficit 15 percent higher than that of 1984 and equaling some 7.5 percent of GDP. Specifically, the authorities should aim at eliminating subsidies, which constituted 12 percent of current expenditure; as Mr. Templeman had pointed out, owing to subsidies, the price of grains had long remained frozen. In addition, he would urge the authorities to modify the existing system of indexation, which effectively frustrated attempts by the Government to increase revenue and was seriously damaging the country's cost-competitiveness. The large premium for civil servants' wages also provided scope for further reductions in current expenditure. The authorities' recent requests for technical assistance in adjusting the fiscal system were welcome, and he encouraged them to broaden and reform the existing tax base while minimizing evasion and delays in tax collection. In addition, a value-added tax might help to hold down consumer spending. Unfortunately, the authorities had delayed taking action since the previous Article IV consultation.

Although the industrial sector was playing an important role in developing and diversifying the economy, some restructuring was nonetheless called for: the present units for manufacturing were too small and lacked adequate skills to move into higher technology, Mr. Wicks said. Did the staff share that view? Did it know of any plans to improve the industrial base? Perhaps the staff could also examine the viability of the parastatals, not mentioned in the staff report.

Implementation of an effective monetary policy in Cyprus seemed constrained by the interest rate ceilings, Mr. Wicks stated, and the credit controls had been ineffective. He did welcome proposals to bring the cooperative credit societies under the supervision of the Central Bank as well as the authorities' intention to influence the Bank's lending capacity by manipulating reserve requirements. Nonetheless, a flexible interest rate policy would be the most effective means of containing the growth of credit, increasing domestic savings, and shifting resources from consumption to investment. He strongly endorsed the staff's recommendation for the authorities to intensify their efforts in those areas.

In view of the high propensity to import in Cyprus, particularly for personal consumption, he agreed with the staff that exchange rate flexibility would have no beneficial long-term effects unless wage rigidities could be removed, Mr. Wicks pointed out. The authorities might stimulate competition by removing certain barriers to the entry of agricultural products, which hindered the efficient allocation of resources. Above all, on the external side they needed to take action to slow the rise in Cyprus's external debt and current account deficits, which would depend primarily upon measures designed to reduce fiscal deficits. Could the staff or Mr. Polak say whether the authorities intended to take any steps to encourage greater direct investment?

Some firm action taken soon should give the economy a chance of sustaining its relatively satisfactory performance, Mr. Wicks concluded. If such action were delayed, much sharper and more costly adjustment might well be forced on the authorities later.

Mr. Ainley remarked that in many ways the Cypriot economy seemed to be doing well. As Mr. Polak had noted, few Fund members had a 5 percent yearly growth rate, moderate inflation, low unemployment, and comfortable reserves. Those were commendable achievements--particularly for a small, open economy at a time of continuing recession in other parts of the world--but they owed much to temporary factors. Cyprus's underlying position was less reassuring, characterized as it was by persistently high budget deficits, rapid growth in the monetary aggregates, and a sizable buildup of external debt. Unless those imbalances were tackled, economic performance could worsen in the short and medium term.

Therefore, Cyprus had much to gain by adjusting, Mr. Ainley continued. As Mr. Polak had pointed out, the first priority was to reduce the budget deficit, an essential step if the authorities were to contain, and then reduce, domestic and foreign borrowing. In addition, for the reasons outlined in the staff paper, there was scope for strengthening the tax system. He welcomed the authorities' plan to introduce a value-added tax in 1985 and to improve tax administration and enforcement, an area in which he was glad to see that Cyprus had benefited from technical assistance by the Fund and by the World Bank. There was also scope for reducing current expenditures--particularly subsidies, transfers, and civil servants' wages--which together accounted for 70 percent of spending. Although the deficit of semigovernmental organizations, at 1 percent of GDP, remained relatively small compared with that of other countries, he hoped that the authorities would ensure that it rose no further.

Fiscal restraint would greatly facilitate the task of monetary management, especially as 60 percent of the budget deficit was being financed by the domestic banking system, Mr. Ainley remarked. He supported the authorities' intention to tighten credit in the private sector with the aim of reducing excess liquidity, but it was unclear how they were going to achieve that objective, given the ineffectiveness of the present quantitative controls and the apparent lack of other suitable policy instruments. Could the staff comment?

Cautious policies of demand management should be supported by continued efforts to reduce labor costs and maintain competitiveness, Mr. Ainley recommended. The authorities should take advantage of the boom in tourism and services to see how the country's current prosperity could be diversified and sustained. Unfortunately, the system of wage indexation had led in recent years to a large increase in real wages, well above the increase in productivity. Although he recognized the difficulty of moving away from a system of indexation, the authorities should explore the scope for doing so in consultation with business and labor. As inflation and unemployment were low, it seemed a good time to undertake reform. If it could be carried out, the prospects for a lasting recovery in productive investment and an expansion in manufactured exports would be considerably improved.

Further adjustment in Cyprus could yield substantial benefits, Mr. Ainley concluded. He hoped that the authorities would use the breathing space that they had to correct the underlying weaknesses in the economy. The recently opened political dialogue on the island's future was also a welcome sign; he hoped that it boded well for economic performance and for improved economic management, particularly in monetary and credit control.

Mr. Templeman commented that he would be interested in hearing staff comments on the disparity between developments in relative unit labor costs and consumer prices.

The staff representative from the European Department, responding to Mr. Wicks's question on public enterprises, remarked that, in Table 13 of SM/84/264, the accounts of the main public enterprises--with the exception of Cyprus Airways, which was omitted even though over 50 percent publicly owned--were shown to have worsened significantly in 1981/82, primarily on account of the worsening finances of the Electricity Authority. Electricity was sent free of charge to the occupied part of the island, and the Authority had not found it possible to cover those missing receipts, but a substantial increase in tariffs in 1983 had helped to improve its financial position. A modest deterioration in the financial position of semigovernmental organizations was expected in 1984, mainly on account of the Cyprus Broadcasting Corporation. The other semigovernmental organizations were in reasonably sound financial condition.

The possibility of tightening monetary policy in Cyprus was limited, the staff representative said, in the absence of greater flexibility in interest rates, as the authorities did not wish to resort to generalized quantitative credit controls and were indeed planning to abolish the existing selective controls, which had proved quite ineffective. The main instrument available would be increases in the liquidity ratio. Moreover, the authorities wished to improve the management of credit policy by bringing under the control of the Central Bank the cooperative credit societies, which were not even included in the monetary survey. They had tried to close that loophole in the past; political opposition had led them to abandon the attempt, but they intended to persevere in their efforts as part of an overall tightening of the credit stance.

It was difficult to quantify to what extent the apparent deterioration in profits implied by the rise of unit labor costs was being offset by the differential tax treatment of profits and wages, the staff representative recognized. In fact, by any standard, the system of tax exemptions in Cyprus was quite generous, a feature that lowered the effective tax rates on profits considerably. In addition, tax evasion was much more widespread among unincorporated businesses, which represented a large share of companies in Cyprus, than among wage earners, who were subject to withholding at the source. Thus, the fairly low tax rates and the presence of evasion might have counteracted to some extent the apparent deterioration in profits.

In the past, there had been some divergence between the movements of consumer prices and the GDP deflator, the latter tending to rise more rapidly than the former, the staff representative recalled. If the staff had used the relative GDP deflator instead of the consumer price index, the divergence would have appeared far smaller, but the trend was obviously unsustainable. Moreover, immediately after the Turkish occupation, wages in Cyprus had fallen drastically; from a long-term perspective, the deterioration that had undoubtedly occurred in companies' profits would have been less sustainable if it had started from a relatively poor position.

To some extent, plans for industrial restructuring and promoting foreign investment were linked: the authorities had already put in place very generous incentive schemes to encourage investment in restructuring enterprises, mergers, or consolidation, the staff representative noted. In 1984, a new tax incentive scheme consisting of a ten-year tax holiday for new investment in priority sectors had replaced some of the earlier schemes. The principal purpose of the industrial restructuring was to move toward higher-technology lines of production, in which productivity growth could be expected to occur more rapidly and could therefore compensate for continued rapid increases in real wages.

The Cypriot authorities were trying to promote a move into export markets in which the country would be competing with different countries, primarily in textiles and agricultural products, the staff representative from the European Department concluded. In direct investment, one new development had been a creation of a "free industrial zone" at Larnaca, where foreign companies locating a branch or business could obtain significant tax incentives, as well as other zones. Finally, despite the suggestions made by the Fund staff for several years, the authorities had made no attempt to quantify the costs of such tax incentives or to assess their cost effectiveness.

Mr. Polak noted that since the previous consultation, the Cypriot authorities had taken severe measures aimed at increasing revenue. However, as generally recognized by Executive Directors, those measures had not gone far enough. Mr. Templeman was correct in maintaining that, if Cyprus took relatively moderate measures at present, it should be able to avoid a debt crisis. There were many reasons why important financial measures had so far not been taken. Undue weight should not be given to one political feature of Cyprus, alluded to by Mr. Wicks, that there was a rather large communist party represented in Parliament. As Cyprus had a presidential system rather than a parliamentary one, voting in Parliament did not regularly go along party lines.

The Chairman made the following summing up:

> Executive Directors noted that the growth and employment performance of the Cypriot economy had been quite satisfactory in recent years and that price increases had remained modest. They welcomed the improvement recorded in 1984 in the performance of exports and investment. However, they expressed concern that an important part of this improvement had been due to exogenous factors, which, in a very open economy such as that of Cyprus, could be reversed.
>
> Directors stressed that many of the underlying problems of the Cypriot economy remained to be tackled and threatened to

lead over time to a difficult balance of payments position. The urgency for determined action was increasing, Directors believed. They emphasized in particular that the budget deficit, at 6-7 percent of GDP, was too high and promoted an excessive level of consumption and too-rapid growth of external indebtedness, which over the time could become unsustainable. Directors urged the Cypriot authorities to intensify their efforts to secure a sustained reduction of the budget deficit through measures aimed at widening the tax base and reducing tax avoidance and at containing government spending, especially on public consumption, and also subsidies. The prospective introduction of the value-added tax in 1985 was welcomed.

Directors welcomed the authorities' intention to tighten the stance of monetary policy and to promote a further moderation in labor costs. Directors urged the authorities to intensify their efforts to reduce the rigidities in the economy, particularly the ceiling on interest rates, and the full wage indexation mechanisms, which could threaten the cost-competitiveness of Cyprus. It was also observed that the industrial base needed to be strengthened.

In sum, the view of Directors was that Cyprus should take advantage of its favorable economic performance over the past few years and of its comfortable reserve position to tackle the underlying weaknesses of the economy. Postponement of action to improve fiscal, monetary, and wage policies, in particular, could only make adjustment more difficult down the road.

It is expected that the next Article IV consultation with Cyprus will take place on the standard 12-month cycle.

The Executive Board then took the following decision:

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

2. Cyprus maintains a restriction on the amount of foreign exchange made available for foreign travel. The Fund notes that the authorities have decided to raise the amount of the allowance effective January 1, 1985 and, in the light of the current economic circumstances of the country, it grants approval for its retention until the conclusion of the next Article IV consultation with Cyprus.

Decision No. 7876-(84/187), adopted
December 19, 1984

2. SUDAN - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Sudan (SM/84/253, 11/9/84; and Sup. 1, 12/14/84). They also had before them a report on recent economic developments in Sudan (SM/84/265, 12/5/84; and Cor. 1, 12/14/84).

The staff representative from the Middle Eastern Department made the following statement:

> As was indicated in the supplement to the staff report that was circulated on December 14, 1984, a staff team visited Khartoum during the period December 9-16, 1984 at the request of the Sudanese authorities to assist them in formulating economic policies aimed at improving the balance of payments situation, and thereby enabling Sudan to discharge arrears to the Fund. During the visit, the mission found that the overall payments situation and prospects had deteriorated since the time of the Article IV consultation in September, with the unfinanced gap in external payments in 1985 now projected at more than $1.3 billion, compared with the estimate of $1 billion indicated in the staff report. The deterioration reflected the effects on exports and imports of the ongoing drought, a small decline in expected aid flows, and larger arrears on external debt service in 1984 that would have to be settled in 1985. The gap would be reduced to about $624 million if relief from external debt service obligations were to be provided on the terms of 1984.
>
> The mission initially aimed at formulating the elements of a domestic adjustment effort which, in combination with normal aid flows, would reduce the uncovered balance of payments gap in 1985 to a level that could be financed with debt relief on the terms obtained in 1984. This attempt was, however, abandoned after it was determined that reliance on domestic effort alone to close the residual gap could jeopardize domestic output and investment objectives, making it difficult to obtain the desired supply responses from the anticipated policy reform.
>
> Accordingly, the mission recommended a less severe but, nevertheless, substantive program which included the following policy actions: (1) immediate unification of the prevailing exchange rates at a realistic level, accompanied by the introduction of a mechanism for frequent rate changes based on objective economic criteria; (2) immediate and full transmission of the effects of the proposed exchange reform into domestic prices; (3) fiscal initiatives and credit control measures that would limit monetary expansion in fiscal year 1984/85 to a rate no higher than that in 1983/84; (4) institutional and policy measures to improve financial intermediation; and (5) steps to restore stability and confidence in the private sector in order to promote saving and investment.

Implementation of these policies was projected to reduce the 1985 unfinanced balance of payments gap, of $624 million, which assumes clearance of all the arrears to the Fund and to other creditors, by about $344 million, leaving a residual gap of about $280 million. It was expected that prompt and effective implementation by the Sudanese authorities of the proposed policy actions, which are essential for medium-term balance of payments viability, could help Sudan in presenting its case to donors and creditors for supplementary assistance sufficient to cover the residual gap of $280 million in 1985.

While recognizing the need for fundamental structural reforms, the Sudanese representatives stated that their Government could not immediately implement the proposed exchange reform and related measures. In view of their response, the staff prepared a memorandum containing the main elements of, and the basis for, its policy recommendations and left it with the authorities. The authorities have indicated that at an appropriate time serious consideration will be given to the staff recommendations contained in the memorandum.

The staff also reiterated the importance of settling overdue financial obligations to the Fund without any further delay and outlined the steps that could be considered by the Fund in the absence of a resolution of the problem. The Governor of the Bank of Sudan responded that Sudan's inability to discharge obligations to the Fund was due to lack of resources and that efforts will be made to find the needed resources to start paying the overdue obligations as soon as possible.

Mr. Mtei made the following statement:

The Sudanese authorities are grateful to the staff for the constructive manner in which the Article IV consultation discussions were conducted. While they generally approve of the staff analysis of recent economic developments in Sudan, the authorities do not fully share the staff's overemphasis on the impact of the recent institutional changes on the country's economic performance. As in many other countries, a whole range of factors in Sudan--including the recurrent drought, deteriorating terms of trade, diminished access to financial markets, and continued inflows of refugees across the borders--had led to an intensification of the economic and financial imbalances much earlier than the recent institutional changes.

As the report indicates, the economy of Sudan has continued to experience increasing difficulties in recent years despite significant adjustment measures taken by the authorities. The implementation of a series of production-stimulating policies notwithstanding, real GDP declined for the second year running by about 1 percent in 1983/84, reflecting a drop of about 5 percent in agricultural output and the related commerce and transport sectors caused by the persistent droughts and adverse external developments. Lack of basic imported inputs and spare parts, due to nonavailability of foreign exchange, coupled with a shortage of skilled labor, hindered output growth in the manufacturing sector which, nevertheless, increased by about 5 percent in 1983/84. A further decline in real GDP is projected in 1984/85 if the weather does not improve. Fiscal imbalances persist and Sudan's external payments position remains particularly difficult. However, the inflation rate dropped by more than 5 percentage points in 1983/84.

Despite the persistent weakness in the Government's financial position resulting from the slowdown in economic activity, there was some improvement in the fiscal outcome for 1983/84 as revenues increased by 15 percent and expenditures were below the budgeted level. As a result, the overall budget deficit was reduced to 6.5 percent of GDP from 6.7 percent in 1982/83. The Sudanese authorities, therefore, while acknowledging the critical financial position of the Government, do not agree with the staff's assessment of the budgetary operations, but have nevertheless taken measures to strengthen the country's finances.

On the revenue side the authorities have introduced reforms, including the introduction of the zakat to broaden the tax base by bringing under the tax net large sectors of the economy that had hitherto not been reached. In particular, the agricultural and livestock sectors, which are now undertaxed, are expected to contribute significantly to public revenues. In addition, new taxes were introduced, and the rates and coverage of indirect taxes were increased as part of the tax reform. More recently, a consumption tax and a progressive income tax on individual incomes and business profits were introduced. These measures are expected to lead to revenue growth of more than 12 percent in 1984/85.

On the expenditure side, the authorities agree with the staff that efforts need to be sustained to bring about a lasting improvement in government finances, including further measures to mobilize domestic resources, improve the efficiency of public entities, and restrain the growth of public expenditure. There are no direct subsidies in the budget, and recently the Government decided that the prices of wheat, wheat flour, and sugar would reflect the full impact of the exchange rate depreciation. A similar step is now being considered for petroleum products. They also believe that a considerable portion of expenditure on social services could be financed from the zakat fund, thereby reducing pressures on budgetary outlays.

Monetary expansion in 1983/84 was within the 18 percent target envisaged under the 1984 program. The strict policies adopted by the Bank of Sudan forced many public entities to retire considerable portions of outstanding bank credit. Control of banks' excess liquidity and strict enforcement of credit ceilings limited credit expansion to the private sector. The authorities are of the view that while the tight monetary policy will be sustained, a further reduction in monetary growth to 12 percent in 1984/85, as envisaged by the staff, may not be attainable in view of the need to stimulate economic activity, reduce the liquidity squeeze on some public entities, and meet private sector demand for credit. The authorities are aware that there are deficiencies in the monetary statistics and are considering means to improve them.

On the institutional changes, the Sudanese authorities are fully aware of the transitional difficulties that might accompany the introduction of interest-free banking and recognize the importance of the stability of the banking system. They agree with the staff that such a process should be effected in a gradual and orderly fashion, with careful planning and due consideration being given to the need for an adequate return on savings and charges for borrowing. While some temporary difficulties may be experienced, the authorities are optimistic about the positive long-run impact on savings mobilization and resource allocation. A preliminary evaluation of the experiences of the noninterest banks in operation--although limited--indicates the relative success of these banks in terms of the size of deposits as well as the return to depositors on their savings. One major advantage of Islamic banks is that they overcome the religious inhibitions that have kept many potential savers from depositing funds with banks, and are therefore capable of mobilizing larger amounts of savings by bringing these people into the system. The direct involvement of noninterest banks in investments is also expected to improve resource allocation and increase the efficiency of bank credits and therefore reduce the inflationary consequences of credit expansion. A recent circular by the Bank of Sudan to commercial banks issued early last week indicated that interest-bearing transactions prior to February 14, 1984 and overdue interest obligations remain binding and that disputes are to be settled by arbitration in special courts set up by the Chief Justice. The circular also indicated that foreign transactions would remain unaffected by the cessation of interest payments, until new alternatives were found.

The authorities are fully aware of the need to secure an environment conducive to investment and private sector activities. Considerable progress has been made to resolve the security issue in the southern part of the country, and it is hoped that work will resume soon on the two major development projects in the south.

The external payments position of Sudan remains fundamentally weak and particularly worrisome. The large current account deficit, extremely low reserves, and a debt service burden that exceeds total export earnings reflect the extent of the external payments difficulties facing the authorities. However, there was some improvement in the external sector's performance in 1983/84: the merchandise trade deficit declined sharply by about 30 percent, exports increased by 28 percent, and imports dropped by 9 percent. The favorable performance of merchandise trade was clouded by a sharp decline in official capital inflows and a drop in expatriate transfers, reflecting a delay in aid disbursements and a slowdown in economic activity in the countries where these transfers originate.

The authorities intend to continue with their pricing and production policies that encourage exports, including timely provision of basic agricultural inputs and reform of financial arrangements to ensure adequate incentives for farmers. They are pursuing a flexible exchange rate policy with the ultimate goal of exchange rate unification through upward adjustment of the commercial banks' rate. Effective October 21, 1984, and in a serious step toward the objective of exchange rate unification, the commercial banks' rate was devalued by more than 22 percent. All exports, with the exception of cotton and gum arabic, were to be valued at the free-market rate. Similarly, all invisible receipts and payments made by the Government (excluding debt service) and all incoming foreign capital, except banks' capital, were moved from the official market to the free market.

The authorities are concerned about the external debt service burden and the unsatisfactory position of external payments arrears, including the overdue obligations to the Fund. They are exploring all possible avenues to clear the arrears to the Fund in the near future, a matter to which they accord top priority. They also intend to approach their creditors for further debt relief. However, the case of Sudan is only a crystallization of the nature of the external debt problem facing many developing countries. With a debt service ratio of 120 percent and the local currency counterpart of debt obligations amounting to more than 100 percent of existing tax revenues, Sudan is effectively not in a position to discharge its debt obligations. It is acknowledged that every country must adjust and live within its means, and Sudan is seriously trying to do just that at the moment, but the adjustment can take place only over the medium and long term, and something must be done for it in the short term. As a matter of fact, the extremely difficult situation that Sudan is facing raises the question whether the time has not come for cases of this kind to be treated in a less conventional way, particularly as Sudan's obligations to multilateral institutions alone are estimated to approximate 50 percent of total proceeds from exports of goods and nonfactor services in 1984/85.

In late November 1984, the authorities, in recognition of the need for a comprehensive adjustment program, requested technical assistance from the Fund to help in designing a program that would address the deep-seated structural imbalances in the economy and put the country on a sustained path of economic recovery. They are grateful for the Fund's prompt response in sending a technical mission, which has just returned, and I am sure that they will continue with the dialogue already set in motion.

In conclusion, I would like to join the staff in stressing that even with full implementation of a comprehensive domestic adjustment effort, the size of the fiscal and external imbalances and the extent of the needed adjustment appear to be beyond what the country can attain if it has to depend on its own resources. Reliance on domestic efforts alone, in the staff's own assessment, would require compression of imports to a level that would trigger a downward spiraling of economic activity and involve a reduction in average real incomes of about 50 percent, which could endanger the political and social fabric of the country as well as the long-term recovery of the economy. For adjustment to succeed, it is essential that Sudan's domestic efforts be backed by the international community with generous debt relief and substantial development aid.

Mr. de Maulde indicated that, exceptionally, he had not been persuaded by Mr. Mtei's statement. On the occasion of the Board meetings held the previous April on Sudan's request for a stand-by arrangement (EBM/84/68 and EBM/84/69, 4/30/84), he had indicated that if it had not been for the meeting of the Paris Club scheduled to take place on May 2, he would have had strong hesitations about concurring with the proposed decision. He had also stated that the general reason underlying those reservations was that the Sudanese authorities had engaged in a complete upheaval of a number of internal policies at the very moment when the success of the adjustment effort required, above all, continuity in policy. Unfortunately, the course of events since then had justified the hesitation that he had expressed, and the situation of Sudan appeared as a cause for extremely serious concern.

On June 15, 1984, Mr. de Maulde continued, the Executive Board had been asked, on the basis of a paper issued at the last minute, to decide that the stand-by arrangement would enter into effect on June 25 if Sudan became current in its obligations to the Fund (EBM/84/94, 6/15/84). Sudan had again fallen into arrears to the Fund as early as July 12, only 17 days after the stand-by arrangement had become operative. Since that time, Sudan's arrears had increased continuously to SDR 82 million and could rise to SDR 250 million by the end of 1985 unless something were done to correct such an unsustainable situation, which would have damaging consequences for the income position of the Fund.

The situation was all the more unfortunate as the international community had done its utmost during the past few years to provide Sudan with all necessary support for its adjustment efforts, Mr. de Maulde observed. Sudan had benefited from a major program of technical assistance provided by the Fund, which had also appointed a resident representative in Khartoum. For its part, the World Bank had appointed a high-level external debt coordinator, Mr. André de Lattre, who had succeeded in putting together the final package needed to close the gaps in Sudan's balance of payments. In February 1983, and again in May 1984, official creditors at the Paris Club had agreed to reschedule Sudan's debt service obligations on extremely generous and favorable terms. Creditors that did not belong to the Paris Club, together with commercial banks, had also provided Sudan with debt relief of an exceptional magnitude compared with the usual conditions. The World Bank, in close collaboration with the Fund, had organized and chaired, in January and December 1983, consultative group meetings that had been instrumental in allowing Sudan to obtain exceptional balance of payments assistance. Moreover, a joint monitoring committee had been established to review Sudan's progress in implementing the recovery program. In other words, no country had been treated with greater care than Sudan in the recent past. It was therefore most worrying to observe that the Sudanese authorities had failed to fulfill their reciprocal commitments toward the international community; they had embarked precipitately on a number of major policy reforms, poorly conceived and badly implemented, that had placed the entire recovery program in jeopardy.

The implementation of the zakat had resulted in such a reduction of government revenue that it had had to be hastily complemented by the re-establishment under new names of some of the old taxes, Mr. de Maulde recalled. But, according to staff projections in Table 3 of SM/84/253, such a mixed fiscal system, which combined the inconveniences of both types of system, would not prevent the budget deficit from reaching 12.5 percent of GDP in 1984/85, compared with 6.5 percent in 1983/84.

The upheaval introduced into the banking system by the suppression of interest rates seemed to have led to a slowdown in the growth of monetary aggregates, Mr. de Maulde noted. However, the staff admitted on page 6 of SM/84/253 that it had been unable to identify correctly the sources of monetary growth. In view of all the technical assistance granted to Sudan, such a deficiency was clearly unacceptable and raised questions about either the adequacy of that technical assistance or suitability of the statistical system in Sudan.

Despite recent measures intended to narrow the gap between the official market and the free market, Mr. de Maulde went on, the authorities still refused to regard the unification of the exchange rate system as a desirable policy action. Moreover, some of the policy changes introduced recently had triggered internal disturbances, leading to the abandonment of two crucial projects: the Jonglei Canal, which had been expected to bring about a sizable increase in agricultural production, and a pipeline to the Red Sea, which should have made Sudan an exporter of oil by end-1986. As construction of the pipeline had been postponed, the medium-term prospects for Sudan's balance of payments appeared unpromising.

To what extent, Mr. de Maulde wondered, could those developments have been foreseen in June 1984? Awareness of the country's deficiencies would have prevented the Fund from losing some of its credibility by giving its seal of approval to a program that had become inoperative after 17 days. In future operations with Sudan, the Fund should make every effort to impress on the authorities the need for them to discharge their overdue obligations promptly. It should be noted that Sudan was current in its obligations to the World Bank and also that much poorer countries, such as Chad, had repaid their arrears to the Fund. Furthermore, the country's track record should preclude any future Fund program *unless it were preceded by decisive actions to reverse current policies* and, in particular, to allow for a resumption of work on the canal and the pipeline. In any event, such an arrangement could not involve a large amount. However difficult the path of adjustment might appear for Sudan, other African countries such as Ghana, Zaïre, or Togo had demonstrated that it was possible to implement far-reaching adjustment programs and that those programs did work provided that the political will was present.

Mr. Steinberg observed that Sudan was in economic crisis, with a second year of negative GDP growth, large balance of payments deficits, and seemingly insurmountable external debt. The staff placed the blame equally on the prolonged drought and on the authorities' inability to take the necessary steps to adjust their policies. The severe external position had induced the staff to state on page 23 of SM/84/253 that, "even with the implementation of a comprehensive domestic adjustment effort, it would appear beyond the capacity of the country to generate enough domestic resources to cope with the projected external payments and budgetary gaps." True, little could be done to increase rainfall in Sudan, but it was possible to reduce the risk of future droughts by expanding irrigated lands with the assistance of the World Bank and others, as Sudan's recent success with cotton and sorghum attested. Also, the authorities could increase the share of other sectors in the economy in order to diminish further the uncertainties of relying on nature. In the more immediate future, additional external aid would be needed to alleviate Sudan's difficulties with the balance of payments and external debt.

The staff report did not explain how the authorities intended to deal with external problems, apart from stating that they expected to receive continuous debt relief in coming years, Mr. Steinberg noted. Sudan had a long history of using Fund resources, and its programs had often fallen short of the original targets; the staff considered that shortfalls in policy implementation had been the most important factor contributing to those shortfalls. The most recent example was the stand-by arrangement of June 25, 1984, which had become inoperative not only because Sudan had fallen into arrears to the Fund but also because the authorities had failed to carry out certain exchange measures. However, the staff did not say which exchange measures had not been taken or whether they had been a performance criterion. In addition, most other targets--for monetary expansion, the budget deficit, and inflation--had been largely achieved. SM/84/253, Supplement 1 listed a number of recent adjustments in Sudan's exchange system but did not indicate whether they had fulfilled the requirements under the June program.

Although no use of Fund resources could be negotiated as long as a country remained in arrears to the Fund, it would be interesting to learn how the Sudanese authorities intended to attain the targets set under the stand-by arrangement, Mr. Steinberg remarked. The staff had been supposed to provide Executive Directors, as part of the first review, with a detailed analysis of the consequences of new Islamic laws in Sudan, particularly the effect of the zakat on the budget and the effect of interest-free banking on savings and resource allocation. The Executive Board had not conducted a review under the stand-by arrangement, but surely such general issues were important enough to be included in the current consultation. Naturally, the Sudanese authorities had the prerogative to adopt any system that appealed to their social and religious tastes. It was encouraging that other countries that had implemented a system such as that of Sudan had not found it to be an impediment to managing a modern economy, and he hoped that the Sudanese authorities would design and incorporate the changes in a way that would not hamper the country's economic and social goals. In that connection, implementation of the changes might be smoother if accomplished in less hectic circumstances and would also benefit from a clearer administrative framework, managed by skilled staff. As Mr. Mtei had explained, the authorities shared that view and had already issued several circulars to commercial banks clarifying some questions about interest-free banking.

The government deficit had reached 11 percent of GDP, Mr. Steinberg said. With all the tax changes and an economic slowdown, total fiscal revenue would be in line with budget estimates, but expenditure had grown faster than projected. The public sector entities were also a cause for concern on account of their large borrowing needs. Could the staff explain why the competitive position of the railway corporation had weakened? Had it been a result of a rise in tariffs intended to generate higher profits, or rather of managerial inefficiencies that had increased operating costs?

Budget expenditures in Sudan seemed to have been contained within the targets, Mr. Steinberg went on. However, recently all additional credit had been directed toward financing the budget deficit. The staff had commented that the Government's position was benefiting from less than full payment in local currency for the budgeted service on external debt; he had understood the comment to mean that the remainder had been paid by the Bank of Sudan, which had later offset its payment by transferring reduced profits to the Government. As the transfer of profit was made on a net basis, the full amount of the debt payment would not show up in the budget. Should not the budget be adjusted to account for such financial arrangements?

Similarly, the four different exchange rates for the Sudanese pound produced not only budgetary biases but also distortions in resource allocation in direct relation to the size of the gaps between the rates, Mr. Steinberg said. As to the lower official exchange rate applicable to most public sector transactions, the authorities seemed to have changed their view that the present was an inopportune time for major exchange reform. SM/84/253, Supplement 1 made it clear that the significant devaluation of the commercial bank rate--from LSd 1.80 to LSd 2.10 per dollar--attested to a more flexible attitude. There nevertheless remained a differential of about 43 percent between the commercial rate and the dealers' rate. At the same time, the official rate had moved out of line to an even larger degree, by at least 60 percent and up to perhaps 130 percent. The staff was absolutely correct in stating that a more appropriate exchange rate policy would be essential to improve incentives to productivity and promote more efficient allocation of resources.

It was up to the Sudanese authorities to evaluate the alternatives before them, Mr. Steinberg observed. Either they could do nothing and wait for external financial constraints to mount even higher, or they could call on the Fund to help them in arranging external aid, as the Fund had recently done for other countries. For their part, they would have to go ahead with an adequate adjustment program that, among other things, would put the exchange system in order and improve the budget position.

The lack of reliable data might blur the vision of those concerning themselves with Sudan, bringing them to biased conclusions and causing the authorities to take incorrect measures, Mr. Steinberg concluded. It was of the greatest importance for the Fund and the World Bank to provide any technical assistance requested. In addition, the staff could facilitate Directors' understanding of economic relationships by providing charts in the staff reports.

Mr. Goos observed that Sudan found itself in a difficult economic situation, salient features of which were the extraordinarily high debt service ratio for 1984/85, unsustainable external payments gaps, widespread arrears, and a shrinking real GDP. Many of the difficulties could be traced to a prolonged drought and adverse external factors, but serious deficiencies in domestic policies had made a major contribution. Such deficiencies were all the more unfortunate because the policy initiatives for structural adjustment undertaken during the past few years--for example, in the cotton sector--demonstrated that the economy did respond to well-designed adjustment measures. However, those measures had fallen far short of what would have been required. The country's problems even appeared to have been exacerbated by stop-and-go adjustment policies and by many of the recent institutional changes as well, the shortcomings of which were clearly spelled out in the staff reports. He could endorse the staff's recommendations.

He agreed with the staff mission that further external assistance to Sudan could hardly be taken for granted, Mr. Goos continued, and that the size and conditions of any such assistance would depend "on a demonstration by the authorities of a serious adjustment effort." No doubt there was ample scope for such a demonstration. For instance, urgent corrective action was needed in the private sector, which seemed to have suffered greatly from recent developments and indeed might be further impaired by the reform of the commercial and tax laws. In particular, the introduction of the Islamic wealth tax or zakat could create widespread liquidity problems because all enterprises would have to pay taxes regardless of whether they were making profits or incurring losses. Introduction of the zakat thus might easily produce a wave of insolvencies, with adverse effects on the country's overall development and the fiscal revenue base. Such an outcome would be quite unfortunate, given the already precarious budgetary situation and its rapid deterioration. Should fiscal revenue decline, the urgent task of achieving a sustainable budget position would become even more difficult.

The authorities should review the current plans for tax reform, Mr. Goos recommended, with a view to improving the elasticity of the tax system in response to income developments. Thus, they could strengthen the revenue base and arrive at a tax system more directly geared to the financial capacity of enterprises. He found it difficult to see how the planned introduction of interest-free banking could be reconciled with the urgent need to stimulate additional domestic savings and to attract external savings. Given the disappearance of interest rates, what instruments and policies were the authorities considering as a means of mobilizing savings?

External indebtedness and payments arrears were Sudan's most pressing problems, Mr. Goos went on. In recent months, unfortunately, renewed payments arrears had arisen to Paris Club members and commercial banks, despite existing rescheduling arrangements with those creditors. Furthermore, Sudan's arrears to the Fund, a matter of the utmost concern, were bound to strain the Fund's relationship with the country. Under the circumstances, there was little basis for discussing any use of Fund resources, particularly the possibility of reviving the existing inoperative stand-by arrangement. Like the staff, he would therefore urge the authorities to make every effort to become current on their overdue obligations. He had found it reassuring to learn from Mr. Mtei that the authorities were dealing with the arrears to the Fund as a matter of top priority.

For years to come, Mr. Goos concluded, Sudan would be unable to reduce its external imbalances to a sustainable point without the cooperation of its creditors. However, the authorities would greatly facilitate such cooperation by undertaking stronger adjustment efforts. They had already improved the exchange rate system and their monetary and budgetary statistics and had also requested Fund assistance aimed at discharging outstanding obligations. Much more needed to be done, particularly with respect to external arrears. Finally, the reform measures affecting the tax and banking systems should be urgently reviewed, or at least postponed until the economy had grown strong enough to cope with their negative side effects.

Mr. Dallara stated that, as other Executive Directors had pointed out, Sudan was facing an economic and financial crisis of grave proportions: economic activity was grinding to a halt, while the authorities' policies were discouraging, if not alienating, international institutions and bilateral donors. Although exogenous developments had contributed to Sudan's current difficulties, the lack of decisive policy actions was the principal cause of the economic deterioration and the closely related donor dissatisfaction. In summer 1984, Sudan had failed to implement agreed policies under its new stand-by arrangement; since that time, its poor debt service performance had become particularly disturbing. It was impossible to lay enough stress on the importance that creditors, particularly the Fund, attached to timely debt servicing. For that reason, it was particularly distressing that the newly issued staff paper on Sudan's overdue financial obligations to the Fund, due to be discussed by Executive Directors in January 1985 (EBS/84/262, 12/12/84), indicated that the authorities lacked any comprehensive plan to reverse the deterioration in debt servicing and improve their relations with external creditors and donors.

Sudan had been experiencing a crisis of confidence, resulting in a severe contraction of private sector activity, Mr. Dallara noted. Although it was not within the Board's purview to render an opinion about the reasons underlying the recent institutional changes in Sudan, he was concerned that the authorities did not appear to take fully into account the economic and financial consequences of their actions. In particular, the manner in which the changes were being carried out might be stifling domestic production further and deterring interest by foreign investors. Frequent drastic changes in the tax and banking systems inhibited normal business activity, besides exerting a direct negative effect on government revenue.

Central to Sudan's financial crisis was the serious disequilibrium in the Government's accounts, Mr. Dallara considered. A lack of comprehensive data left the authorities with insufficient information on which to base their policies. SM/84/253, Supplement 1 outlined some recent policy changes, including the collection of tax arrears, but unidentified budgetary expenditures, which apparently covered public enterprises, were estimated regrettably to have risen even higher. In addition, the authorities had prepared a budget for 1984/85 containing a deficit half the size of the one that realistically could be expected on the basis of current policies, as shown in Table 3 of the staff report. Such a budget served as a serious deterrent to external donors, who looked for fiscal responsibility when evaluating the appropriateness of providing aid to a country.

Further efforts to contain current expenditures were needed, probably including price increases in the public enterprise sector, Mr. Dallara continued. In addition, the authorities might have to re-evaluate the investment budget, a point on which he would be interested in hearing the staff's views. With external financing disappearing, the only option left to the authorities appeared to be to finance their deficit by borrowing from the Bank of Sudan under current policies, thus increasing inflationary pressures at a time when the prospects for increased production to meet higher demand generated by expansionary monetary and fiscal policies were quite poor. Moreover, without adequate credit, the private sector could not function properly.

With regard to the introduction of interest-free banking, Mr. Dallara urged the authorities to move in such a way as not to disturb the financial viability of the banking system. Without extensive and detailed plans, the authorities' changes would be detrimental both to domestic savings and to remittances in foreign exchange.

Given the authorities' apparent unwillingness to make the needed comprehensive changes in policy, the external position clearly indicated the dismal prospects for Sudan, Mr. Dallara noted. Recent policy changes had gone in the right direction: exports of cotton and gum arabic were permitted at a more attractive exchange rate, but the dealers' rate had depreciated even further, so that it remained twice as high as the new export rate. The rate on all other exports, while it had been raised, had reached only about 70 percent of the dealers' rate. Although it was impossible to state definitively that the dealers' rate was necessarily an equilibrium rate, the divergence among the various exchange rates indicated that a serious disequilibrium remained in the foreign exchange market. After all, Sudan was in desperate need of foreign exchange and had to provide adequate incentives to exporters. Unification of the exchange rate, with a commitment and a follow-through to suitable future adjustments, appeared to be the only feasible alternative. The country simply did not have enough resources to sustain the current multiplicity of rates.

In view of the suggestion for a windfall profits tax on exports following any devaluation of the Sudanese pound, Mr. Dallara said, producers of export commodities must earn higher profits for there to be an incentive to increase production. The authorities should make every effort to conserve fiscal resources before resorting to taxes that could be detrimental to production, especially of export commodities.

Decisive action on taxes and the exchange markets, supported by appropriate monetary and institutional measures as outlined by the staff, would indicate to both the Sudanese business community and the external financial world that the current lack of clarity in policymaking was only temporary, Mr. Dallara continued. Policy change leading to economic recovery was indeed of paramount importance to Sudan, to provide growth and development and also to generate the resources needed to become current in its obligations to the Fund and other creditors. Only through such policy changes could Sudan restore its credibility in the international financial community and encourage donors to support its adjustment efforts once more.

A comprehensive adjustment program was necessary to address Sudan's economic problems, thus permitting repayment of arrears to the Fund, Mr. Dallara stated. Yet he saw no evidence that the authorities were formulating such a program.

In spite of the authorities' extreme reluctance to tackle their problems, quick and decisive action could provide the basis for settling the arrears to the Fund, Mr. Dallara remarked. Despite widespread donor dissatisfaction at present, such action could reignite the interests of donors in supporting Sudan. The authorities should heed the warning being given and not wait until the Board had to deal with the arrears more directly. For those reasons, he had been discouraged to hear the report by the staff on its most recent technical assistance mission to Sudan; considering the extremely difficult situation in which the country found itself, he had difficulty believing that the authorities were unwilling or unable to take the necessary steps. Although he was glad to learn that the authorities would try to find needed resources to start paying the Fund, the key means of unlocking donor support and enabling Sudan to eliminate its arrears to the Fund was a comprehensive adjustment program. Unless the authorities took prompt action to reverse the deteriorating economic situation, the financing gaps would grow wider, and the international community would become even less willing to provide support. With decisive, comprehensive action, Sudan could avoid such an outcome and could begin to restore the confidence of the international financial community. However, the margin of error, if any, in terms of timing was quite small. In the absence of immediate action by Sudan, he could only be discouraged about the prospects.

Mr. Wicks remarked that the position of Sudan presented the Fund with perhaps its most difficult problem. Although part of the country's difficulties derived from factors outside its own control, which were common to many African countries, the authorities had contributed to their own difficulties by adopting inadequate or inappropriate domestic policies. The present situation, as Mr. de Maulde had pointed out, was doubly disturbing, as Sudan had been supported by a sequence of Fund programs spanning a considerable period; there had also been extensive investments by the World Bank. There might be a lesson for the Fund as well as the authorities in that those programs and investments had achieved only limited, temporary results. At EBM/84/69 (4/30/84), many Executive Directors had expressed misgivings about the adequacy of the financing schemes devised, which had given Sudan the benefit of the doubt. In restrospect, he wondered whether, in doing so, his chair had acted in the best interests of the Fund and of the member country.

Sudan's economic prospects would not improve materially unless the Government adopted substantial changes in its policy stance and carried them through with the utmost firmness, Mr. Wicks recommended. Even then, as Mr. Dallara had pointed out, there would be a need for a good deal of financial assistance from Sudan's major creditors. Nevertheless, unless such an economic reform program were forthcoming, serious doubts would persist whether further financial support, on its own, could have any worthwhile effects on the country.

According to staff projections, the deficit of the Central Government would reach 12.5 percent of GDP in the current fiscal year, Mr. Wicks continued. In addition, with present commitments, the net inflow of external finance in the form of grants and loans was expected to be quite small, so that the unbridged financing gap was still about 12 percent. Furthermore, the staff had stated on page 15 of SM/84/253 that the Sudanese authorities expected the borrowing requirement of public sector entities to be "considerably in excess of the staff estimates." There was thus a need for a substantial measure of fiscal retrenchment. In line with World Bank recommendations, he welcomed the recent reform of the customs service and would be interested in the staff's view on its likely effect in practice, particularly in widening the tax base. In addition, the authorities had much more to do both to increase the buoyancy of the tax system and to secure firmer control of expenditures, including off-budget items. It was hardly encouraging to read in SM/84/253, Supplement 1 that the entire increase in expenditure during the three-month transitional period had emanated from unidentified extrabudgetary operations, a practice that suggested a lack of financial control.

As to monetary policy, given the absence of a strong domestic capital market, the major threat to adequate control by the authorities was the expansion of bank credit to finance the public sector deficit, Mr. Wicks said. In the longer term, that threat suggested a need to develop other channels of public sector funding and new domestic savings instruments. More immediately, it provided another reason for curbing government borrowing. Furthermore, the authorities were continuing to experience difficulty in reconciling the monetary statistics with those for the balance of payments and for the budget.

The dominant factor in Sudan's external policy was the huge accumulation of debt and the need to secure a sustained improvement in trading performance if there were to be any prospect of resuming full debt service payments, Mr. Wicks went on. One element would have to be a reform of the exchange system: the authorities should eliminate the present multiplicity of rates and allow an adjustment of domestic prices that would restore incentives, especially in the agricultural sector. Indeed, he had been encouraged to read that there had been an appreciable devaluation of the exchange rate applied to noncotton exports. A second element, of potentially crucial influence in the medium term, would be the development of Sudan's oil resources, which held out the prospect for a substantial improvement in the external position. To obtain such an improvement, the construction of the pipeline would have to proceed, yet it had been substantially delayed. Could the staff review the progress achieved on the pipeline, and also the robustness of the figures for oil receipts quoted in the projections in SM/84/253? Could the staff comment on reports circulating in Sudan that the country had mortgaged most of its new cotton crop in return for supplies of petroleum?

In many areas, the Sudanese economy was suffering from the effects of past deficiencies in policy, Mr. Wicks considered. The authorities had recently undertaken a major shift with the Islamization of both the fiscal and the monetary systems. Although it was difficult to judge how effective the new approach might prove in the medium or long term, it certainly seemed to have compounded the short-term difficulties of implementing a satisfactory economic policy at a time when Sudan could ill afford any such hindrances. He would urge the authorities to introduce the new framework in a way sensitive to their economic problems. As collaboration between the World Bank and the Fund needed to be extensive in Sudan, he welcomed the frank Appendix II in SM/84/253, which reviewed the operations of the World Bank group in the country.

In conclusion, the main requirement for Sudan was a commitment by the authorities to take strong, early action to deal with their grave economic problems, Mr. Wicks noted. Until they had demonstrated that commitment, it seemed hardly helpful to discuss any details of policy. Nevertheless, as part of that commitment, and as a first step toward stabilizing the economy, they should regularize their position with the Fund.

Mr. Joyce observed that recent events in Sudan had not been encouraging. Climatic factors had not helped the country's development, and the difficulties experienced by the authorities in the southern part of the country had led to the suspension of work on certain projects. He hoped that the work could be resumed shortly. In addition, the Sudanese authorities had not taken adequate policy measures to adjust to the difficult situation. Indeed, policies in some areas seemed to run counter to the stand-by arrangement approved by the Fund in principle at EBM/84/69 (4/30/84), arrears had been building rapidly, and the stand-by arrangement had become inoperative. In those circumstances, he found it difficult to be optimistic about Sudan's economic prospects. Only a major reconsideration by the authorities of many of their policies and the adoption of new, comprehensive measures could bring about the necessary improvement in the economy and lead to the achievement of the objectives of the stand-by arrangement.

The staff admitted that the Sudanese authorities had been hampered in their attempts to strengthen the balance of payments by a prolonged drought and by a difficult external environment, Mr. Joyce noted. The drought, which persisted in much of the Sahel and East Africa, was continuing to diminish agricultural output in Sudan, even more than expected: the real value of agricultural output in 1984/85 might decline by as much as 12 percent, having already fallen by 5 percent in 1983/84. Declines of that magnitude placed enormous pressures on the authorities to increase food imports, despite the already difficult balance of payments position. Moreover, shortfalls in aid disbursement as well as aid procurement problems had added to the country's payments difficulties. Countries in the donor community would have to examine with the authorities ways of disbursing aid more rapidly and effectively.

At the same time, the economic policies pursued by the Sudanese Government during the previous year had been inadequate, perhaps even counterproductive, Mr. Joyce went on. During the past few years, Sudan had taken a number of significant measures to expand production, improve government finances, and slow inflation, but those measures had been insufficient. The outlook remained bleak, and the burden of external debt servicing appeared increasingly untenable, yet, as Mr. de Maulde pointed out, precisely at such a time the authorities had decided to embark on a series of innovative changes. In his view, the changes were unlikely to strengthen the country's economic prospects.

During the Executive Board discussion in April 1984 of the program under the stand-by arrangement (EBM/84/68 and EBM/84/69, 4/30/84), Mr. Joyce recalled, his chair had expressed some concern that the introduction of new Islamic regulations might lead to considerable uncertainty in business and financial circles and hence have an adverse effect on the economy. At the time, his chair had wondered whether the timing for the introduction of those changes had been propitious, the program under the stand-by arrangement being exposed to a number of risks. In retrospect, both those concerns had indeed been warranted. The financial system had not been working smoothly, and the program under the stand-by arrangement had gone off course, at a time when Sudan urgently needed to adopt a realistic medium-term strategy and to carry out a comprehensive set of measures to bring the economy around. There was little prospect at present that either the strategy or the measures would be implemented.

He agreed with the staff that the available monetary data contained serious inconsistencies, Mr. Joyce noted. Indeed, there was no way to be sure of the overall balance of payments position for 1983/84. How could the authorities monitor the progress of the economy from a monetary point of view, unless they rectified the inconsistencies? Although the Fund had been providing some help, he would urge the authorities to seek Fund technical assistance to deal with the serious accounting problems of the Bank of Sudan. At present, he was not sure whether discussing targets for the rate of monetary expansion in 1984/85 was a meaningful exercise. However, if the rate of inflation were to be kept in check, the Government had to curb its recourse to credit from the banking system and reduce public sector deficits.

Interest rates had a vital role to play in bringing about the required degree of constraint; they provided an incentive to save and allocated credit to sectors that could reap the greatest economic benefits, Mr. Joyce observed. In Sudan, incentives to saving were particularly important with respect to workers' remittances and other capital inflows. Therefore, he would urge the Sudanese authorities to rethink their policies and restore some measure of stability to banking practices. If, for religious reasons, they intended to eliminate interest charges and payments, they might have to make sure that the new system of charges and commissions would do the same job as interest rates themselves.

The staff had correctly seen that the recent structural changes in Sudan's revenue system were likely to weaken rather than strengthen the Government's fiscal position, Mr. Joyce continued. Such a prospective weakening was particularly serious, as the fiscal position was deteriorating even faster than the Fund had previously expected. Measures to limit expenditure and increase revenue would be necessary if the authorities were to avoid greater reliance upon domestic credit to finance the fiscal deficit. As it was, the most recent tax changes presaged a further weakening of the revenue position in 1985/86. He would also urge the authorities to establish tighter control over budgetary transfers to public enterprises and utilities. Finally, as the staff had suggested, regular adjustments in the fees for public sector goods and services would be essential to improve the financial position of state enterprises.

He welcomed the adjustments in the exchange system introduced on October 21, 1984, including a modest depreciation of the commercial bank exchange rate and wider use of that rate for export goods, Mr. Joyce said. However, they represented only an intermediate step toward further liberalization. The staff's earlier recommendation for further devaluation of the pound and unification of the exchange rate was still warranted. He had been unimpressed by the Sudanese authorities' arguments against unifying the exchange system; rather, the severe imbalances in Sudan's external accounts required that major adjustment measures be taken, among which greater exchange rate flexibility would be crucial. It was doubtful whether the authorities were going to find it any easier in the future to move in that direction if they delayed taking action.

Sudan's medium-term balance of payments prospects, as set out in Table 6 of SM/84/253, must give all Executive Directors pause for thought, Mr. Joyce pointed out. Even under the set of assumptions spelled out on page 21, which appeared quite favorable, large balance of payments financing gaps would continue until the end of the 1980s. As the staff had correctly observed, the Sudanese authorities must adopt and maintain a strong domestic policy stance if debt relief and concessional financing were to be forthcoming. Fund assistance could form part of that effort, but the Fund could furnish little assistance as long as Sudan's arrears to it continued. While noting the authorities' awareness of the urgency of the problem, he would urge them to take measures speedily to deal with the arrears that had arisen, a point on which he supported Mr. Dallara. Failure to act quickly on arrears would cast a dark cloud over all Sudan's external financial relations.

Like Mr. Wicks, he welcomed the detailed review in the papers of the World Bank Group's operations in Sudan, Mr. Joyce remarked. The World Bank had provided large sums to finance a variety of important projects, yet there had been major problems with some of them. Apparently, the Bank had been no more successful than the Fund in inducing the Government of Sudan to make the structural changes deemed essential if the development strategy were to produce results.

He supported the staff's view that the private sector had a vital role to play in any recovery in Sudan, Mr. Joyce said. For that reason, the authorities must not only supply enough credit to the private sector but also establish a climate more favorable to private investment and private economic activity. As the staff had said, existing controls on prices and profit margins, together with licensing arrangements, needed to be rationalized. Indeed, many controls needed to be eliminated. Only if the price mechanism--including the exchange rate--were working properly and were underpinned by effective demand management policies could Sudan begin to make progress toward achieving sustainable growth. In conclusion, he supported the proposed decision.

Mr. Nimatallah commented that the stand-by arrangement that had become effective in late June 1984 had since become inoperative, Sudan having fallen into arrears to the Fund. The authorities had been making good progress in tackling deep-seated structural problems: they had implemented important policy measures to stimulate the growth of exports and to reduce domestic inflationary pressures through demand restraint. As those adjustment efforts had been supported by the international community, enabling Sudan to obtain debt relief and new financing, it was unfortunate that the adjustment effort had been prematurely interrupted. His authorities were concerned that Sudan's economy might be drifting.

He agreed with the staff's analysis and conclusions, which demonstrated the magnitude and seriousness of Sudan's present economic and financial difficulties, Mr. Nimatallah went on. The more recent information given by the staff in SM/84/253, Supplement 1 underscored the same difficulties. Sudan's economic problems were compounded by the large external debt. The debt service burden had grown so heavy that it could not be sustained, even if the authorities took timely and appropriate adjustment measures, indicating that the country's economic problems had not been systematically addressed over time. Indeed, despite many programs with the Fund in recent years, the lack of any visible or lasting improvement in Sudan's economic situation was attributable, in part, to inadequate economic management and an inability to implement stabilization programs consistently. Inappropriate program design might also have played a part; for instance, Fund programs during the early 1970s had paid little attention to structural aspects of adjustment. More recently, however, such issues had been adequately taken into account, and the efforts of the Fund had been complemented by close collaboration with the World Bank.

It was not in the interest of Sudan for domestic and external finances to deteriorate while external arrears accumulated, Mr. Nimatallah noted. Sudan required a stronger political will with an imaginative new approach. The staff had correctly indicated the need for a medium-term recovery program to address the country's immediate problems and lay the foundation for a viable medium-term position. Therefore, it was essential to put together a workable medium-term program, with an appropriate financing package. In view of Sudan's track record on program implementation, the Fund would have to take great care in designing and monitoring any future program. Substantial prior action would certainly be necessary to enable Sudan to obtain international financial support, and the authorities would have to show strong determination to sustain the adjustment effort.

Over the medium term, it was important for Sudan to make speedy progress toward restoring external equilibrium and to settle its arrears in an orderly manner, Mr. Nimatallah continued. Therefore, far-reaching measures were needed to strengthen the external sector and to reduce reliance on external resources. It would also be helpful to increase the role of the private sector and to address the long-standing weaknesses in the structure and management of the economy. Reforms were needed to improve production incentives and stimulate domestic output for exports. He urged the authorities to implement measures conducive to mobilizing savings and rationalizing expenditures. In that connection, they should give due consideration to measures for effective fiscal management and control, as well as to the rehabilitation of public sector entities.

The Sudanese authorities should be encouraged to prepare and implement a medium-term economic program along the lines suggested by the staff and Executive Directors, Mr. Nimatallah concluded. The task should involve both the Fund and the World Bank. However, Sudan must first settle its overdue obligations to the Fund without delay. Even while recognizing the economic and other difficulties facing the country, he would urge the authorities to make a more determined effort to clear their outstanding arrears to the Fund. There was no time to lose, as clearing arrears was the only viable option. Sudan would be unable to tackle its economic difficulties unless it had the support of the international financial community. Sudan could tap a still considerable store of international goodwill only if it first made a convincing case that it would put its own house in order. He supported the proposed decision.

Mr. Finaish observed that the case of Sudan was particularly difficult, for a number of reasons. First, the magnitude of the economic imbalances was quite large; second, after years of Fund involvement, the degree of adjustment achieved so far was only partial; third, the outlook for the future indicated that, even under favorable assumptions, balance of payments viability would continue to be an elusive objective for some time to come. More recently, the cancellation of the stand-by arrangement approved in April 1984 and the accumulation of substantial arrears to the Fund had complicated the situation even further.

In analyzing the underlying causes of Sudan's economic difficulties, the staff had identified a wide range of factors, both external and domestic, Mr. Finaish noted. The severe drought, the deterioration in the terms of trade, and, more recently, the worsening security situation in the southern region, together with other factors, had certainly been major contributors to the increased pressures on the country's finances. On the other hand, slippages in the implementation of certain adjustment policies and the authorities' inability to respond properly to unfavorable exogenous developments also had represented major obstacles to the adjustment process. One problem with which the authorities had had to deal in recent years and to which he found little reference in the staff report, had been the inflow of refugees from neighboring countries; according to many reports, the magnitude of the problem was quite large, and its economic implications were hardly insignificant. Could the staff or Mr. Mtei shed some light on the issue?

The major disappointment in 1983/84 had occurred in the agricultural sector, Mr. Finaish observed. Despite measures to stimulate production, including an increase in minimum procurement prices, real value added in agriculture had declined by 5 percent, compared with a targeted figure of 9 percent growth. In a country where agriculture dominated economic activity, such a decline was bound to increase financial pressures on all sectors of the economy. Nevertheless, an improvement had been recorded in the current account, and the authorities had apparently realized both the budgetary and the monetary targets for the 1983/84 program. However, the staff paper indicated that the outcome of the 1983/84 program might have been much less favorable in reality than the data appeared to indicate, particularly in the budget and government borrowing. According to the staff, the reason for the discrepancy lay mainly in the quality of data and government accounting practices. Although the general deterioration in national statistics could be attributed, at least partly, to a drain on skilled manpower in recent years, he found it surprising that, after years of Fund involvement, Sudan's statistical deficiencies should have become so serious.

For 1984/85, a further substantial decline in agricultural output was likely, mainly as a result of persistent drought, Mr. Finaish said. On the positive side, continued moderation in monetary growth was expected, while tax revenue for the fiscal year was projected to equal the figure estimated in the budget. As the staff paper showed, however, the fiscal deficit was expected to widen, and no significant improvement in the external payments position was likely, so that a strengthened adjustment effort would be needed for the authorities to achieve a turnaround in the economy in the foreseeable future. Given the wide range of problems in the economy, their effort would have to be comprehensive, covering not only demand management policies but also structural reforms essential for Sudan's longer-term prospects for sustained growth and financial stability. Those structural reforms should also include changes in pricing policies, which could be useful in improving the environment for economic activity by the private sector. In formulating future policies, the authorities would have to take into account the lessons of the past.

One aspect of economic policy upon which the staff and some Executive Directors had repeatedly commented was the introduction of institutional changes, particularly with respect to taxes and banking, Mr. Finaish continued. The staff's original concern on the fiscal front seemed to have been the possible revenue loss resulting from the elimination of certain taxes and their replacement by the zakat. However, as SM/84/253, Supplement 1 and Mr. Mtei's statement indicated, the Sudanese authorities had adopted a number of revenue measures to compensate for potential shortfalls in fiscal revenue. In addition, the staff had emphasized the possible negative impact of the uncertainties associated with changes in the interest rate laws and had also considered the abruptness of institutional changes in general to be detrimental to adjustment. Therefore, he was encouraged by the clarifications made by the Sudanese authorities, particularly concerning the binding nature of previous interest-bearing transactions. As Mr. Mtei had indicated, whether abrupt or gradual, the transition would inevitably entail certain costs, which might well be far outweighed by its potential benefits. Of course, basic institutional changes in an economic system--the choice of which rested with the country--should be adopted after careful planning and preparation. Obviously, if Sudan were to overcome its enormous economic difficulties, the authorities could neither avoid nor postpone a clear, determined adjustment effort.

At the same time, however, Mr. Finaish went on, it would be unrealistic to expect a quick solution to Sudan's economic problems, no matter how strong the adjustment effort. Even under the best of circumstances, only a combination of adjustment and adequate external financing would have a chance of putting Sudan back on the path of recovery, which would be long and difficult. In that respect, he agreed with the view expressed by the staff in the last paragraph on page 23 of SM/84/253.

As Mr. Dallara and Mr. Wicks had reminded the Executive Board, the choice of a particular social system and set of institutions was the prerogative of each member country, Mr. Finaish concluded. For example, Article IV, Section 3, read in part: "These principles [of surveillance] shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members." Moreover, the guidelines adopted on conditionality in Executive Board Decision No. 6056-(79/38), adopted March 2, 1979, stated: "In helping members to devise adjustment programs, the Fund will pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members, including the causes of their balance of payments problems." Of course, basic institutional changes should be adequately planned for and implemented, in a manner that avoided disruptive consequences. Only limited information was made available by Sudan, so that it was difficult for the Board to reach a judgment. As relatively little was known about the impact of such institutional changes, he could sympathize with Mr. Mtei's statement that the matter had been overemphasized in the staff report. Besides, it was not as though Sudan's economic problems had begun in September 1983, with the institutional reform. There was no clear evidence to support the statement made by the staff on page 3 of SM/84/253, attributing the disturbances in the south to institutional changes. Problems in the southern region dated back to the mid-1950s, and he found it difficult to see how they could have been caused by changes introduced only one year previously.

Mr. Orleans-Lindsay expressed agreement with the staff appraisal and support for the proposed decision. Present economic and financial developments in Sudan, as detailed in the staff report, were disturbing.

Prospects for the future also appeared bleak, mainly because the complex, deep-seated internal and external imbalances originating from structural factors had not been adequately tackled by the authorities. Sudan had made some progress under a series of Fund-supported programs in the past, but the authorities had been unable to maintain that pace of adjustment under the most recent stand-by arrangement, so that the present difficult situation still required substantial, sustained adjustment.

Having identified the problems, the staff had indicated the direction for new policy initiatives that the authorities had to take as part of a comprehensive medium-term recovery program, Mr. Orleans-Lindsay continued. The World Bank, long involved in Sudan's structural adjustment efforts, had endorsed the new policy direction outlined by the Fund staff. As other Executive Directors had stated, the authorities needed to strengthen economic management, in which task an important element would be the need for strong political commitment. It was not enough for the authorities to admit that they were aware of existing problems. Awareness should be coupled with a determination to implement a well-designed and financeable program, and the rationale for such a program should be communicated effectively to the Sudanese public in order to dispel the uncertainties prevalent in the private sector at present. He shared the staff view expressed on page 24 that "a clear enunciation of the role of the private sector in the economy and a commitment to a clearly defined medium-term policy and institutional framework in which the private sector can make economic decisions with a greater degree of certainty and confidence" would be an important element in the new policy.

While sympathizing with the severe economic and financial problems confronting Sudan, Mr. Orleans-Lindsay concluded, he would urge the authorities to intensify their efforts to formulate and implement far-reaching policies enabling them to settle the mounting external payments arrears, particularly those to the Fund. Thus, the authorities would reduce or remove what Mr. Dallara had described as donor dissatisfaction and could attract the external financing without which Sudan's adjustment programs, however well designed, would not succeed.

Mr. Jayawardena recalled that when the Board had considered the one-year stand-by arrangement for Sudan in April, he had been glad that the staff had used a medium-term scenario showing continuing difficulties for some years, because he had been hopeful of a longer period of Fund collaboration, with generous support from the World Bank and the international community. He was greatly disappointed that the arrangement had been suspended. No doubt, adverse terms of trade, prolonged drought, world recession, and problems of international security had contributed to the difficulties, but the authorities had adopted inappropriate policies and unwise investment decisions. Nevertheless, there had been signs that they were taking steps to rectify the situation, some measures having even been taken before the current Fund program.

As Mr. Mtei had said, the authorities were aware of the need to undertake further policy reforms, especially those directed at the structure of the economy, Mr. Jayawardena went on. He welcomed the progress achieved in containing fiscal and external deficits; a large part of the remaining deficits reflected foreign aid absorption. Could the staff explain what it perceived as an appropriate, viable fiscal and external deficit for Sudan--which should influence exchange rate policy--when the related deficits primarily reflected foreign aid absorption?

Strong measures had been taken to liberalize price controls, eliminate subsidies, and restore market incentives, in which fields further progress might be helpful, Mr. Jayawardena said. Continued monetary restraint was called for, lest inflationary pressures overwhelm the adjustment effort. A realistic exchange rate policy would be crucial, especially for eliminating distortions and attracting foreign remittances.

The medium-term scenario and the debt service projections indicated a difficult situation for Sudan in years to come, Mr. Jayawardena concluded. Hence, it was most regrettable that, so soon after the beginning of the Fund program and the rescheduling of Sudan's debts, the authorities had permitted themselves to get into arrears. Certainly they were aware that it was the Fund that underpinned the international effort to rehabilitate the economic position of Sudan; he would urge them to settle all arrears to the Fund as a matter of the highest priority. Had there been a breakdown in the dialogue, or perhaps a lack of understanding or appreciation of the size of the problems facing Sudan? If so, the dialogue should be kept going. At the same time, the international community should continue to show sympathy and understanding.

The staff representative from the Middle Eastern Department, responding to questions, recalled that at the time that the Board had approved the stand-by arrangement, the staff had deliberately not mentioned the specific policy actions that the authorities had agreed to take regarding the exchange system, because of the sensitive nature of the undertakings. However, it could now be mentioned that the authorities had committed themselves to four actions. First, in July 1984, the commercial bank exchange rate was to have been unified with the exchange rate available from private dealers into one free market rate; previously, commercial banks had not in practice been able to offer the same exchange rate as dealers, causing a significant distortion in what was meant to be a unified free market. Second, once the two exchange rates had been merged, the commercial banks would be allowed to move the rate they offered along with the dealers' rate. Third, the authorities would shift certain transactions from the official market to the free market, as a means of adjusting the average effective exchange rate without having to devalue the official exchange rate. Fourth, once the authorities had taken those steps in July, the staff had planned to review with them policy actions with a view to complete unification of the exchange rates at some time in 1986. However, the undertakings had not been carried out and, moreover, arrears to the Fund had developed in mid-July. Thus, the review of exchange rate policy could not take place.

In October, the authorities had taken actions somewhat similar to those that they had been committed to taking in July, the staff representative noted. By then, however, the economic situation had deteriorated so rapidly that those actions had turned out to be inadequate in relation to the extent of the problems. Moreover, the authorities' actions had not addressed some fundamental problems. For example, they had actually widened the foreign exchange resource gap in the official market because, while allowing some of the export proceeds to be moved to the free market, they had made no corresponding move on the import side to the free market; as a result, the official market had become more unbalanced. The lack of foreign exchange was reflected in the authorities' inability to pay their arrears or import some commodities and by their borrowing at high interest rates to meet foreign exchange obligations. In the light of those developments, and on the basis of a comprehensive review of the competitiveness of Sudan's exports, the staff had concluded that the only reasonable solution for Sudan was to have a unified exchange rate, which should be kept flexible. If the rate could not be floated under the dictates of market forces, it should at least be adjusted periodically on the basis of objective economic criteria. The staff had said as much in its recommendations to the authorities the previous week, presenting a detailed analysis of the various elements and their consequences in relation to domestic pricing policies.

The staff had learned from unofficial sources in Khartoum that the Sudanese authorities had mortgaged some future cotton exports in return for petroleum imports, the staff representative explained, but there had been no official confirmation or denial of the report. In the past, the authorities had borrowed on a short-term basis by pledging some of their export receipts. Because of Sudan's acute foreign exchange difficulties, it would not be surprising if they had done so again.

As to the oil pipeline, the staff had received conflicting reports, depending on whom it had consulted, the staff representative continued. The Sudanese authorities tended to believe that security in the south had improved sufficiently for work on the pipeline to begin again, but apparently the companies undertaking the project were not convinced that it was safe yet to continue. In addition, the issue had been complicated by a recent move by the Sudanese authorities to arrange for a contract with another firm for oil exploration.

The recently introduced institutional changes might have contributed to increased civil disturbances in the southern region of the country that had stopped the construction of the pipeline and delayed the construction of the Jonglei canal, the staff representative said. Moreover, the disturbances had affected the medium-term economic projections for Sudan: at present, the staff foresaw that Sudan would begin to export petroleum by 1988 or 1989; under the initial program, oil exports had been supposed to begin in 1986. However, resumption of work on the pipeline and the canal would depend largely on the political situation, which could not be forecast with any great accuracy.

A number of questions had been asked about the effect of the zakat on the fiscal system, the staff representative commented. When instituting the zakat, the authorities had announced that most traditional taxes would be abolished, a policy action that would have severe implications for the budget. For one thing, the amount of revenue to be generated by the zakat had been uncertain, and, under a strict interpretation, only certain well-defined expenditures could be financed with funds raised through it. However, recently new taxes had been introduced, which essentially reinstated the old taxes in another form. Thus, the newly introduced "social justice tax" was similar to the old income tax, while the "consumption tax" was essentially the same as the old domestic excise duties. In its most recent calculations, taking account of all those changes, the staff had concluded that the revenue prospects might be a bit brighter than the September projections had indicated, but that the improvement made little difference to the huge overall deficit. Thus, the reintroduction of various old taxes had brought revenue up to a slightly higher position than the staff had expected in September. In introducing the various policy changes, however, the authorities had created uncertainties that had exerted adverse effects on business and trade.

Railways in Sudan suffered from both inefficient management and competition from truck transport, the staff representative went on. Highway transport was in a favorable position, partly because the fuel that it used was priced at the official exchange rate. If petroleum were priced at the free-market foreign exchange rate, the railways could probably be more competitive, in the short term. However, railway operations suffered from weak management and from a serious deterioration in fixed capital.

The 1983/84 shortfall in external debt payments had helped the budget position, the staff representative recalled, by diverting part of the local currency resources of the Government from servicing Sudan's external debt into financing other expenditures. Had the authorities met all the external debt obligations budgeted, then, in order to meet other expenditures, they would have had either to rely on borrowing from domestic banks or to generate additional resources themselves. Furthermore, it was likely that some other borrowing not identified with the Government had actually been undertaken in favor of the Government but had been accounted for somewhere else. In that connection, technical assistance from the Fund was available to help improve accounting practices at the Bank of Sudan.

In the absence of debt relief, the budget deficit in 1984/85 would be about LSd 1.2 billion, the staff representative said. If the assumption were made that the authorities could obtain debt relief on the same scale as in 1984, and if the full amount of the debt relief were passed on to the budget, the authorities would still have a financing gap of about LSd 500 million, most of which they would have to cover by mobilizing domestic resources.

The staff recommendation that the authorities impose a windfall profit tax on January 1, 1985 had been made in the context of exchange reform, the staff representative recalled. The staff had concluded that the restoration of adequate production incentives required that the prices of those commodities not purchased from farmers by the Government should rise drastically. However, since the agricultural season was already well advanced, the staff had thought that unless a temporary tax were imposed during 1985, the benefits of the higher prices would go not to the producers but to the export merchants in the form of windfall profits. The authorities therefore could siphon off the windfall profits that were not going to producers without affecting producer incentives. The staff had proposed that after 1984/85 the authorities might abolish the windfall profit tax and develop other sources of revenue to compensate for the loss of such revenues.

The staff was unable to quantify the implications of the recent changes in the banking sector, the staff representative stated. The changes, for which the authorities had failed to prepare the public, had led to a substantial slowdown in economic recovery in the private sector. For example, little if any expansion of credit to the private sector had occurred recently, and the Government had taken up the slack. There had also been indications of capital flight, reflecting the uncertainty created. The banks had been uncertain about how the authorities would adjust interest rate policy and how they themselves were going to replace interest with an alternative arrangement. One circular outlining the changes had been followed by another, different one, and it had been difficult to determine which was correct. The staff had, of course, confined its comments to the economic impact of the proposed changes. The staff had emphasized that effective implementation of a successful economic policy package required, first, that the changes should be introduced speedily, and, second, that the repercussions of the changes should be carefully taken into account. For instance, interest rates should be replaced by something equivalent, or the important function of reward and charge in relation to borrowing and lending would be undermined.

The staff had discussed with the authorities the effects of the accelerated inflow of refugees but had not received any precise information, the staff representative noted. The inflow from neighboring countries was to some extent being mitigated by increased humanitarian assistance from external sources but was also resulting in increased outlays for internal security and relief by the Government. In addition, the drought was influencing the movements of people within Sudan, most moving toward Khartoum, but the effects of those developments on the authorities' adjustment efforts were difficult to evaluate in the absence of more detailed information about the extent and costs of the movement.

The staff had tried to identify and record deficiencies in Sudan's data, the staff representative from the Middle Eastern Department concluded. Furthermore, the staff had been attempting to help the authorities to improve their data base, but as improvements were introduced in some areas, deficiencies seemed to develop in other areas, partly reflecting the movement of trained personnel out of Sudan during the 1970s. In that regard, the Sudanese authorities could avail themselves of further technical assistance from the Fund.

Mr. Nimatallah asked about the recent agreement between a contractor and the authorities to perform some work jointly with the Government of Sudan in financing petroleum imports. What would be the impact of that agreement on the interrupted program with the Fund? Did it have anything to do with the authorities' petroleum purchasing fund?

The staff representative from the Middle Eastern Department explained that the authorities had made it clear that the recently signed agreement with a Saudi Arabian entrepreneur mainly involved oil exploration and similar facets of oil industry developments; it was not intended to replace the oil financing arrangement. The Governor of the Bank of Sudan had expressed hope that the arrangement, which the authorities were trying to work out with U.S. and Saudi Arabian assistance, could be put into place soon to finance the country's oil imports. The staff was unaware whether the recently signed agreement would involve arrangements to import oil, although in the past Sudan had negotiated private agreements, usually involving prices considerably in excess of prevailing world market prices. However, concern had been expressed, particularly by Chevron, which was engaged in extensive oil development in Sudan, about the implications of the new exploration agreement for the concession rights of those already engaged in exploration and development. The authorities maintained that the arrangement was not a replacement for their other dealings.

Mr. Mtei noted that, as one Executive Director had said, it was an understatement to say merely that Sudan faced problems; they were severe indeed. Aware of the difficulties, the authorities were trying to tackle them as forcefully as possible.

The inflow of refugees into Sudan came from the eastern, western, and southern borders, Mr. Mtei explained. The presence of so many refugees posed problems of settlement, whose effects on the economy were difficult to quantify, but which had led the authorities to direct government expenditure toward meeting refugees' needs.

As mentioned by Mr. Finaish, Mr. Mtei continued, any member country had the right to adopt any social system that it pleased, whether new or ancient, and the Executive Board as well as the Fund was in no position to pass judgment on it. All that the Fund could do was to assess the economic impact of a country's choice and point out the potential problems to national authorities.

Almost all Directors had referred to Sudan's arrears to the Fund, Mr. Mtei remarked. When the annual debt of a country was as large as that of Sudan, $1 billion, it was clearly difficult for that country to meet its commitments. In exceptional cases like that of Sudan, a more comprehensive and pragmatic approach to debt relief should be given serious consideration. The elements of such an approach could be, consideration by bilateral donors and creditors of converting official loans into grants; rescheduling commercial debt over a number of years, with reasonable grace periods and due provisions for mitigating the impact of interest rates; when countries' debt obligations were to multilateral organizations and amounted to a considerable sum, there might be a need for some innovative action in those organizations' policies. Finally, a meaningful reduction in the economic and financial imbalances that prevailed in Sudan would require a strong commitment by the authorities. Indeed, they were willing and had already begun to take action on that question, but there was also a need for joint efforts, together with understanding from the international community.

As to the exchange rate, when the parallel or unofficial rate was so different from the official rate and continued to rise whenever the official rate also rose, a solution was called for that differed from merely insisting on further devaluations, Mr. Mtei considered. For example, if the Fund were to suggest to the Sudanese authorities that they should set the rate at LSd 3 per dollar rather than LSd 1.5 or LSd 1.3, as at present, once the official rate reached LSd 3 per dollar, the parallel market rate--because it was affected not only by economic factors but also by social disturbances and political instability--might go up to LSd 4 or even LSd 5 per dollar, so that equilibrium might never be attained.

The Chairman gave the following summing up:

Executive Directors expressed general agreement with the staff appraisal contained in the report of the 1984 Article IV consultation with Sudan. Although Sudan had taken a series of important measures over the past five to six years, the domestic and external imbalances had become deep-rooted because of lack of full, continuous, and effective implementation of stabilization policies. In spite of difficult exogenous factors, like drought and insecurity, Sudan had had the opportunity, Directors emphasized, and had received substantial support to proceed with the adjustment effort, but unfortunately the hoped for improvements had not materialized, even though the responsiveness of the economy to well-conceived structural adjustment policies had been demonstrated in some areas.

While noting the beneficial effect of the policies that had contributed to the expansion of output in the irrigated sector and to a reduction in the rate of monetary expansion and price inflation during 1983/84, Directors observed that the balance of payments position had deteriorated. Disappointment was expressed that the stand-by arrangement with the Fund, which had entered into effect in June 1984, had become inoperative only a few days after the first purchase had been made and, in particular, that the review of the program under the arrangement could not be held because of the incurrence of arrears to the Fund, and also because of the failure of the authorities to carry out certain exchange rate actions that they had undertaken to do in July under the arrangement.

Directors emphasized the importance of implementing, without delay, a comprehensive medium-term strategy for economic recovery. In this context, they expressed great concern that the Central Government, in the absence of additional measures, was likely to incur an unsustainable deficit in 1984/85--projected at some 12.5 percent of GDP with full servicing of external debt--and that recourse to domestic bank financing by the Government would be excessive. Directors emphasized the need to expand the revenue base and to improve tax elasticity in order to arrest the erosion of tax revenues. The downward trend in budget revenue as a proportion of GDP was a cause for serious concern. The actions taken to limit the loss of revenue from the replacement of some taxes by the Islamic Zakat were noted by Directors, but doubts were expressed whether these offsetting measures would be commensurate with the situation. Realistic tax reform geared to the needs of the economy was thus necessary. Concern was also expressed over the growth of current and extra-budgetary expenditures, and the urgency of a significant and sustained control over expenditure was stressed.

Directors also emphasized that the financial position of public entities needed to be improved through more flexible pricing policies, better cost controls, and more efficient and effective management. Directors called for continuing cooperation of the staffs of the Fund and the World Bank, especially in evaluating, in conjunction with the Sudanese authorities, the performance of the public entities and the suitability of the public investment program. Several Directors suggested the importance of coupling the Government's efforts to mobilize resources from the public entities with policies to encourage private sector activity. In this context, they stressed the need for a clear institutional framework that would assist the private sector in its production and investment decisions by reducing the level of uncertainty as well as by rationalizing controls on prices and profit margins.

Noting that the reduction in monetary expansion in 1983/84 had made an important contribution to the containment of inflationary pressures, Directors stressed the need for continuation of a cautious credit policy. In this regard, concern was expressed about the impact of increased government borrowing, and the authorities were urged to monitor closely the monetary aggregates and adjust fiscal and other policies promptly as needed. Several Directors noted the importance of securing the effective functioning of the banking system and of a positive real rate of return on financial assets, under whatever institutional arrangements for the financial system that best suited

Sudan's circumstances and traditions. On a more general plane, Directors indicated that institutional reforms, which they considered to be indeed the free choice of the Government, should always be implemented in a manner that was consistent with the economic objectives of the Government.

The prospects of a deterioration of the balance of payments in 1984/85, aggravated by the adverse impact of the severe drought on the output of some important export crops, were noted with considerable concern. Directors were generally of the view that the adoption of a unified rate at a realistic level, accompanied by market-determined flexibility in exchange rate policy, would improve production incentives and ensure a more efficient allocation of resources. To be successful, however, such a reform of the exchange system would have to be accompanied by measures aimed at restraining demand and boosting the production of tradable goods. Directors expressed their disappointment that the Sudanese Government did not at present envisage implementing the much needed reforms in the exchange rate system.

Directors commented that Sudan's unfavorable medium-term debt profile, with projected debt service exceeding export proceeds, would require a number of years of strong and continuous adjustment effort, which could in turn encourage external creditors and donors to agree to additional assistance. All Directors who spoke addressed themselves to the question of Sudan's arrears to the Fund and noted with grave concern the substantial growth of these arrears. Directors urged the authorities to give immediate and top priority to becoming current in their payments to the Fund. In addition to foreclosing discussions on further use of Fund resources, such arrears also had serious adverse consequences for debt relief, for trade credit, and, in a more general fashion, for Sudan's relations with the international financial community. Directors also observed that, despite the substantial and exceptional debt relief of recent years, Sudan had arrears to several multilateral, bilateral, and commercial creditors, and that these arrears had already had a significant negative impact on aid disbursements.

Directors urged the authorities to advise the Fund promptly of their plans for discharging their obligations to the Fund. In the meantime, the authorities were also encouraged to continue to seek technical assistance from the Fund in formulating and implementing policies for improving the balance of payments position, enabling Sudan to discharge its obligations to the Fund.

Directors commented on the deterioration in the quality of Sudan's economic and financial data in spite of long-standing technical assistance by the Fund, and expressed the hope that these could be improved, particularly as regards the Bank of Sudan's accounts. They noted that the Fund staff stood ready to provide further technical assistance for this purpose.

Sudan was clearly faced with an economic and financial crisis of grave proportions, Directors noted. One root cause of its difficulties had been the discontinuity in the adjustment effort, as well as the abruptness of some institutional changes introduced recently. Directors stressed that, without a very serious and sustained effort to address the continuing deterioration in the external payments position, the prospects for progress toward attaining viability of the balance of payments were grim. It was therefore most essential that the Sudanese authorities formulate and implement without delay a comprehensive program to address the difficult problems facing their country. In this respect, Directors expressed some disappointment on the outcome of last week's discussions between the staff and the authorities in Khartoum. Thus, the Sudanese authorities should be clearly aware that Directors took the view that Sudan must demonstrate to the institutions and to the countries that had provided support in the past that the Government was determined to implement the needed corrective actions on a sustained basis.

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

The Executive Board then took the following decision:

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

2. Sudan's exchange system includes a multiple currency practice and restrictions on payments and transfers for current international transactions as described in SM/84/253 (11/9/84). These restrictions are subject to approval by the Fund under Article VIII, Section 2. The Fund urges Sudan to take prompt steps to unify the exchange system and to eliminate the restrictions on payments and transfers for current international transactions.

Decision No. 7877-(84/187), adopted
December 19, 1984

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/186 (12/17/84) and EBM/84/187 (12/19/84).

3. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/84/279 (12/18/84) is approved.

APPROVED: October 23, 1985

LEO VAN HOUTVEN
Secretary