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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/122

3:00 p.m., August 24, 1983

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	T. Ramtoolah, Temporary
	H. G. Schneider
	P. D. Péroz, Temporary
A. Donoso	
R. D. Erb	
M. Finaish	T. Alhaimus
	T. Yamashita
J. E. Ismael	
	M. Casey
A. Kafka	
	G. Grosche
G. Lovato	G. Gomel, Temporary
R. N. Malhotra	
	J. E. Suraisry
	T. de Vries
	J. Schuijer, Temporary
	K. G. Morrell
	A. A. Agah, Temporary
F. Sangare	E. I. M. Mtei
	J. L. Feito
	A. K. Juusela, Temporary
	C. Taylor
	J. Bulloch, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

B. Legarda, Consultant. African Department: J. B. Zulu, Director; L. M. Goreux, Deputy Director; N. Abu-zobaa, E. L. Bornemann, J. A. J. Bove, E. A. Calamitsis, N. Calika, A. G. A. Faria, J. Hicklin, M. C. Niebling, S. M. Nsouli, M. Reichardt. Asian Department: H. O. Roden. Central Banking Department: G. Hacche, M. R. Vaez-Zadeh. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Kanesa-Thasan, K. M. Meesook. External Relations Department: H. Puentes. Fiscal Affairs Department: R. K. Basanti, J. R. Modi. Legal Department: P. L. Francotte, Ph. Lachman, J. K. Oh, J. V. Surr. Research Department: N. M. Kaibni. Secretary's Department: A. Wright, Deputy Secretary; R. S. Franklin, J. A. Kay. Western Hemisphere Department: E. Wiesner, Director; J.-P. Amselle, M. A. Costa, J. E. Gonzalez, M. E. Hardy, M. C. Spinola, G. Terrier, F. van Beek. Advisor to the Managing Director: E. W. Robichek. Advisors to Executive Directors: S. R. Abiad, T. A. Connors, S. El-Khouri, S. M. Hassan, P. Kohnert, H.-S. Lee, Y. Okubo, P. Péterfalvy. Assistants to Executive Directors: E. M. Ainley, H. Alaoui-Abdallaoui, H. A. Arias, R. Bernardo, M. Camara, M. B. Chatah, L. E. J. Coene, R. J. J. Costa, M. K. Diallo, M. Eran, C. Flamant, N. U. Haque, J. M. Jones, H. Kobayashi, M. J. Kooymans, W. Moerke, J. A. K. Munthali, V. K. S. Nair, G. W. K. Pickering, C. A. Salinas, Shao Z., D. I. S. Shaw, P. S. Tjokronegoro, M. Toro, Wang C. Y., J. C. Williams.

1. GRENADA - 1983 ARTICLE IV CONSULTATION, AND EXTENDED ARRANGEMENT

The Executive Directors continued from the previous meeting (EBM/83/121, 8/24/83) their consideration of the staff report on the 1983 Article IV consultation with Grenada, together with Grenada's request for an extended arrangement in an amount equivalent to SDR 13.5 million (EBS/83/164, 8/9/83). They also had before them a report on recent economic developments in Grenada (SM/83/182, 8/11/83).

The Acting Chairman remarked that it was regrettable that the World Bank had been unable to give a more detailed appraisal of Grenada's development program. As the staff representative from the Western Hemisphere Department had explained, for various reasons the World Bank had not been sufficiently active in Grenada to be in a position to provide more than the relatively brief report that was contained in EBS/83/164. The Fund's management continued to believe that, as a rule, it was appropriate and important for the World Bank to give a full appraisal of the dominant project of a member country's development program and, preferably, of the entire program. However, in the case of Grenada, the Government strongly wished the Fund to approve an extended arrangement and the World Bank was not in a position to provide the substantive evaluation that the Fund had requested, despite the urging of the Fund's management.

The issue at hand, the Acting Chairman continued, was whether the Fund should act in such a way that the World Bank, having chosen not to be sufficiently active in Grenada to be able to provide the desired appraisal of the development program, was nonetheless in a position in effect to veto the approval of an extended arrangement for the country. Such an outcome would be going too far. Management had not changed the views on the Grenadian economy that it had put to the Executive Board and the authorities two and a half years previously (EBM/81/79, 5/11/81), but it was important to take into account events as they evolved. Refusing Grenada's request for an extended arrangement solely on the ground that the World Bank had been unable--as a result of its own decision to be inactive in the country--to provide the requested appraisal, would place the Fund in a difficult and awkward position vis-à-vis Grenada.

Mr. Casey stated that he agreed with the Acting Chairman. The World Bank's operational rules were different from the Fund's. For instance, the World Bank usually did not become directly involved in smaller countries; it tended to deal with them through the regional development bank concerned.

Commenting on the request for a waiver of the four-week rule on the distribution of staff reports that were to be discussed by the Executive Board, Mr. Casey said that the Government had waited patiently for three years for the Fund to consider an extended arrangement for Grenada. The country faced a liquidity problem, and the sooner it was able to make the first drawing under the extended arrangement, the better. In that connection, he agreed with Mr. Kafka that, in the future, the Treasurer's

Department might consider shortening the period between Board approval and the first purchase. In fact, that could be done at present in exceptional circumstances, but the definition of "exceptional" had not been clearly defined. Another reason for the request for a waiver was that the letter of intent had been agreed upon a long time ago but, at the last moment, the staff had insisted on adding a new paragraph (16), concerning the exchange rate and interest rate regimes. The authorities had not been unduly worried about the substance of paragraph 16, but they had not unnaturally suspected that with it the Fund was trying yet again to change the rules of the game to prevent Grenada winning approval of an extended arrangement.

As a sort of quid pro quo--and indeed a very reasonable one--it was felt that the Executive Board should discuss the proposed arrangement on the present date, without further delay, Mr. Casey went on. The Executive Directors had in fact been given 15 days of what Mr. Péroz had described as "good quality" time to consider the staff reports, considerably more notice than they had had for some of the recent requests by the larger Latin American countries, Romania, or Yugoslavia. In any event, approximately 70 percent of previous discussions had broken the four-week rule, which was more honored in the breach than the observance. The fact that some staff were not available to answer technical questions before the Board meeting was not the fault of the staff, who were under severe pressure. In fact, the staff representative from the Western Hemisphere Department had had to return on an early flight from another country to be present at the Board meeting.

There had apparently been some misunderstanding of the second appendix of his opening statement (EBM/83/121), Mr. Casey said. The gist of his argument was that, in cases like that of Grenada, in which the burden of adjustment fell almost exclusively on the fiscal side, adjustment could be much more economically and politically difficult than in cases in which it was spread over a wide number of policy instruments. In addition, it was of course inappropriate to tell a country that had no external arrears that it would qualify for an extended arrangement only after it had built up such arrears.

It was important, Mr. Casey continued, to recognize more fully the adjustments that were to be made under the proposed program. Few countries could achieve a current budget surplus as high as 6 percent of GDP. Such adjustment had nothing to do with the completion of the airport, which involved capital, not current, expenditure. Moreover, nonconcessional government financing would be completely eliminated. The Fund resources that were to be provided under the extended arrangement would be used largely to build up the reserves of the banking system--an ideal use of Fund resources--and not for development. The limit on wage growth of 5.5 percent a year constituted a strong adjustment by comparison with previous wage developments in Grenada, and by comparison with other countries.

As for the external economy, Mr. Casey went on, the authorities were prepared to discuss the exchange rate and interest rate regimes in the context of the East Caribbean Regional Arrangements, and there was nothing more that they could reasonably be expected to do in that area at the present stage. The balance of payments adjustment was considerable, even excluding the effects of the airport: the current external deficit would fall from 33 percent of GDP to 16.5 percent if the airport was included, and from 26 percent of GDP to 16.5 percent without the airport.

In general, Mr. Casey commented, Grenada's adjustment program was similar to that of Dominica, which had recently been praised by the Executive Board, and he was therefore surprised by the criticism at the present meeting. It was also important to appreciate the authorities' commitment to the program. The technical delays concerning the letter of intent had occurred because the authorities wished to be absolutely certain of the commitments they were undertaking, and they could be counted on to adhere to the program as proposed. The program had, in a sense, been a product of three years of negotiation, during which the Fund had held fast to its orthodox approach and principles and the authorities had shown a large measure of flexibility and compromise.

The role that the private sector must play was clear in the mind of the authorities, Mr. Casey said. They wished to encourage a productive private sector, as the recently adopted investment code clearly indicated. The authorities in fact wanted to encourage a transfer of resources from less productive activities to more directly productive forms of activity within the private sector as a whole.

The question had been raised, Mr. Casey recalled, whether there had been any intention of converting the previous stand-by arrangement into an extended arrangement. When the most recent stand-by arrangement was approved in 1981, the authorities had been informed that, if a feasibility study of the airport was endorsed by the World Bank, the stand-by arrangement could be converted into an extended arrangement. That had not happened. But there had been no presumption that in the future Grenada would be automatically entitled to an extended arrangement. Indeed, the staff and management had been quite tough-minded during the negotiations.

There was no certainty that an increase in deposit interest rates would bolster private savings, Mr. Casey remarked. The effect of such adjustments in small developing countries was still being debated. Moreover, in small island economies local commercial banks were usually foreign-owned, thus making it difficult for the authorities to determine interest rates and interest rate spreads that would affect the profitability of the banks. In addition, a unilateral increase in interest rates within a currency region would tend to attract capital from the other members of the currency union and could prompt them to introduce exchange controls.

In retrospect, Mr. Casey commented, the issue of the airport seemed to have been exaggerated. Nearly 80 percent of the airport had been completed, and most of the money for it had been earmarked for that purpose, so that no opportunity cost had been involved; indeed, the argument that a feasibility study, including cost-benefit analysis, would have been useful, was meaningless. In any event, the new airport was essential if Grenada was to reach the take-off stage of development. The existing airport was a substantial bottleneck to the achievement of sustainable economic growth and medium-term balance of payments viability.

The question had been raised, Mr. Casey said, whether the current external deficit would be sustainable at the end of the period of the proposed extended arrangement. The deficit would still be fairly large, approximately 16 percent of GDP, but it would be much smaller than the deficit at the beginning of the period, which was equivalent to about 33 percent of GDP. In principle, of course, any current external deficit was sustainable if the inflow of capital was adequate. It seemed reasonable to conclude that Grenada could probably afford to run a fairly sizable current account deficit in the medium term as long as concessional aid was available and, more important, if imports were used to increase the country's export capacity. He was fully confident that Grenada's export capacity would be enhanced. The authorities' program strongly emphasized the need for directly productive and quick-yielding investments. At the same time, the reserves of the banking system were being built up, and the debt service ratio, which would peak at approximately 12 percent in 1985/86 and fall thereafter, was not expected to be a serious problem. The chances for achieving a sustainable balance of payments position sooner would probably be improved if Grenada had the option of exchange rate flexibility, but for obvious institutional reasons the authorities did not have the option at the present time.

There had been some criticism of the apparent lack of a clear delineation of Grenada's adjustment effort under the proposed program, Mr. Casey noted. In that connection, it was important to remember that the data base in Grenada, as in many developing countries, was poor. In any event, a great deal of detail in adjustment programs was probably not essential. No previous three-year program for other countries had included precise medium-term forecasts for every aspect of the economy. Moreover, there were to be regular reviews of Grenada's program, and the adjustment could be more sharply delineated over the course of the program period. The comments by the staff representatives and Mr. Kakfa on the medium-term framework of adjustment programs were very useful.

The fire in the Holiday Inn in Grenada did, in fact, have an important adverse effect on tourism, because the hotel accounted for one quarter of first-class hotel capacity, Mr. Casey explained. The restoration of the hotel had been delayed because the foreign owners had asked the Government for a much larger tax break than they had already enjoyed, and the matter had been the subject of negotiations. However, the main constraint on tourism was the lack of adequate air access. The projections for tourism in the staff report were not overly optimistic. After all, Grenada was extremely beautiful, and the unfavorable publicity that the island had been receiving had been receding. The cruise ship element of Grenada's total tourist revenues was small; it accounted for only about 10 percent of expenditure per visitor and was not a good indicator of trends in tourism.

The Acting Chairman made the following summing up:

Directors noted that the ambitious investment efforts undertaken by the Grenadian authorities had resulted in the emergence of significant financial imbalances affecting especially the government-owned commercial banks. Grenada's foreign debt and debt servicing were also rising, although they appeared to be still within manageable limits. In these circumstances, Directors urged that government policies should now stress the achievement of greater public sector savings, the containment of the growth of foreign debt on nonconcessional terms, and the rebuilding of the liquidity of the government-owned commercial banks. The projected decline in the overall fiscal deficit in 1983/84 was regarded by several Directors as inadequate, particularly after taking into account the reduction in investment outlays for the international airport, and Directors stressed that further significant efforts to strengthen domestic savings would be needed to sustain more rapid economic growth.

Directors welcomed recent steps taken by the authorities to encourage private investment, to foster private sector confidence, and to improve Grenada's attractiveness in the traditional tourist markets. The efforts of the authorities to strengthen and diversify Grenada's economic base were welcomed, although they were considered by a number of Directors to be inadequately specified, and it was strongly hoped that the World Bank would be more closely associated with the investment program. Several Directors expressed serious concern regarding the inability of the World Bank to provide a fuller and more detailed appraisal of the development program. The commitment of the authorities not to use nonaid financing in development projects during the Fund program period was noted.

Directors felt that wage restraint would be essential in order to secure the required improvement in the public finances and to preserve the competitiveness of Grenada's export sector, especially in the light of the substantial real appreciation over the past two years of the East Caribbean dollar. In this connection, it was noted that the Government's wage policy envisages a reduction in real wages, which appears to be clearly needed, particularly since Grenada is not in a position to use exchange rate policy actively. The continuation of negative real interest rates was criticized by Directors, who stressed the need to encourage private savings.

Directors noted that a joint review of exchange rates and interest rate policies in the East Caribbean Currency Area was desirable, and welcomed Grenada's intention to participate in such a review in the near future. The urgency of such a review was underscored by the medium-term balance of payments projections, which some Directors thought suggested that the external deficits would be unsustainable. Directors encouraged the Grenadian authorites to eliminate as soon as possible the multiple currency practice arising from the tax on purchases of foreign exchange.

Several Directors were strongly critical of the proposal to provide support for the program of Grenada under the extended Fund facility, since they considered that, despite the presence of some positive elements, the necessary structural elements were not adequately present and the extent of the adjustment was insufficient. A number of other Directors, however, were impressed with the efforts already made or being undertaken by Grenada and expressed their support for, or could go along with, the staff proposal.

Finally, the long interval since the last consultation was much regretted, and it is expected that the next Article IV consultation with Grenada will be held on the standard 12-month cycle.

The Executive Directors then turned to the proposed decision on the extended arrangement.

Mr. de Vries said that he had referred to the procedures concerning the consideration of staff reports by the Executive Board because he was worried that the case of Grenada would raise issues of general importance if it was brought to the agenda on the proposed date. The raising of the issues might have been avoided if the Executive Directors had had more time to discuss them privately. The main issue at hand was whether or not the Executive Board should approve the extended arrangement, thereby setting a precedent, or accommodate Grenada without setting a precedent.

The difficulties he had in accepting the proposed extended arrangement went beyond the situation in Grenada, Mr. de Vries continued. Access to Fund resources was determined by policy decisions and their application in particular cases. The case of Grenada involved taking a concrete decision on the basic policy on access to the Fund's resources; he had hoped to avoid debating that issue at the present stage, but it had become unavoidable, especially as the Executive Board was scheduled to discuss the policy on access and the Managing Director was seeking additional borrowed funds. Large refinancing operations were being requested for member countries, and the lenders would certainly wish to know how the loans were to be used. In the case of Grenada, the Executive Board was being asked to approve an extended arrangement under which "the adjustment is primarily in the field of financing," as the staff had concluded. In other words, the adjustment involved primarily a substitution of Fund financing for other financing. There were in effect only three operative performance criteria--apart from review clauses--and they all had to do with financing, namely, ceilings on the flow of nonconcessional resources, the use of foreign grants and concessionary loans, and the net foreign assets of the two foreign-owned commercial banks. Approving an extended arrangement under which the structural adjustment would, at best, be very weak, would set a most unfortunate precedent, thereby adding fuel to the fire of those who wished to restrict the Fund's operations.

Moreover, Mr. de Vries went on, the Executive Board was being asked to approve an extended arrangement that had a large investment component--equivalent to about one fourth of GDP--without a favorable review of the investment program by the World Bank. On a previous occasion, the Managing Director had stated that "the Board has clearly indicated on a number of occasions that the Fund should not engage in an extended arrangement with a member when there was an investment program without having an indication from the World Bank that the thrust of the investment program is appropriate." That statement was applicable even when Grenada's airport project was not taken into account. Indeed, he had never made an issue of that particular project. If Grenada's adjustment program was noncontroversial, he would fully agree with the Acting Chairman that the Fund should not refuse the country's request solely because the World Bank had not expressed its opinion on the development program. In fact, however, he harbored serious doubts about the adjustment that would be made under the program, and receiving the World Bank's opinion would be appropriate. Similarly, he fully agreed with the Acting Chairman that, if the Executive Directors had no serious doubts about the adjustment effort, the World Bank should not in effect be given a veto over the approval of the extended arrangement.

He wished to amend the proposed decision on the extended arrangement, and to do so in the way that would be the least painful to Grenada, Mr. de Vries remarked. The second paragraph should be amended to provide that, while Grenada would receive in the coming year the same volume of resources that had been proposed for the first year of the extended arrangement, the Fund would specifically refrain from committing itself in any way with respect to the subsequent two years. The World Bank staff was expected to visit Grenada in the near future, and a favorable opinion of the development program might be available within the year. Moreover, the exchange rate had become far out of line and the currency union planned to discuss it fairly shortly; hence, that matter too might be resolved in the coming 12 months.

Mr. Malhotra observed that, under Mr. de Vries's amendment, the Executive Board would approve a one-year stand-by arrangement, rather than an extended arrangement. Mr. Casey had clearly stated that the Grenadian authorities were interested in an extended arrangement and not a one-year arrangement. Deciding at the present stage to accept a one-year stand-by arrangement rather than the extended arrangement that had been negotiated by the staff after lengthy discussion and approved by management would thus be tantamount to rejecting the proposal altogether and would set an unfortunate precedent. He could not, therefore, accept Mr. de Vries's amendment.

Mr. Grosche stated that Mr. de Vries's amendment was acceptable.

Mr. Taylor commented that he preferred a one-year stand-by arrangement for Grenada. A number of the program objectives were admirable and several commendable measures had been adopted, thereby warranting a degree of appropriate financial support from the Fund. Nevertheless, despite the staff replies, he remained unconvinced that the requirements for an extended arrangement set out in the 1974 decision on the extended Fund facility had been broadly met. The inability of the World Bank to provide the substantive approval that the Fund had clearly and consistently stated was necessary--and not merely desirable or helpful--was an important factor. It was not in itself the decisive factor, but it seemed to be an indication of the lack of confidence among experts in Grenada's development policy, although there had been no precise explanation of the reasons why the World Bank had not reviewed Grenada's development program. In accepting Mr. de Vries' s approach, he wished to make every possible effort to avoid giving the authorities the impression that the Executive Board was making an example of Grenada. A reasonable solution was to offer Grenada a compromise that went some of the way toward meeting the country's wishes.

Mr. Alfidja considered that the staff could usefully produce a paper on the practice of relying on the World Bank's assessment of member countries' development programs. Three countries in his constituency had been adversely affected by the practice. The Grenadian authorities had engaged in lengthy negotiations with the staff and had apparently already agreed on a compromise in the form of the proposed arrangement. It seemed inappropriate to make the authorities accept yet another compromise, in the form of another one-year stand-by arrangement; in any event, as Mr. Casey had stated, the authorities did not wish to have such an arrangement. The Fund should not be obliged to act in all cases in accordance with the World Bank's judgment. An extended arrangement for Grenada was warranted, and the proposed amendment of the draft decision should not be accepted.

Mr. Casey said that he wished it to be clearly understood that his Grenadian authorities would not accept the kind of compromise that had been proposed by Mr. de Vries; consequently, he could see little point in considering such a proposal. The proposed program provided for sufficient adjustment and regular reviews. There was no need to be overly concerned about the medium-term adjustment effort. Finally, he doubted whether the World Bank had fully endorsed the recently approved programs for Brazil, Mexico, and the Dominican Republic.

Mr. Erb stated that he could go along with Mr. de Vries's proposal. The issue raised by the present case was whether the proposed program met the criteria specified in the decision on the extended Fund facility. He had abstained from approving or had opposed several programs that had raised the same issue in the past.

During the discussion on the progam for the second year of Dominica's extended arrangement (EBM/81/117, 8/28/81), Mr. Erb continued, he had said that "as we have stated during previous discussions of this program, this chair continues to believe that Dominica's balance of payments financing needs are more appropriately met by long-term financing." His position on such programs had been increasingly firm. Given the demands that were being made on the Fund's resources, and in the light of his view on the financing role of the Fund, he had difficulty in supporting the kind of program that Grenada had put forward, which raised questions of the Fund's priorities and objectives with respect to the use of its resources. Even if the limits on access to Fund resources were reduced, the projected borrowing requirement of the Fund was large. Priorities must be set in the field of structural adjustment financing, so that the Fund committed its resources under programs that clearly provided for structural adjustment and fitted the Fund's mandate.

Mr. Suraisry considered that Grenada should be given the benefit of the doubt. Accepting the proposed amendment would set an unfortunate precedent, and the draft decision should be accepted as it stood. After all, Grenada was clearly not interested in a one-year arrangement.

Mr. Agah commented that, in the light of the recent treatment of several other Latin American countries, the proposed amendment probably violated the principle of equal treatment of members. Grenada was either entitled to the proposed arrangement, or it was not. The draft decision should be adopted with no amendments.

Mr. Péroz stated that, in the light of the comments by Mr. Casey and the staff representatives, he was fully convinced of the merits of Grenada's case and could accept the proposed decision as it stood. The kind of amendment that Mr. de Vries had proposed should not be approved.

Mr. Mtei said that he continued to agree with the staff appraisal. The Fund should support Grenada in its efforts to restructure its economy. In the past, the Executive Board had approved programs of countries that had undertaken large viable development projects that had not been fully supported by the World Bank. Mr. de Vries's amendment was not helpful. Structural adjustment in Grenada was much more likely to occur under a long-term arrangement than under a short-term one.

Mr. Gomel remarked that, although he had some misgivings about certain details of the proposed program, the staff had made a strong case in favor of the proposed extended arrangement. The review clauses and other performance criteria were satisfactory, and the decision, as drafted, was acceptable.

Mr. Kafka said that he continued to support the proposed program; he did not accept Mr. de Vries's proposal, the approval of which would establish an unfortunate precedent. The proposed program provided for a considerable amount of structural adjustment, and, in any event, the Fund was amply protected by the review clauses. Finally, the parallel that Mr. Casey had drawn between various members was not convincing. The Dominican Republic had been in a borrowing relationship with the World Bank and IDA for some time, and the World Bank was reviewing the economy and a medium-term investment program was expected to emerge soon; it was not the Dominican Republic's fault that the review had not proceeded more rapidly. As for Brazil, it was one of the largest World Bank borrowers, a fact that clearly constituted an endorsement of its development policies.

Mr. Schneider remarked that he too had harbored some doubt whether the proposed program was fully consistent with the provisions in the decision on the extended Fund facility. However, in the light of the remarks by Mr. Casey, the staff representatives and the Acting Chairman on the position of the World Bank, and even though some of his doubts remained, he could, with some reluctance, accept the decision as drafted.

Mr. Morrell stated that the proposed decision was acceptable. The present occasion was not the appropriate one at which to determine the Fund's enlarged access policy. The period covered by the current policy was drawing to a close, and the Fund's borrowing program was based on a number of large arrangements. It was highly unlikely that the Managing Director's efforts to raise additional funds would be undermined by the approval of an SDR 13 million arrangement for Grenada. It appeared that Grenada had been made to suffer for its smallness and lack of significance in the international financial system. Although there were some reservations about the extent of the adjustment under the proposed program, approval of the extended arrangement would increase the pressure on the authorities to introduce the needed measures. Hence, approval of the proposed program seemed to be a positive and necessary step.

Mr. Donoso said that he too approved the proposed decision. Changing the proposed decision in the way that Mr. de Vries had suggested would reduce the staff's ability to negotiate successfully with member governments, and would set an unfavorable precedent.

Mr. Ismael stated that, in the light of the arguments that had been presented by the Acting Chairman, Mr. Casey and the staff representatives, he accepted the draft decision.

Mr. Finaish said that the decision as drafted was acceptable. Some of the general issues that had been raised during the discussion were important, and particularly the question of collaboration with the World Bank. He himself had raised similar questions in the past during discussions on one of his countries, and he agreed that they should be clarified in the future.

Mr. Juusela commented that, although the staff projections had caused him to worry about some aspects of Grenada's economy, the proposed decision was acceptable.

Mr. Yamashita remarked that, while he had no strong position on Grenada's request, he shared many of the concerns that had been expressed by previous speakers. He was inclined to support the proposal for a one-year stand-by arrangement for Grenada but, given the full discussion on Grenada's situation, and in a spirit of compromise, he could go along with the majority view.

The Acting Chairman said that a majority of Executive Directors appeared to support the draft decision as it stood. In summing up the discussion on Fund collaboration with the World Bank in assisting member countries (EBM/81/62, 4/20/81) the Managing Director had made the following statement:

> Obviously, the World Bank should make clear its views on this program...[one in which the supply-side program is likely to affect the overall investment policy.] For example, in some cases, the World Bank might not have made a detailed examination of the investment program of the country in question. Perhaps, in such a case, it might be sufficient to rely on a clear, written indication by the World Bank that, in its view, the general thrust of the program is appropriate. Thus the Fund would not delay entering into an extended arrangement while waiting for a detailed Bank study on the exact contents of the total investment program. This is a question of judgment, which we will, of course, in every case bring to the Executive Board.

Judgments could of course differ on the extent to which the Fund should insist upon obtaining the World Bank's final assessment of all the aspects of an investment program.

Continuing, the Acting Chairman commented that Executive Directors who still harbored doubts about the proposed arrangement might take some comfort from the statement in paragraph 4(c) of the extended arrangement: "Grenada will not make purchases under this arrangement after January 31, 1984, until the review contemplated in paragraph 17 of the attached letter dated August 9, 1983 has been completed or understandings reached under this review are being observed." Paragraph 17 stated that "the Government of Grenada will also review with the Fund by January 31, 1984 the progress made in implementing the fiscal program in Table 2." The fiscal program in Table 2 was a rather detailed elaboration of the main fiscal accounts of the country. Executive Directors' comments during the present discussion would of course be taken fully into account during the review scheduled for end-January 1984. Although the exchange rate would not necessarily be one of the matters covered by the review, a very broad area of policy would be dealt with.

The Executive Board then took the following decisions:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision relating to Grenada's exchange measures subject to Article VIII, Section 3, and in concluding the 1983 Article XIV consultation with Grenada, in the light of the 1983 Article IV consultation with Grenada conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Grenada applies a tax of 5 percent on most purchases of foreign exchange, which gives rise to a multiple currency practice. In view of the circumstances of Grenada, the Fund approves the retention by Grenada of the multiple practice resulting from the tax on foreign exchange purchases until July 31, 1984, or the completion of the next Article IV consultation, whichever is earlier.

Decision No. 7498-(83/122), adopted
August 24, 1983

Extended Arrangement

1. The Government of Grenada has requested an extended arrangement for a period of three years from August 24, 1983 in an amount equivalent to SDR 13.5 million.

2. The Fund approves the extended arrangement set forth in EBS/83/164, Supplement 1 (8/25/83).

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

Decision No. 7499-(83/122), adopted
August 24, 1983

Mr. Alfidja remarked that it was his understanding that the staffs of the Fund and the World Bank occasionally held informal meetings to discuss ways of improving the collaboration between the two institutions. He wondered whether a record of the discussions was kept. In any event, it was important to keep in mind possible ways of improving the collaboration.

The Acting Chairman replied that retreats for the purpose that Mr. Alfidja had mentioned had occasionally been held. The most recent one had involved staff working on African member countries. The discussions had been candid and wide-ranging, and both the Fund and the World Bank staff participants had found them useful. No formal records of the discussions had been kept. It was possible that, in the future, collaboration between the Fund and the World Bank as it related to specific country programs could be dealt with, to the extent necessary and appropriate, in staff reports.

The Deputy Director of the Exchange and Trade Relations Department added that most staff reports, including those on operational matters, routinely included some indication, including tabular material, of the state of collaboration between the Fund and the World Bank. As to the informal discussions between the staffs of the Fund and the Bank, their usefulness might be undermined if a detailed account was required.

The Executive Directors concluded their discussion on Grenada.

2. SOMALIA - STAND-BY ARRANGEMENT - REVIEW

The Executive Directors considered the staff report for the review of the stand-by arrangement with Somalia (EBS/83/154, 7/27/83; and Sup. 1, 8/23/83).

Mr. Finaish made the following statement:

> In a review of Somalia's recent economic performance, two features that stand out prominently are the strong political will and the high degree of flexibility displayed by the authorities in dealing with a difficult set of adjustment problems--made more serious by several adverse exogenous developments--in one of the least developed regions of the world. The severe drought of 1974-75, the outbreak of regional hostilities of 1977-78 followed by a massive inflow of refugees, and the severance in 1978 of financial and technical assistance from a major source were all factors contributing to a further limiting of policy maneuverability in an already resource-constrained economy. Nevertheless, faced with a virtual stagnation of domestic economic activity and mounting financial imbalances, the Somali authorities, helped by a series of Fund-assisted programs, have been able to implement a wide range of corrective measures during the last three years, both for demand management and for structural adjustment. The improvement in the country's economic performance over this period, in the face of a deteriorating international environment, is largely attributable to these measures and the continued adherence to Fund adjustment programs is reflective of the authorities' enduring approach to economic adjustment.
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> The first of the stand-by arrangements with the Fund, the program for the calendar year 1980, mainly emphasized restrained demand mangement in order to ease the growing financial imbalances. The 1981-82 one-year program that followed combined policies of financial restraint with structural measures in order to enhance domestic production, curb inflation, and move toward a sustainable external position. While further tightening the fiscal and and monetary policies, the availability of credit to the private sector was increased, domestic interest rates were raised, and some new taxes were introduced alongside improvements in tax

collection procedures. Other important measures comprised a 50 percent devaluation, abolition of the issuance of licenses for own exchange imports, substantial increases in producer prices of most agricultural products, improvements in the performance of public enterprises and strengthening of the development planning process.

The program, though considered ambitious by many Directors at its inception, was fully implemented; economic performance turned out to be better than envisaged and all Fund performance criteria were observed. More specifically, the fiscal deficit was substantially narrowed, private sector credit was appreciably increased, the rate of inflation was significantly reduced, and the external position was improved beyond that projected.

While consolidating gains from earlier stabilization measures, the 18-month stand-by arrangement which started in mid-1982 aimed at making further important advances toward the achievement of stable longer-term growth. At the outset of the arrangement important financial and structural measures were implemented, including the unification of the dual exchange rate, a shift to an SDR peg, an additional substantial devaluation of the Somali shilling, and an upward revision of the interest rate structure. At the same time, measures were adopted to liberalize imports further, to advance the process of liberalization of marketing and pricing policies and to improve the efficiency of public enterprises. These measures, supplemented by tight monetary and fiscal policies, contributed to achieving by the end of 1982 an estimated annual growth rate of 10 percent, nearly halving the rate of inflation and turning the current account around--from deficit to surplus. Consequently, the 1982 part of the program was successful, meeting all performance criteria through end-December 1982 and the requirements of the first semiannual review.

The stabilization program has been continued into 1983, again quite effectively. All quantitative performance criteria through end-June 1983 have been observed and the program appears on track. The consumer price index rose by only 4.7 percent in the first quarter of 1983 compared with 11 percent in the first quarter of the previous year. At the end of March 1983 the current account showed a surplus, no external payments arrears were outstanding, and no new nonconcessional debt had been negotiated. Domestic credit expanded by 2 percent during the first quarter of 1983, compared with 7 percent during the first quarter of 1982. In consonance with policy objectives, however, private sector credit increased significantly, accounting for 32 percent of total domestic credit compared with only 13 percent at the end of March 1982. Latest estimates show that these trends in the growth of credit have continued into the second quarter of 1983.

The authorities continue to follow a policy of expenditure restraint, including the maintenance of limits on public sector wages and hiring. As a result of the austerity measures and the continuing efforts to streamline the structure of taxation, the overall fiscal deficit is expected to be reduced to 16.7 percent of total expenditures in 1983 from 28.9 percent in 1982, with revenue projected to increase by 21 percent. The authorities have also implemented some recommendations of the 1980 IMF tax survey. On January 1, 1983, specific excises were converted to an ad valorem basis. In addition, a general sales tax at the rate of 5 percent has recently been levied on the value of most wholesale and import transactions and the retail sales of public enterprises, the exceptions being essential commodities. Furthermore, revenue loss from underinvoicing of livestock exports will be checked by an increase in minimum export prices by November 1983.

Efforts to improve the economic performance of public enterprises are being continued. Some financially unviable enterprises have already been closed while viability of others is being carefully scrutinized by an Inter-Ministerial Commission, whose report is expected later this eyar. Meanwhile, some steps to promote private sector activity have been taken; namely, the sale of the majority share of the National Banana Board to the public, the change in the previous monopsonistic role of the Agricultural Development Corporation to that of a price stabilization board only, and a movement away from a government monopoly on imports.

Sparked off by the continuing border conflict, capital outflows financed by private remittances outside the banking system reached significant levels by the end of 1982. The authorities, to encourage the inflow of remittances through the banking system, instituted in January 1983 a bonus scheme providing a 25 percent premium (measured in dollars) above the official exchange rate for all amounts remitted by Somali nationals abroad. In addition, the participants of the bonus scheme were given priority in the granting of import licenses. At the same time, external accounts denominated in dollars were further liberalized, opening their use to a wider group of traders, removing ceilings on the amounts deposited, raising the rate of interest to internationally competitive levels, and allowing the use of these accounts for import purposes. From early indications it seems that of the two schemes, the latter has been relatively more successful. Principal reasons for the lack of success of the exchange premium have been identified as (a) the increased attractiveness of the external accounts, (b) the administrative limitations of commercial banks, and (c) the continuing border conflict. Expected capital outflow is expected to decline by 25 percent this year. Further gains in this direction are expected from the review of the commercial bank operations that has recently been initiated and from the granting of permission with effect from July 1, 1983 to foreign banks to open branches in Somalia. Additionally, as an aid to stabilizing the real effective exchange rate, a managed float based on the peg to the SDR adjusted for relative price developments has been adopted. The new exchange rate policy could also be helpful in maintaining Somalia's competitiveness in the world.

As noted by the staff, owing to an unforeseen external development, Somalia's principal export, livestock, has recently suffered a setback. While the authorities have been taking steps to deal with the situation, they have approached the Fund for a possible drawing under the compensatory financing facility.

In recent months, the authorities have made substantial progress in preparing, in collaboration with the Fund and the World Bank, a medium-term recovery plan for stable longer-term growth. The plan includes a public investment program for 1984-86 which is consistent with an underlying macroeconomic framework and an overall policy action program to improve long-term domestic resource mobilization, allocation, and utilization. The plan will seek over the envisaged three-year horizon to increase domestic commodity production, particularly in agricultural export-oriented sectors, and to maximize returns on given resources by concentrating on quick-yielding high-return projects. However, as noted by the staff, the implementation of the plan would require a substantial increase in external financing. In collaboration with the Fund and the Bank the document for this plan is expected to be completed in time for the Consultative Group meeting to be held this October.

In conclusion, despite extreme domestic poverty, a continuing regional conflict and an extended worldwide recession, the Somali authorities have been able to widen, much beyond initial expectations, the scope of their adjustment efforts. Far-reaching demand management and structural reform measures have been implemented at a rapid rate in a relatively short period of time. It is worthy of note that the implementation of such an extensive policy package is normally accomplished within a framework of a longer-term program, which affords the suthorities concerned with continuity of finance and policy formulation over an extended planning horizon. The short-term programs have, however, been beneficial in their contribution to the development of Somali confidence and skills in economic management and in their demonstration of the authorities' ability to implement successfully wide-ranging adjustment programs. The authorities' serious commitment to adjustment has consistently been praised by both the Board and the staff. As mentioned earlier, in cooperation with the Fund and the Bank, attention is now being focused on the longer term. In this connection, useful discussions have taken place recently between the authorities and the Fund staff on the elements of an extended facility for 1984-86, which it is hoped will finally provide the Somalis with an arrangement that matches their efforts.

Mr. Suraisry said that the adjustment policies that the authorities had been implementing since 1981 had yielded very encouraging results: economic growth had been stimulated; the rate of inflation had slowed considerably; and the external payments position had improved significantly. The authorities were to be commended on their achievements, and they should be encouraged to maintain their adjustment efforts. The performance under the stand-by arrangement was satisfactory, and he wished to concentrate his remarks on the exchange rate policy and the public sector investment program.

Commenting on the exchange rate, Mr. Suraisry noted that since July 1, 1983 the authorities had maintained the interesting and novel policy of pegging the Somali shilling to the real SDR. However, the limited availability of price indices in Somalia made it difficult to compute the desired magnitude of changes in the exchange rate. The consumer price indices were probably not the best indicators of price and cost developments in Somalia and the SDR currency basket countries. In Somalia, the only available price index was the one for the capital city which, as the staff had shown, probably did not accurately reflect consumer price changes throughout the country. It was therefore important to exercise caution in deciding on exchange rate adjustments on the basis of changes in consumer prices, and the flexibility that was provided by the wide margins around the real SDR was welcome. Despite the difficulties, it might be worthwhile examining whether the trade-weighted index of the real effective exchange rate could be approximated by the real SDR in other countries. The real SDR peg could conceivably be used in some cases to help maintain a flexible exchange rate policy.

The significant progress that had been made by the authorities and the World Bank on the preparation of an investment program that was consistent with the country's resource availability was encouraging, Mr. Suraisry remarked. The authorities were collaborating closely with the World Bank and the Fund in preparation for the coming Consultative Group meeting on Somalia.

Somalia had demonstrated that it could effectively implement Fund-supported adjustment programs, Mr. Suraisry commented. If the authorities adopted a realistic, sound investment program for 1984-86 within the framework of economic and financial stability, as he believed they would, they would deserve the support of the Fund in the form of an extended arrangement.

Mr. Lovato said that he agreed with the staff appraisal and accepted the proposed decision. The authorities had met all the quantitative performance criteria; their supply- and demand-oriented measures, including tight fiscal and monetary policies, had reduced the public sector deficit, the public sector credit requirement, and the rate of inflation, and had improved the external current account position while stimulating economic growth. The authorities' success in keeping the budget operations under control to a large extent, despite the pressures caused by the conflict with a neighboring country, was remarkable. The Government had already made an effort to shift the bulk of economic activity toward the private sector in order to increase efficiency. The authorities had a record that constituted a rare case of excellent performance, and they were clearly determined to implement additional major measures and to tighten further their financial policies. Their intention of opening the economy to branches of foreign banks and their general efforts to improve the efficiency of the banking system were commendable.

Somalia's more flexible exchange rate and interest rate policies, Mr. Lovato continued, and its efforts to improve the productivity of the public enterprises and to close nonviable ones should help to establish the foundations for accelerating the adjustment process. The emphasis being placed on promoting economic growth and on further reducing the rate of inflation in the remainder of 1983 was appropriate, but he hoped that the stress on growth would result in increased investment and exports rather than in greater domestic consumption.

The restructuring of the economy and the implementation of the investment program should be given high priority, Mr. Lovato considered. The three-year public investment program, which was aimed at channeling available resources into development activities, increasing exports and replacing imports, was commendable. The Government's emphasis on the development of the agricultural sector was welcome.

Given the results that the authorities had already achieved and their determination to maintain the adjustment effort, Mr. Lovato said, the possibility of an extended arrangement for Somalia should be explored. In that connection, their progress toward a medium-term recovery program for 1984-86 was welcome. Nevertheless, despite the support that the authorities had received from international institutions, the unfinanced gap was still relatively large, and the full implementation of the program would depend upon the generosity of donor countries.

Mr. Erb stated that he broadly agreed with the staff appraisal and accepted the proposed decision. The authorities were to be commended for their continued perseverance in implementing the adjustment program during the first half of 1983. The additional policy measures that had been taken in mid-1983 were welcome and were further evidence of the authorities' commitment to making the reforms needed to strengthen the economy. The rate of inflation had slowed, the balance of payments position was stronger than had been expected, and economic activity had continued to expand.

The authorities' decision to maintain the tight fiscal policy stance through the rest of 1983 was appropriate, Mr. Erb considered. He hoped that their efforts would result in a sharp reduction in the ratio of the fiscal deficit to total expenditure to 16.7 percent in 1983. To that end, control over expenditures would have to be strengthened.

Monetary policy seemed broadly appropriate, Mr. Erb continued. The authorities had wisely decided to continue to channel credit to the private sector. Given the inflationary trend in Somalia, the interest rate structure seemed appropriate, but the need to keep the rates--including those on external accounts--under review should be stressed. He agreed with the staff that the planned reform of the commercial banking system was a positive development. There was considerable potential for strengthening the financial system as a result of the decision authorizing foreign banks to open branches and of the plan to improve the efficiency of the existing commercial bank.

The managed float based on the peg to the SDR was appropriate, Mr. Erb commented, but it should be kept under continuous review. The link to the SDR should make it easier for the authorities to devalue the shilling while avoiding the recurrence of the large disruptive currency adjustments of the past. During the discussion on the 1982 Article IV consultation with Somalia, he had expressed his concern about the loss of foreign exchange resulting from the practice of underinvoicing livestock exports, and the authorities' decision to begin increasing the minimum export prices for livestock was welcome. They had had limited success in stemming the large volume of private capital outflows, which had begun in 1982; in particular, the bonus scheme, which constituted a multiple currency practice, had had only a marginal effect on capital inflows. Did the staff feel that the scheme was appropriate for the coming period?

During the previous discussion on Somalia, Mr. Erb recalled, he had expressed his concern about the projected increase in the debt service ratio from 12 percent in 1982 to 31 percent in 1983. The authorities had subsequently received debt relief, but it constituted merely a temporary solution to Somalia's debt problem, and it would be useful to have the staff's view on Somalia's export potential over the medium term and on its ability to achieve a sustainable debt service ratio. The staff has assumed that exports of goods and services would rise at an annual rate of 13 percent in the period 1984-87. Were the assumptions underlying that projection consistent with the analysis of the medium-term recovery? In which areas of macroeconomic policy would further adjustments be required in order to achieve a sustainable balance of payments position in the medium term?

It would be critically important, Mr. Erb considered, for the authorities to formulate an appropriate medium-term adjustment strategy that could be endorsed by the World Bank. Over time the World Bank and other sources of development finance should replace the Fund as the major source of financing. As he understood it, there had recently been slippages in the completion of a medium-term program for presentation at the Consultative Group meeting of donor countries. He wondered whether the staff had any additional information on the plans for convening the Consultative Group and on the status of the preparatory work.

Mr. Grosche commented that Somalia's record under the stand-by arrangement continued to be good. All the performance criteria had been observed, and the program as a whole seemed to be on track. He agreed with the staff appraisal and accepted the proposed decision.

The Government had made considerable progress in stabilizing the economy, Mr. Grosche remarked. Favorable weather conditions and foreign financial assistance had clearly helped, but an even more important factor had been the strong determination of the authorities to implement corrective measures.

Despite the favorable developments with respect to economic growth and the government finances, Mr. Grosche noted, the balance of payments was far from sustainable and continued to be a cause for concern. The conflict between the objective of raising the very low per capita income through the substantial investment program and the wish to reduce the balance of payments constraints could not be resolved easily. The evaluation of the three-year investment program had apparently been improved, but the authorities should have a list of priority projects in the event that economic developments were less positive than expected. The planned investment program would have a considerable effect on the debt service ratio. The substantial debt relief in 1983 had reduced the ratio from 36 percent to 18 percent, but it was expected to increase significantly in the coming five years. That expectation was particularly worrying because the projected rate of increase in exports--13 percent a year--seemed overoptimistic.

Somalia would continue to require substantial concessional foreign assistance to meet its medium-term economic objectives, Mr. Grosche said, and the question naturally arose as to the extent to which the Fund should participate in its financing. As a general rule, his authorities did not favor continued Fund financing of a country's development effort. They preferred to see the Fund play a catalytic and policy-coordinating role. In that connection, the role that the Fund and the World Bank had played in the preparation of the medium-term recovery program was welcome.

Mr. Mtei stated that he agreed with the staff appraisal and accepted the proposed decision. There had been a considerable increase in economic growth in 1982 and 1983, partly because of favorable weather conditions and partly because of the authorities' determination to implement strong and consistent adjustment measures. Their close cooperation with the Fund, other international institutions, and bilateral agencies had helped to improve the economic situation: the internal finances had become more balanced; the government fiscal deficit had been considerably reduced; the rate of inflation had fallen; and domestic credit expansion had decelerated and had been redirected from the government sector to the productive sectors. As a result, a sustainable trend of improvement had been recorded in the external position.

The staff's assessment of the medium-term prospects were a cause for concern, Mr. Mtei commented. In the absence of an increase in foreign assistance, per capita income would be bound to stagnate or decline over time if the balance of payments position was to be sustainable. He hoped that the participants in the coming Consultative Group meeting on Somalia would be able to offer sufficient assistance to ensure that the medium-term and long-term external positions would be viable.

The impressive exchange rate arrangements that had become effective on July 1, 1983, Mr. Mtei considered, were designed to avoid both a gradual overvaluation of the Somali shilling and the need for large exchange rate changes in the future. The new system was relatively simple and should be easy to operate. The success of the peg to the real SDR would be watched with great interest, as it might be suitable for the stabilization programs of many developing countries, particularly in Africa. Finally, it would be useful to have a further comment on the reasons why the bonus scheme for workers' remittances had not been as successful as the authorities had hoped.

Mr. Ramtoolah said that the proposed decision was acceptable. Somalia had faced serious problems due to the severe droughts in 1974-75, 1979, and 1980. The Government had responded by undertaking an important adjustment program, supported by two successive stand-by arrangements in July 1981 and July 1982, primarily to stimulate domestic production, slow the rate of inflation, and achieve a sustainable external position.

Impressive gains had already been made in various areas, Mr. Ramtoolah continued. Livestock raising--the main source of foreign exchange--had recently recovered. Production of bananas--the most important cash crop and the second largest export commodity--had fallen in 1980-81 but had risen sharply in 1982 following two devaluations and improvements in marketing and shipping facilities. As a result, real GDP was estimated to have grown by 5 percent in 1981 and some 10 percent in 1982, compared with just 2 percent in 1980 and a negative rate of growth in 1979. Moreover, the rate of inflation had fallen considerably; it was estimated at approximately 12 percent for 1983, compared with 59 percent in 1980.

The overall government deficit had decreased considerably in the program period, Mr. Ramtoolah noted. Total revenues had risen rapidly in 1981 as a result of increases in import duties and excise taxes, and expenditure control had been tightened. The restrictive fiscal stance had been maintained in 1982, and the government deficit had fallen further. The authorities had also introduced a very tight monetary policy that had caused a considerable decline in net domestic credit in the period 1980-83.

In the external sector, Mr. Ramtoolah remarked, the 50 percent devaluation in 1981 had been followed by a significant further adjustment in 1982 in order to restore competitiveness, and the current account had apparently responded favorably. According to the latest estimates, a small current account surplus was expected in 1983, compared with the substantial deficit--$75 million, excluding grants and loans--recorded in 1980.

Somalia had no external payments arrears outstanding at end-1982, Mr. Ramtoolah observed, and most of its debt was on concessional terms. The debt service ratio had increased substantially in 1981, and although it had fallen in 1982 as a result of rescheduling, the authorities should continue to monitor the debt situation very closely.

The adjustment effort had resulted in major structural changes in the economy, Mr. Ramtoolah commented. The role of the private sector was being considerably enhanced, and inefficient public enterprises were being weeded out. The share of nongovernment credit outstanding that was accounted for by the private sector had been increasing. The authorities, in consultation with the World Bank and the Fund, were wisely preparing a medium-term recovery program for 1984-86 that should go a long way toward consolidating the gains that had been made.

Because the external account for import purposes was draining significant amounts of foreign exchange instead of helping to attract foreign resources as originally intended, Mr. Ramtoolah commented, the authorities might wish to review it. In addition, it was not fully clear to him why the authorities had chosen to peg the Somali shilling to the real SDR. Apparently they intended to base adjustments of the exchange rate on consumer price developments in the countries whose currencies were included in the SDR basket. However, there was a wide disparity between the price indices of the five countries and the price index for Somalia, and he wondered whether the arrangement would not create distortions in the exchange rate for the Somali shilling. In any event, most of Somalia's trade was with Saudi Arabia and Italy.

Mr. Zhang stated that the proposed decision was acceptable.

Mr. Malhotra said that he agreed with the staff appraisal. The Government had shown its determination to achieve adjustment by taking steps in both the fiscal and monetary areas, which, together with certain favorable factors, had enabled it to increase the rate of economic growth. However, the debt service ratio was rather high. The recent rescheduling of the external debt was welcome, and he hoped that similar agreements could be reached in the coming several years to ease the country's debt service burden. Finally, the proposed decision was fully acceptable.

The staff representative from the African Department explained that the new exchange rate system was designed to avoid the gradual overvaluation of the Somali shilling, the resulting erosion of the profitability of export and import-competing activities, and the economic disruptions that could result from large step-wise devaluations. The authorities had sought a system that would keep constant the effective exchange rate, adjusted for the relative movements in prices between Somalia and its major trading partners. The staff had carried out a number of simulations for the authorities to determine the exchange rate that would result from pegs to the real import-weighted exchange rate, the real export-weighted effective exchange rate, and the real trade-weighted effective exchange rate. The staff had found that a peg to the real SDR closely approximated those baskets. The advantage of the peg to the real SDR over the other exchange rate arrangements was that it was simple to administer. The staff's simulations over a two-year period showed that the peg to the real SDR stabilized the trade-weighted real effective exchange rate with a standard deviation of less than 1 percent.

A number of speakers had noted the limitations on using the consumer price index for the capital city as the basis for the peg to the real SDR, the staff representative continued. The authorities and the staff recognized the limitations of using a price index that was applicable to only one area of the country. The index for Mogadiscio was relatively accurate, but it admittedly did not fully reflect price developments in the country as a whole. A Swedish team was in Somalia to help the authorities prepare an index for the whole country, and the expectation was that the new index would replace the present consumer price index as the basis for computing the peg to the real SDR. Meanwhile, in recognition of the limitations of the price index for the capital city, the authorities had adopted a relatively wide band--7.5 percent--around the fixed real SDR relationship, thereby permitting considerable flexibility in the movement of the exchange rate in response to developments in the balance of payments, reserves, and other variables. The wide band also enabled the authorities to avoid adjusting the exchange rate in the event of movements in the consumer price index that seemed to be merely temporary.

Commenting on the bonus scheme and the flow of capital, the staff representative said that the staff and the authorities believed that the capital outflow had been due to noneconomic factors, especially the political uncertainty caused by the border conflict. Nevertheless, the authorities had decided to adopt a number of measures to stem the outflow. The bonus scheme had not been effective mainly for two reasons: the first was the limitations of the banking system in Somalia. The commercial bank had not been able to handle with sufficient efficiency the necessary transactions; the parallel market had been able to carry them out more quickly and efficiently. The second was the broadened scope for external accounts. They had turned out to be a much more attractive alternative for people who wished to send remittances or capital into Somalia, as the external accounts could be used to import goods that could be sold in Somalia. The use of the accounts had initially been limited to livestock exporters, and their scope had been expanded only at the beginning of 1983. It was now expected that the accounts would generate imports of approximately $20-30 million, thereby limiting the capital outflow by roughly the same amount.

The authorities shared the staff's concern about the heavy debt service burden, the staff representative commented. They had succeeded in rescheduling some of the external debt and were seeking to negotiate further rescheduling and the conversion of some loans into grants. They had been reluctant to undertake any new borrowing on nonconcessional terms, even though the present program included a limit of up to $25 million for such borrowing during the program period.

With regard to the calculations of the extended debt service ratio, the projected rate of increase in exports of goods and services reflected essentially the authorities' policy of gradually reducing underinvoicing, the staff representative explained. The expectation was that in the coming years the minimum price of livestock exports would rise by some 10 percent a year; in addition, those exports were expected to grow at a rate of 3 percent in real terms, accounting largely for the 13 percent growth rate projected by the staff.

The interest rate structure in Somalia had been revised several times in the recent past, the staff representative noted, and interest rates had doubled during the previous three years. The authorities fully recognized the need for an appropriate interest rate policy to encourage financial intermediation and improve resource allocation. They felt that the interest rate structure was now appropriate for their economic objectives, particularly that of encouraging private sector economic activity. Nevertheless, they had stated that they remained ready to revise the interest rate structure in the light of the trends in domestic inflation and foreign interest rates.

During the previous months, the staff representative remarked, the authorities had worked closely with the World Bank and the Fund in the preparation of the medium-term recovery program for 1984-86. They were therefore hopeful that they would be able to set out the policies required for an extended arrangement. The Fund staff had reviewed the public investment program with the authorities during the most recent mission to the country. The level of investment under the core investment program had been scaled down from $1.5 billion to $1.2 billion. Total available financing amounted to some $800 million, leaving a gap of $400 million. A World Bank mission was in Somalia to discuss the projects in the core investment program. The authorities felt that the target for investment of $1.2 billion was the minimum necessary for the achievement of a sustainable rate of economic growth.

The staff had also reviewed with the authorities the macroeconomic framework of the medium-term recovery program and the policy action program, the staff representative continued. Under the current and previous stand-by arrangements, the authorities had introduced major measures that would contribute to the adjustment process during the period covered by the medium-term recovery program. They intended to continue to maintain balanced and appropriately restrained fiscal and monetary policies in the medium term and to introduce a number of additional structural measures to encourage private sector economic activity. The new measures included the reform of the banking system, improvements in the operation of the public enterprises, the elimination of public enterprises that were no longer viable, the continued liberalization of pricing and marketing policies, and a further reduction in trade restrictions.

In mid-May 1983, the staff representative from the African Department explained, Saudi Arabia had imposed an embargo on imports of cattle from Somalia and a number of other African countries. As a result, Somalia had been unable to export any cattle since June. A delegation from Somalia had visited Saudi Arabia seeking a temporary lifting of the ban until Somalia met Saudi Arabia's requirements, including vaccination of the cattle and certification by the FAO that the cattle were free of rinderpest. The Somali authorities had indicated in early August that they were optimistic that the ban would be lifted temporarily, for a period of about four months; but they had not reached a final agreement with the Saudi Arabian authorities. In that connection, the Somali authorities were expected to provide the staff soon with the relevant data to enable it to consider Somalia's eligibility to use the compensatory financing facility.

Mr. Finaish remarked that developments in Somalia under the stand-by arrangement clearly constituted a success story. The authorities had already begun negotiating an extended arrangement. They had fully cooperated with the Fund and had successfully implemented all the staff recommendations in a short period. Their excellent performance should be kept in mind in the course of the negotiations for an extended arrangement; in that connection, conditionality should not be seen as an end in itself. The new program should take into account the many structural and other measures that had been implemented in the recent past. The authorities would of course take all the necessary, possible, and desirable steps for the requisite adjustment of the economy.

There were still problems facing the economy, Mr. Finaish continued, and he agreed with Executive Directors who had stressed that Somalia would need additional external assistance. Somalia should receive the assistance necessary to help it to attain sustainable long-term growth.

The authorities, Mr. Finaish said, had taken every possible step to deal with the problem of cattle exports. However, they had already approached the Fund about the possibility of using the compensatory financing facility. In the investment area, the authorities were closely cooperating with the Fund and they had received two World Bank missions in Somalia and had met with the World Bank staff in Washington; they planned to participate in additional meetings in Washington in September 1983. It was his impression, and that of the Fund staff, that the World Bank was inclined to be more cooperative with Somalia than it had been in the past.

Mr. Suraisry commented that Saudi Arabia had been very helpful to Somalia in many ways. The ban on cattle exports to Somalia had been imposed, as the staff had recognized, because of the outbreak of rinderpest among the cattle of some African countries, including Somalia. The ban had been imposed on the cattle exports of all the countries in which the disease had broken out. His authorities were anxious to lift the ban and they were waiting for their conditions to be met to ensure that all the cattle that entered Saudi Arabia were healthy. As soon as the conditions were met, the ban would be lifted.

Mr. Finaish said that he fully appreciated that the ban on cattle exports from Somalia had been introduced solely for health reasons. Saudi Arabia had been very helpful to Somalia in the past, and he was certain that the Saudi Arabian Government would maintain the same policy in the future.

The Executive Board then took the following decision:

Review Under Stand-By Arrangement

1. Somalia has consulted the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Somalia (EBS/82/105, Sup. 1, 12/20/82) in order to establish performance criteria subject to which purchases may be made by Somalia under the stand-by arrangement during July 1-January 13, 1984.

2. The letter from the Minister of Finance and the Governor, Central Bank of Somalia, of June 6, 1983 shall be annexed to the stand-by arrangement for Somalia, and the letters of April 15, 1982 and December 8, 1982, attached to the stand-by arrangement, shall be read as modified and supplemented by the annexed letter.

3. Accordingly, paragraphs 4(a) and (b) of the stand-by arrangement shall be amended to read:

(a) during any period until December 31, 1983, in which the data at the end of the immediately preceding performance period indicate that

(i) the limit on total net domestic credit of the banking system described in paragraph 12 of the annexed June 6, 1983 letter is not observed; or

(ii) the limit on net bank credit to the Government described in paragraph 12 of the annexed June 6, 1983 letter is not observed; or

(b) (i) if Somalia fails to observe the limits on contracting of new public and publicly guaranteed external debt described in paragraph 18 of the annexed June 6, 1983 letter; or...

Decision No. 7500-(83/122), adopted
August 24, 1983

3. LESOTHO - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Lesotho (SM/83/155, 7/7/83). They also had before them a report on recent economic developments in Lesotho (SM/83/180, 8/10/83).

Mr. Sangare made the following statement:

On behalf of my Lesotho authorities, I would like to thank the staff for their comprehensive papers on Lesotho and to express the authorities' broad agreement with the views and conclusions stated in the documents.

Besides being completely bordered by South Africa, Lesotho's economy is linked to that country institutionally by a Customs Union and by its membership in the Rand Monetary Area. Moreover, more than 50 percent of Lesotho's labor force, contributing 40 percent of GNP, work in mines in South Africa. It is evident that in these circumstances not only is the scope for independent policy action constrained, but also the process of development itself is highly dependent on the inclination of South Africa and the progress of its economy. These are facts which the authorities have had to live with; however, Lesotho's membership in the Southern African Development Coordination Conference, a group of nine regional states working to promote cooperation and reduce the influence of South Africa on their economies, demonstrates the awareness of the authorities of the need to integrate their economy with other countries in the area which share similar social, political, and economic goals.

Following reasonably satisfactory rates of growth in real GNP in the previous two years--4.6 percent in 1980/81 and 6 percent in 1981/82--the pace of economic activity in Lesotho subsided in 1982/83. Several factors, including the international recession, which led to the closure of Lesotho's main diamond mine, and the severe drought contributed to the marked slowdown in economic growth. The cutback in public sector expenditure in an attempt to contain the widening budget deficits also played a major role. Were it not for increased remittances from workers in South Africa, growth in GNP would have been virtually nil. Meanwhile, inflationary pressure persists, with the rate of increase in consumer prices in 1982 estimated to be in the range of 13-15 percent. This situation reflects in part the impact of the drought on food prices as well as the exchange rate depreciation which more than offset the benefits of the international deceleration of inflation in U.S. dollar terms in 1982. In the external sector, the current account deficit in 1982 widened despite an estimated rise of 21 percent in workers' remittances and the efforts of the authorities to slow import growth. The main reason for this occurrence was the decline in exports--mainly diamonds--and transfer receipts.

An encouraging development was the authorities' success in reducing the overall budget deficit from the equivalent of 10 percent of GNP in 1981/82 to 6 percent in 1982/83. This was brought about through increased revenues resulting from the introduction of a sales tax, and by limiting the rise in expenditure. Net claims on the Government therefore increased by only 17 percent in 1982/83 compared with 150 percent in the previous period.

The authorities recognize that resumption of sustained economic growth and correction of internal and external imbalances will require adoption of appropriate policies to reduce public expenditure and further contain the growth in private consumption, while seeking ways to expand exports and increase production of import-competing goods.

In the context of this overall development strategy, agriculture, which is the second major sector in the economy, continues to receive top priority. Substantial investments have already been made in a number of agricultural projects aimed at achieving self-sufficiency in food production and expanding domestic employment opportunities. These efforts, however, have been hindered by rising costs, a reduction in support from donor countries, adverse weather conditions, and the continuing drain of manpower from farming, lured by higher wages in the South African mines. As regards the latter, the authorities hope that their efforts to raise farm productivity and income will ameliorate the situation. Meanwhile, they are considering giving more attention to livestock production, which would require less labor as well as generate high income.

In the manufacturing sector, the authorities are undertaking policies to create an environment favorable to private investment, with particular emphasis on export promotion and selective import substitution. However, the South African investment incentive policies continue to offer stiff competition to Lesotho's efforts to attract prospective foreign investors.

Despite the improvement in the budget during the last fiscal year, the authorities are aware of the need to continue the policy of austerity. It is expected that spending restraint and revenue increases as a result of vigorous and efficient tax collection, including improvement in sales tax administration and an estimated 43 percent increase in receipts from the Customs Union, would result in the actual deficit being much lower than budgeted in 1983/84. Meanwhile, the planned 40 percent rent increase in the government housing sector and the introduction of an income tax on miners' incomes, which represent 40 percent of GNP, would broaden the revenue base and help to increase receipts. Regarding expenditure, the authorities believe that the proposed increase in prices of social services, the freezing of personnel expenditure, and the efforts to improve the performance of public enterprises, or the intention to sell some of them to the private sector would provide scope for further reduction of recurrent expenditure. It is to be noted that there are no subsidies on consumer goods. The authorities acknowledge that some social services are provided at relatively low prices, and they intend to raise these gradually to cover an increasing part of the cost. The authorities also recognize the strain on the budget as a result of outstanding debt and are committed to make all possible efforts to avoid short-term nonconcessional borrowing. They also consider it necessary to lengthen the maturity structure of outstanding debt. To alleviate shortcomings in debt recording, the authorities have asked the Fund for technical assistance. In my authorities' view, the steps being taken to increase revenue and to control recurrent expenditure should make it possible to channel resources into more productive projects.

However, the impact of the prolonged and disastrous drought and strained relations with South Africa continue to throw a shadow on the prospects for the immediate future, and the authorities recognize that economic recovery could be delayed. Under such circumstances, Lesotho might approach the Fund for financial assistance.

The Central Bank of Lesotho commenced its operations on August 1, 1982. However, as in any monetary union, the country's membership in the Rand Monetary Area leaves little scope for independent action. Hence, budget policy continues to be the principal tool of financial control. Because of restrictive budget measures, credit to the Government will continue to slow. A further slackening of advances to the private sector is also expected due to the low level of economic activity. Lesotho maintains a flexible interest rate policy.

The situation in the external sector remains difficult. The projected 25 percent decline in exports and 20 percent increase in imports could not be outweighed by the estimated rise in miners' remittances and the Government's efforts to dampen demand. Therefore, the current account deficit is expected to widen, and the overall balance is expected to shift from a position of approximate balance into deficit. The authorities realize the seriousness of the situation and have agreed that sustained efforts would be needed to restore equilibrium to the balance of payments. In this connection, they are aware of the central role which appropriate budgetary policies can play. As already mentioned, they intend to limit external borrowing to financing which can be obtained on concessional terms.

It is worth noting that the Lesotho authorities are committed to maintaining a free trade and exchange system.

Continuing, Mr. Sangare said that his authorities had recently confirmed their intention of seeking financial assistance from the Fund.

The staff representative from the African Department remarked that, according to the most recent information, the interest rates paid by commercial banks on various categories of deposits had been raised by 1-2.5 percent during the second quarter of 1983, while the lending rates had remained stable. The adjustment was in line with the recommendation of the staff mission and reduced the large spread between the lending and deposit rates that had occurred in the final months of 1982.

Miss Bulloch said that she broadly agreed with the staff appraisal and supported the proposed decision. The authorities faced the difficult task of reducing the external current account deficit, which had been rising steadily and was projected to grow from about 10 percent of GNP in 1982 to nearly 14 percent in 1983 in the absence of corrective measures. Moreover, the medium-term prospects for the balance of payments were uncertain. Because of the underlying weakness of the external position, some further quantification of the position during the coming two or three years would have been welcome.

The problems facing Lesotho in pursuing balanced adjustment were typical of members of monetary unions, Miss Bulloch commented. There was limited scope for Lesotho to adjust by means of monetary policy. Only an improvement in the fiscal position could be expected to have a marked impact on the balance of payments. The authorities were to be commended for the steps that they had already taken to reduce the budget deficit. It was very important for them to maintain that effort.

The introduction of the sales tax had made a welcome contribution to reducing the budget deficit in the 1982/83 financial year, Miss Bulloch went on. The income tax on mine workers' earnings seemed both equitable and appropriate. Nevertheless, she agreed with the staff that the measures in the 1983/84 budget would at best hold the deficit to the level of 1982/83. The authorities would therefore have to act both to control current expenditure and to strengthen the nonfinancial public enterprises through suitable pricing policies and tighter financial control. That the authorities were contemplating measures along those lines was encouraging. Given the traditional reliance on receipts from the South African Customs Union--which still accounted for some three fifths of government revenues--the staff had correctly stressed the need for a continued broadening of the tax base, and the authorities' endorsement of that priority was welcome.

The task of controlling the budget deficit, Miss Bulloch commented, would be made easier if capital expenditure was limited to projects that offered a good rate of return and did not require an inordinate amount of recurrent expenditure. On the basis of those criteria, the new international airport was questionable, as the staff had concluded. She also shared the staff's doubt about the advisability of the Food Self-Sufficiency Program, especially as competition for local resources had resulted in the withdrawal of donor support from the ongoing basic agricultural services program. However, it was reassuring to note that the authorities intended to avoid overlapping projects in the future. The staff had correctly underscored the desirability of a shift in emphasis from arable to livestock farming, which was likely to benefit the economy in the longer term, and she was pleased that the authorities were considering that possibility. The industrial development strategy was being revised with the assistance of the World Bank, and it would be useful to know what progress had been made as well as how the World Bank's views on the investment priorities compared with those of the Fund staff.

Commenting on external policy, Miss Bulloch remarked that the authorities had wisely adopted the strategy of containing import growth and promoting exports. In view of the projected 25 percent decline in exports following the closure of the diamond mine, the Government's decision to accelerate the Highland Water Scheme, which was expected to generate substantial foreign exchange earnings, seemed appropriate. The need for rapid diversification of the export base was underlined by the sizable role played by workers' remittances, which were projected to account for 11 times the value of merchandise exports in 1983.

The authorities' efforts to improve the management of the public debt were welcome, Miss Bulloch commented. The Fund had played a useful role in providing technical assistance. She hoped that in the future the authorities would not have to resort to commercial bank financing of balance of payments, especially as the debt service burden was already large; it had absorbed 30 percent of government revenues in 1983. The authorities' commitment to make every effort to avoid short-term nonconcessional borrowing was encouraging. Finally, during the previous consultation her chair had asked whether the Fund might not play a more direct role in supporting the authorities' adjustment efforts, and Mr. Sangare's statement to the effect that the authorities intended to seek Fund support was welcome.

Mr. Grosche stated that he broadly agreed with the staff appraisal and accepted the proposed decision. Government expenditure--especially on consumption--would have to be brought more into line with available resources, but the scope for policy action was severely limited by Lesotho's membership in the Rand Monetary Area. The main instrument for economic policy adjustment was the budget. The present effort to reduce the budget deficit was welcome, but it would no more than contain the deficit for 1983/84 to the level of the previous year and would do so at the cost of investment expenditure. A greater effort would have to be made, as only an improvement in the fiscal position would have a marked effect on the external balance, and particularly in reducing the demand for imports. Further restraint on current expenditure and increases in revenue constituted the only way of making additional funds available for development.

It would be difficult for Lesotho to strengthen its domestic resource base, particularly in agriculture, given the wide and growing gap between the incomes of farmers and miners, Mr. Grosche commented. While the drain of manpower to the Republic of South Africa would probably diminish, the pressure on the wage level in Lesotho would probably persist, thereby raising the wage bill and making investments costly. He looked forward to hearing the response to Miss Bulloch's question concerning the changes in the country's industrial policy. The authorities should aim at creating a solid financial base, and he agreed with the staff that they could not afford to maintain costly infrastructure projects when scarce resources were needed for more productive activities.

Mr. Alfidja made the following statement: 1/

After a relatively good performance in the 1970s, Lesotho's economy has been adversely affected by the world economic recession and the severe drought during 1982/83. Indeed, despite a large inflow of workers' remittances from South Africa, there has been no real economic growth in 1982/83, compared with a 6 percent average increase in the two previous years. The rate of inflation--13-15 percent--is still high. However, it is encouraging to note that the authorities have introduced measures in an attempt to restore economic viability. In the agricultural sector, which accounts for 25 percent of GDP, efforts have been made to increase agricultural and livestock production. Priority has been given to the food self-sufficiency program, which was begun in 1981, and modern farming techniques have been introduced.

The authorities have also paid attention to the performance of the public sector. On the expenditure side, the authorities are committed to reducing the expansion of current outlays. Furthermore, the expenditure control procedures are to be strengthened under the 1983/84 budget. As the staff has noted, a comprehensive tax package is being introduced. In this respect, it is hoped that the yield from the new tax measures, such as the 5 percent sales tax introduced in December 1982, and the improvement in the tax regulations applicable to such sectors as small traders and housing, will generate the much needed additional revenue. In any event, the efforts being undertaken by the authorities to reduce the overall fiscal deficit from about 10 percent of GNP in 1981/82 to 6 percent in 1982/83 are commendable.

As for the external sector, Lesotho's current account position is expected to come under pressure as a result of the decline in the country's main export product, diamonds, as well as of the increase in imports because of the drought. The current account deficit is estimated to have widened from 10 percent of GNP in 1982 to about 14 percent in 1983 and, as a result, the overall balance of payments is expected to be under pressure. The tightening of the fiscal operations in the 1983/84 budget might help to alleviate the pressure. Finally, the proposed decision should be approved.

1/ This statement was not delivered. It was inserted in the record by Mr. Alfidja with the permission of the Executive Directors without meeting.

The staff representative from the African Department commented that the industrial sector enjoyed one of the highest rates of growth of all the sectors of Lesotho's economy. The sector was still very small, but it was promising for a number of reasons. Lesotho had sufficient skilled labor, and foreign investors often preferred to invest in industrial enterprises in Lesotho, which enjoyed certain privileges in the European Communities that South Africa did not. A World Bank mission had just returned from Lesotho. For two years the World Bank had worked closely with the local Industrial Development Corporation, which had corrected certain structural shortcomings in its organization. The latest results of the cooperation was the establishment of an ice cream factory, which although relatively small, employing some 70 persons, was important for Lesotho. Its establishment was the result not only of the cooperation between the World Bank and the authorities, but also of the Government's determination to keep the economy open and to attract as much foreign investment as possible.

Mr. Sangare remarked that Lesotho's membership in the regional monetary union reduced its scope for policy maneuver. Indeed, the only room for adjustment was in the fiscal policy area. The main problem facing the economy was the large financial imbalance. The authorities had taken steps to reduce the imbalance, particularly by considerably slowing the rate of increase in external expenditure and by diversifying the revenue base. The new sales tax and the proposed increase in rents were expected to discourage consumption, and a possible reduction of subsidies on social services was being examined by the Government. The authorities intended to avoid undertaking new short-term nonconcessional loans, and they hoped to lengthen the maturity structure of the existing debt. Nevertheless, Lesotho's situation was very difficult because of the drought, and the authorities hoped that they would continue to receive assistance from friendly countries and the Fund.

The Acting Chairman made the following summing up:

Executive Directors noted with concern that domestic expenditures, especially on consumption, have exceeded resource availability in recent years. This has entailed a serious deterioration of the fiscal and external current account situations with a trend to larger budget deficits, a higher debt-service burden, and continuing increases in imports in the face of weakening exports.

Directors welcomed the measures already taken by the authorities, notably the introduction of a sales tax. However, they felt that in present circumstances stronger and sustained action was needed to improve the overall economic and financial situation. Directors stressed that in the fiscal area it would be important to broaden the tax base and to reduce subsidies and consumption, as well as to limit capital outlays to rapidly productive projects. By reducing the demand for imports, these measures would also have a positive effect on the balance of payments. The intention of Lesotho to seek Fund financial assistance to deal with the external disequilibria was noted with approval.

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

The Executive Board then took the following decision:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Lesotho, in the light of the 1983 Article IV consultation with Lesotho conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

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

Decision No. 7501-(83/122), adopted
August 24, 1983

4. YEMEN ARAB REPUBLIC - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with the Yemen Arab Republic (SM/83/160, 7/15/83). They also had before them a report on recent economic developments in the Yemen Arab Republic (SM/83/163, 8/2/83).

Mr. Finaish made the following statement:

Over the last decade, the economy of the Yemen Arab Republic has undergone a major transformation from being dominated by subsistence agriculture into a more diversified one characterized by an increasing number of modern institutions and a market system of production and exchange. The vigorous pace of development experienced during the period of the First Five Year Plan, 1976-81 has been made possible by the determined efforts of the authorities along with high levels of workers' remittances and official external assistance from neighboring countries. Over the period, the rate of economic growth averaged close to 6 percent annually; construction, manufacturing, and other nonagricultural sectors achieved rates of growth in excess of 10 percent, while the growth of the agricultural sector was much less satisfactory. At the same time, the rate of inflation decreased steadily from 17 percent in 1977/78 to 5 percent in 1981.

The trend of noninflationary growth continued into 1982, which marked the beginning of the Second Five Year Plan, with the rate of economic growth falling only slightly to 5 percent and inflation dropping further to less than 3 percent. The performance of the agricultural sector, however, continued to be relatively unsatisfactory, mainly owing to shortages of farm labor, unfavorable weather conditions, and inadequate methods of cultivation. To deal with these problems, a High Ministerial Council for Agricultural and Rural Development has recently been established with the purpose of initiating measures that promote agricultural production.

During 1982, the pressures on the country's fiscal and external positions intensified. In addition to other adverse exogenous developments, the situation was aggravated by the devastating earthquake in December of the same year. The widening budget and balance of payments deficits as well as the significant decline in the country's foreign reserves have prompted the authorities to implement a wide range of measures intended to ease the financial pressures on the economy.

The Government's fiscal position, which had shown signs of strain since 1978/79, worsened in 1982. The increase in government expenditures, which was the principal cause of the widening of the deficit, was accounted for, mainly, by an upward adjustment in the salary scale and increased public sector employment. The increases in wages and salaries were intended to attract qualified personnel to the civil service and to discourage the departure of such personnel. It should also be noted that while the data show an increase in the ratio of current to capital expenditures in 1982, the former contain certain outlays, including investments in human capital, which are essential for long-term growth and stability. Current revenues rose by 12 percent in 1982 but were significantly lower than the budget estimate. Grants increased by one third and direct taxes increased by 44 percent, the latter reflecting better tax administration and an expansion of the tax base.

In order to deal with the fiscal imbalance, the authorities have implemented a number of measures that are expected to reduce the deficit by 25 percent in 1983. On the expenditure side, these include (a) a freeze on public sector hiring with the exception of university graduates and technically trained Yemeni personnel in critical shortage, (b) a halt to new construction unless complete financing was already available, (c) improvements in monitoring procedures for external contracts, and (d) reductions in capital expenditures financed by foreign borrowing. These and other measures are expected to reduce government expenditures by 8 percent in 1983.

On the revenue side, a number of tariff rates have been revised upward, especially on luxury and high-profit imports. Moreover, in order to improve tax collection, companies are being required to settle any tax liabilities before the Treasury will repay debts owed to them. A number of other measures are also being considered, including an increase in the effective tax on cigarettes and petroleum products, as well as increases in various fees and charges. Closer supervision of public authorities and enterprises is expected to result in improved profitability and higher nontax revenue. In addition, special taxes are to be introduced with proceeds earmarked for earthquake rehabilitation expenditures. It is also expected that some profits will accrue to the Treasury from the Petroleum Corporation since the recent drop in international oil prices is not being passed to consumers. These and other measures are projected to raise current revenues by 16 percent in 1983, while grants are projected to decline slightly.

One of the effects of the fiscal deficit in 1982, most of which was bank-financed, has been an increase in liquidity of 26 percent above its 1981 level. This buildup of liquidity was especially evident in the reserve ratio of commercial banks, which exceeded the statutory reserve ratio by a substantial margin. In order to reduce the adverse effect on bank profitability of such excess liquidity and to slow down any further liquidity expansion through the banking system, the Central Bank has started paying 5 percent interest on excess reserves held by banks. The authorities also plan to introduce in the near future a scheme of selling government bonds to commercial banks. Such bond sales would not only help in absorbing some of the excess liquidity but would also be an important element in the efforts of the authorities to broaden the financial market.

The Central Bank has kept domestic interest rates at the same level since December 1981 in spite of the substantial decline in international interest rates during the period. This policy has been motivated by the country's external financial position as well as the need to enhance financial intermediation and to mobilize domestic financial resources.

In spite of a drop in the current account deficit in 1982, which was mainly due to a recovery in workers' remittances, the overall deficit continued to increase, as did the drawdown on reserves. Tentative projections indicate a 12 percent drop in the current account deficit in 1983. However, since little change is expected in the overall deficit, and because the level of reserves may fall even further during the course of the year, the authorities are keeping the reserve position under active consideration.

Because of its peg to the U.S. dollar, the Yemeni rial appreciated significantly in 1982. While the authorities consider the present exchange rate policy to be broadly adequate, they are keeping it under review, particularly in light of the more recent appreciation of the rial.

It is to be noted that in spite of the worsening fiscal and external positions of the Yemen Arab Republic, the ratio of debt service to current account receipts continues to be low. This is due largely to the fact that the country has been able to obtain foreign loans on a concessional basis.

Regarding the earthquake of December 1982, relief operations designed to deal with the immediate needs of the regions affected by the disaster have been essentially completed. The relief outlays were financed mainly through assistance from foreign governments, international organizations, and Yemeni citizens living abroad. The reconstruction phase, which is just beginning, is expected to take about three and a half years to be completed. Total outlays, including relief expenditures, are estimated at YRls 1.8 billion, a large part of which will be spent on housing, the sector most seriously affected by the earthquake. In order to finance the reconstruction outlays, a number of measures are being taken, the proceeds of which will be earmarked specifically for that purpose. These include increases in various fees and charges as well as in income tax and customs duty rates, with an estimated yield of about YRls 183 million on an annual basis. In addition, the authorities are seeking bilateral grants from several sources.

In conclusion, the authorities have shown awareness of the need to take necessary measures to deal with the current financial difficulties aggravated by the 1982 earthquake, and have had a useful exchange of views with the staff on adjustment policies being pursued. They are keeping the situation under careful review, and would consider any additional measures which may become necessary, while continuing to maintain a liberal trade and exchange system.

Mr. Suraisry said that he agreed with the thrust of the staff appraisal and accepted the proposed decision. Responding to the economic difficulties that had begun to appear in the late 1970s, the authorities had adopted commendable measures, with good results. However, further action was needed, particularly in the fiscal area, which was still a cause for concern. An overall fiscal deficit equivalent to 36 percent of GDP was large by any standards and would be difficult to sustain. Without swift action to reduce the deficit, the gains that had been made as a result of the recently introduced adjustment measures could be undermined. The deficit could not be reduced without a cut in government expenditures, which had been equivalent to 75 percent of GDP in 1982.

Government expenditures had risen by 41 percent and revenues by only 12 percent. The authorities were fully aware of the need for additional measures to correct the fiscal imbalance, and their intention of reducing government expenditures--particularly through sharp reductions in extra-budgetary outlays--was welcome. The steps that had already been taken or were to be adopted to strengthen the revenue base were also welcome.

The monetary stance was generally appropriate, Mr. Suraisry commented. The authorities' response to the excess commercial bank liquidity, including the effort to channel the liquidity back into the economy, was sound.

The balance of payments was clearly under pressure, Mr. Suraisry said. In the past, reserves had been sufficient to finance the external payments deficits. At present, the level of reserves was low, and the authorities had no alternative to introducing additional demand management measures. However, the debt service burden did not constitute a problem. Finally, the authorities were to be commended for maintaining a trade system that was free of restrictions despite the difficult problems facing the country, and for their quick and efficient response to the adverse effects of the highly destructive earthquake.

Mr. Schuijer remarked that his chair was pleased to take up the consultation with the Yemen Arab Republic. When the Executive Board had agreed to provide rather generous assistance in the aftermath of the earthquake, several Executive Directors had observed that the country's imbalances had been caused by factors in addition to the natural disaster; they had felt that the Yemen Arab Republic would be better served by the provision of financial assistance under an arrangement with the Fund. At present, there was even more reason than hitherto for the authorities to consider requesting a stand-by arrangement. Excessive expenditure had been continued, and reserves had been falling at a worrying rate; if the decline was not slowed, reserves might well fall to zero within a year or so.

As Mr. Suraisry had noted, Mr. Schuijer went on, the overspending was clearly the root cause of the fiscal deficit. The demand pressure that it had created had been translated into an increase in imports rather than a rise in domestic production. The staff had indicated that one of the causes of the lack of response by the domestic sector was the appreciation of the rial. However, it was not fully certain that a devaluation would greatly benefit domestic production. Exports were virtually nonexistent, and a devaluation would therefore not be warranted on the ground of the need to increase competitiveness. In addition, a devaluation probably would not promote import substitution in the Yemen Arab Republic, which had a small domestic market and few resources. That was not to say that a devaluation should be ruled out; there was indeed reason to believe that the appreciation of the rial had contributed to the external imbalance. Experience had shown that member countries--Rwanda, for instance--whose currency was pegged to the U.S. dollar, were hesitant to adjust their exchange rates downward. In the case of the Yemen Arab Republic, a devaluation would merely be a correction for the recent increase in the value of the dollar, rather than a signal for an increase in domestic production.

While a devaluation, although useful, would not greatly enhance domestic production, Mr. Schuijer said, a reduction in labor costs would serve such a purpose and would directly benefit the public sector. Wages had been increased to make them more competitive with incomes abroad, but the narrowing of the wage differential with other countries had contributed to the decline in remittances. It might be appropriate for the authorities to use merit premiums for highly skilled labor alone, rather than to raise the entire wage structure, as had apparently been the case. In addition, better control over public expenditures was needed. The large extrabudgetary outlays obviously did not contribute to improved expenditure control. On the revenue side, there might be room for additional taxation, as personal incomes had increased considerably; and the revenue measures that had been introduced to support the reconstruction effort could be made permanent.

He hoped that additional adjustment measures would be introduced, Mr. Schuijer concluded, and that the authorities would be encouraged to explore all possible means of achieving further adjustment, including a stand-by arrangement. Finally, the authorities' determination to maintain a free exchange regime was welcome, and the proposed decision was fully acceptable.

Miss Bulloch stated that she fully endorsed the staff appraisal and supported the proposed decision. When the Executive Board had considered the country's request for an emergency drawing in 1983, her chair had commended the authorities' decision to collaborate with the Fund in finding a solution to its balance of payments problems and in formulating an adjustment program as soon as possible. The 1983 Article IV consultation had been seen as a suitable forum in which to reach agreement on such a program. It was therefore disappointing that, although an adjustment program had been discussed, the staff and the authorities had not been able to agree on the appropriate policy measures. What were the prospects for such an agreement in the coming period?

It had been agreed at the time of the provision of the emergency assistance that a program should be an expectation, rather than a condition, of early access to the Fund's resources, Miss Bulloch recalled. Her authorities had accepted that view, but, as a general rule, permitting early access when there was little or no expectation that the authorities concerned would agree on a program was inappropriate, particularly in the light of the continuing need to safeguard the Fund's resources. In the case of the Yemen Arab Republic, the size of the emergency drawing had been small in absolute terms, but it had been large--50 percent--in relation to quota. In the circumstances, it seemed natural to have expected a more definite commitment on a program by the authorities. The Government had understandably given first priority to dealing with the direct effects of the earthquake through the program of reconstruction, but additional policy measures were clearly needed to restore the stable financial conditions that were needed for continued economic growth. In the light of the rapid decline in foreign reserves and of the vulnerability of the sources of foreign exchange, the balance of payments deficit was clearly unsustainable.

She shared the staff's concern about the size of the government deficit, which was a prime cause of the deterioration of the overall financial conditions in the Yemen Arab Republic, Miss Bulloch remarked. The recent Departmental Memorandum by Mr. Abed and Mr. Brillembourg contained useful background material on the impact of fiscal policy in an open economy such as that of the Yemen Arab Republic. They had concluded that the most visible effect of a growing fiscal deficit was on the balance of payments. In the circumstances, the staff had correctly recommended an increase in control over current expenditure in the Yemen Arab Republic as a part of the effort to reduce the fiscal deficit.

While fiscal action was needed to deal with the root causes of the financial imbalances in the country, Miss Bulloch commented, she agreed with the staff that the authorities should review the appropriateness of their exchange rate policy in the present circumstances. Finally, since the Yemen Arab Republic had maintained a free system of external payments and transfers, she wondered whether the authorities were prepared formally to undertake the obligations of Article VIII.

Mr. Erb said that he agreed with the staff that the economic and financial developments in recent years were worrying, and that the Government's policy stance had caused unsustainable balance of payments deficits and reserve losses. The Government had not made the needed changes in fiscal, monetary, and exchange rate policies despite the provision of emergency assistance by the Fund. He hoped that the authorities would make the additional policy adjustments that the staff had suggested in order to achieve a stable financial environment for the continued growth and development of the economy.

The staff representative from the Middle Eastern Department said that the staff and the authorities had discussed a possible Fund-supported program, and the authorities had taken the staff's policy recommendations into account in formulating their measures for dealing with the fiscal deficit. However, the authorities had refrained from discussing an official request for a stand-by arrangement. The reasons why the authorities were reluctant to make such a request were not fully clear to the staff. It was conceivable that the authorities felt that the size of the country's quota was still small in relation to the adjustment needs. In addition, the authorities might have felt that regional economic and financial developments would make it difficult for them to introduce a Fund-supported program.

The possibility of undertaking the obligations of Article VIII had been raised on occasion with the authorities, the staff representative from the Middle Eastern Department commented. It had not been a significant topic during the most recent discussions, and the authorities had not raised with the staff the possibility of the Yemen Arab Republic formally accepting the obligations of Article VIII.

Mr. Finaish remarked that the difficulties facing the economy, particularly those that had arisen in 1982, had been caused largely by temporary factors. Hence, the extrabudgetary expenditures were expected to fall by 50 percent in 1983. The overall economic picture was also expected to improve somewhat in 1983, especially in the fiscal area, where the deficit was projected to fall by 25 percent as the result of the introduction of a wide range of measures. The authorities were aware of the need to cut government spending but, as the staff had noted, in a country like the Yemen Arab Republic, a considerable amount of current expenditure was required for developmental, educational, and health purposes. For instance, the number of teachers on the government payroll had risen from 3,000 in 1978 to 26,000 in 1982. It was difficult for the Government suddenly to cut certain items, such as health, education, and security, which were required to maintain growth and stability. The authorities were doing their best in the present difficult circumstances.

The emergency assistance that the Fund had provided had not been given as a matter of generosity, as one of the speakers seemed to have implied, Mr. Finaish commented. The staff and the authorities had spent considerable time discussing a possible drawing of SDR 5 million, and the Executive Board had decided, on the basis of established Fund policy, to increase the amount to SDR 10 million, in the second credit tranche. The case for the increase was convincing, and there had been several cases in which the assistance had exceeded the first credit tranche. The staff had described the authorities' program for dealing with the effects of the earthquake on the balance of payments. The reconstruction stage would last three years, and the financing--basically by Yemeni citizens living abroad and foreign governments--would be noninflationary. The staff had described in detail the measures that the authorities had already introduced and intended to adopt. The Yemen Arab Republic had done everything that a country was required to do under the Fund's policy on emergency assistance.

It was inappropriate to force a country in an emergency to adopt a Fund-supported program, Mr. Finaish considered. Any government needed time to consider such a Fund-supported program, and the Yemeni authorities had not ruled out the possibility. As the staff had implied, the size of the country's quota was probably one of the reasons why it had not yet made a formal request for an arrangement with the Fund. The present quota was SDR 19.5 million, and the new quota would be SDR 43 million. The Yemen Arab Republic had been receiving external assistance for some time. As one Executive Director had noted, given the structure of imports and exports, it was not fully certain that a devaluation of the rial would greatly benefit domestic production. Nevertheless, the exchange rate remained one of the policy areas under review.

The Acting Chairman made the following summing up:

Executive Directors who spoke indicated broad agreement with the staff appraisal. While noting the continued noninflationary growth in the economy, concern was expressed about the continued high levels of consumption, which indicate the need for more vigorous domestic resource mobilization and reduced reliance on external resources.

As regards financial developments, Directors focused on the weakening of the fiscal position, which has become increasingly worrisome. Under the sustained pressure of increases in government spending, the budget deficit has widened sharply and may have reached unsustainable levels. Directors acknowledged the measures already taken by the authorities in this regard. The need was underlined, however, for dealing with the fiscal imbalance at an early date by adopting more effective measures to enhance revenues and, more importantly, by taking effective action to reduce government spending, including extrabudgetary outlays.

Directors also noted with concern the rapid deterioration in the balance of payments and the consequent decline in external reserves to uncomfortably low levels. Directors emphasized the critical importance of greater restraint in demand management policies as a means of relieving the pressure on the balance of payments. In addition, Directors indicated that the time may be appropriate for the Yemen Arab Republic authorities to undertake policy adjustments that affect the balance of payments more directly. In this connection, Directors considered that the Yemen Arab Republic's exchange rate policy may usefully be reviewed in the current circumstances. It was noted with satisfaction that the Yemen Arab Republic intends to continue to maintain an exchange system that is free of restrictions.

The Yemen Arab Republic authorities were encouraged to seek a solution to the economic disequilibria in the framework of a policy program that could be supported by a stand-by arrangement with the Fund.

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

The Executive Board then turned to the proposed decision.

Mr. Finaish said that the words "in view of the recent sharp deterioration in the external payments position and the difficult outlook" in the second paragraph should be eliminated. The staff had already used strong--indeed, alarmist--language in its report, and there was no need to extend the use of such language to the decision. The remainder of the text could be amended to read: "The Fund notes with satisfaction that, despite external payments difficulties, the Yemen Arab Republic intends to continue to maintain an exchange rate system that is free of restrictions on payments and transfers for current international transactions." The Executive Board's decision concluding the consultation in 1982 had not been as critical as the proposed decision, even though the outlook for 1982 had not been much different. The outlook for 1983 was relatively good, and there was little justification for the critical tone of draft paragraph 2.

The Executive Board then took the following decision, as amended by Mr. Finaish.

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with the Yemen Arab Republic, in the light of the 1983 Article IV consultation with the Yemen Arab Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that, despite external payments difficulties, the Yemen Arab Republic intends to continue to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Decision No. 7502-(83/122), adopted
August 24, 1983

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/83/121 (8/24/83) and EBM/83/122 (8/24/83).

5. ARAB REPUBLIC OF EGYPT - TECHNICAL ASSISTANCE

In response to a request by the Governor of the Central Bank of Egypt for technical assistance, the Executive Board approves the proposal set forth in EBD/83/216 (8/19/83).

Adopted August 24, 1983

APPROVED: February 21, 1984

LEO VAN HOUTVEN
Secretary