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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/67

10:00 a.m., May 22, 1991

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	L. E. N. Fernando
	G. C. Noonan
	D. Powell, Temporary
Dai Q.	
	J. M. Abbott, Temporary
	J. Prader
	B. Szombati, Temporary
E. A. Evans	
R. Filosa	
M. Finaish	
M. Fogelholm	I. Fridriksson
B. Goos	
J. E. Ismael	
	J. C. Jaramillo
J.-P. Landau	J.-F. Cirelli
	O. Kabbaj
L. B. Monyake	
	P. Wright
G. A. Posthumus	G. P. J. Hogeweg
C. V. Santos	
	R. Marino
	L. E. Breuer, Temporary
K. Yamazaki	N. Tabata

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant

Also Present

IBRD: A. W. Morris, Africa Regional Office; S. Ahmed, Asia Regional Office. African Department: M. Touré, Counsellor and Director; E. L. Bornemann, Deputy Director; G. E. Gondwe, Deputy Director; C. V. Callender, M. M. Mateus, O. J. Nnanna, D. Robinson. Asian Department: H. Neiss, Deputy Director; K. A. Al-Eyd, M. W. Bell, E. Gurgen, I. H. Lee, J. R. Marquez-Ruarte. Exchange and Trade Relations Department: J. T. Boorman, Director; T. Leddy, Deputy Director; A. Basu, J. H. Felman. External Relations Department: K. White. Fiscal Affairs Department: P. S. Lopes. Legal Department: H. Elizalde, R. B. Leckow. Research Department: N. M. Kaibni. Secretary's Department: A. Tahari. Treasurer's Department: O. Nyawata. Advisors to Executive Directors: J. O. Aderibigbe, M. A. Ahmed, C. D. Cuong, A. Gronn, Y.-H. Lee, J.-L. Menda, A. Napky, A. Raza, A. M. Tanase. Assistants to Executive Directors: B. Abdullah, T. Berrihun, B. Bossone, B. A. Christiansen, S. B. Creane, Deng H., H. Dognin, T. P. Enger, N. A. Espenilla Jr., S. K. Fayyad, B. R. Fuleihan, S. Gurumurthi, K. Ishikura, J. Jonas, M. E. F. Jones, P. K. Kafle, W. Laux, L. J. Morelli, J. A. K. Munthali, J.-P. Schoder, Shao Z., Tin Win, C. M. Towe, J. C. Westerweel.

1. INDIA - JOINT FUND-BANK STATEMENT

The Acting Chairman informed Executive Directors that the President of the World Bank and the Managing Director had issued the following statement on May 21, 1991:

> Mr. Rajiv Gandhi's death is a tragic loss for India and for the international community at large. The Bank and the Fund have long been associated with India's economic development. This will continue.
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> During the recent Interim and Development Committee meetings in Washington in April, an informal meeting of the major donors of the India Consortium was held to discuss India's economic and financial situation. The Indian authorities said then that they were preparing, in consultation with the Fund and the Bank, a program of corrective policies aimed at strengthening their economy. We will continue to work to that end and thus to provide the basis for support by the Fund, the Bank, and all the other members of the India Consortium, which remains strongly committed to India's economic development.

Mr. Fernando expressed his appreciation for the sentiments, and encouragement expressed in the statement.

2. LESOTHO - 1991 ARTICLE IV CONSULTATION, AND ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1991 Article IV consultation with Lesotho and its request for arrangements under the enhanced structural adjustment facility (EBS/91/71, 4/25/91; Cor. 1, 5/7/91; and Sup. 1, 5/21/91), together with a statistical appendix providing background information (SM/91/84, 5/3/91). They also had before them a policy framework paper for the period 1991/92-1993/94 (EBD/91/122, 4/24/91), together with a statement by the Managing Director, which read as follows:

> There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Committee of the Whole of the Executive Directors of the Bank and IDA in their meeting on May 14, 1991:
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> The Committee of the Whole commended the Government of Lesotho for continuing to maintain impressive economic growth while reducing the fiscal deficit further than previously. This had been achieved despite unfavorable conditions, notably the increase in the price of oil.

Longer-term structural reforms require similar attention. Although the difficult social nature of some of these reforms was recognized, a more determined effort was required, in particular to ensure employment opportunities. The implementation capacity of the Government was considered to be a key factor--hence the importance of human resource development and improved civil service performance.

Executive Directors noted Lesotho's high degree of dependence on South Africa through migrant miners' remittances and customs union benefits. With rapid geopolitical change taking place, Lesotho needed to be ready to capture the opportunities as well as minimize the risks. The country's strategy of economic diversification and accelerated development of skills was appropriate; so was the proposed program of investment promotion and industrial sector reform. Some Directors felt that the overall program was based on assumptions more optimistic than justified.

The risk of a postsanctions South Africa diverting investment away from Lesotho was recognized. Lesotho had a number of advantages, especially in its preferential markets and low unit costs; it would be important to exploit these.

Members questioned the projections of high economic growth, although it was noted that these were consistent with the historical average for manufacturing and agriculture, while the activity associated with the Highlands Water Project would be an additional major factor, the effects of which should be maximized.

Effective and transparent administration of the associated Development Fund was also considered vital; so was Lesotho's ability to generate spin-off activities and ensure absorption of labor returning from outside the country.

Members commented on the slow progress in implementing the Government's land reform program. It was noted that the Government had chosen a course of broad consultation throughout the country to gain social acceptance of the key proposals, especially in regard to grazing fees, land administration, and women's rights. This process had recently been completed. Progress on land reform was seen to be closely linked to implementation of the Environmental Action Plan. Although the Plan's objectives were essentially long term, prompt action was needed to create the administrative mechanism and hasten implementation, highlighting population policy. Members stressed that the Government should give priority to poverty alleviation, support for women farmers, and social sector spending. In addition, while commitment to privatization was acknowledged, progress with parastatal reform should be accelerated. The need for increased administrative capacity in the area was also acknowledged.

The staff representative from the African Department made the following statement:

> On May 2, 1991, there were changes in Government, with the Chairman of the Military Council of Lesotho and some other military concillors and Cabinet Ministers, including the Minister of Finance, being replaced by new personnel. The new Minister of Finance and Planning, Mr. A.H. Thoahlane, who was the former Principal Secretary of Finance when the structural adjustment arrangement was negotiated, has advised the Fund in a letter dated May 14, 1991, which has been circulated to Executive Directors, that the Government intends to implement the economic and financial program adopted by the previous Military Council and would like the Board to proceed as planned with the discussions of the request for arrangements under the enhanced structural adjustment facility (ESAF).
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> Subsequently, during a recent visit, the new Minister of Finance reaffirmed to the staff his Government's intention to proceed with the program for which support under the ESAF has been requested. He also discussed two major problems that have emerged. The first problem was the general dissatisfaction with the recent salary increases, which, for the majority of civil servants, implied a significant reduction in real terms compared with 1988 levels, and which gave rise to a request by the Army for an additional adjustment. He emphasized that this request had been partly responsible for the change in Government and posed a serious challenge to the stability of the new Government and the current program for returning the country to democracy.
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> The second problem concerned the political and economic developments in South Africa and their implications for Lesotho and for the southern African region as a whole. The optimism regarding an early resolution of the political problem in South Africa had begun to wane, and this had implications for investor confidence, not only for South Africa but also for the entire region. But, more important for Lesotho, the recent closing of some gold mines has resulted in the retrenchment of some 6,000 miners thus far, and more retrenchment is expected in the near future.
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> The Minister said that the Government hoped to tackle the salary question by achieving savings in expenditure, particularly through reductions in the Government's vehicle fleet, and by increasing revenues through improved collection of income taxes and custom duties. It was the Government's intention to devise a

strategy that would enable it to tackle the emerging problems while keeping the program on track. In this regard, the Minister promised that upon his return to Lesotho, the authorities would prepare a detailed package of measures, which would be submitted for the consideration of the staff prior to the midterm review. In this context, he requested that the work of the review mission be advanced to begin in late August or early September, instead of October-November as had been tentatively scheduled.

Mr. Monyake made the following statement:

The efforts begun in 1988/89 under the structural adjustment arrangement, and continued in 1989/90, were intensified in 1990/91, in terms of both policy orientation and implementation. As the staff has indicated, performance in 1990/91 was very encouraging. Most of the targets were achieved and the quantitative benchmarks observed. Strong economic growth has been sustained, with the estimated rate of growth of real GDP at about 8 percent, although this was lower by about 1 percentage point than that originally envisaged. The rate of inflation, broad money, and domestic credit expansion were within the program limits.

The overall fiscal deficit is estimated to have been reduced by more than the program target, thanks mainly to strengthened expenditure controls, including a freeze on fresh recruitment and on general salary increases, and layoffs of some workers paid on a daily basis. Significant improvements have been made in the formulation, review, and monitoring of the recurrent budget and in the shortening of the time lag in the reporting of budgetary data. However, the revenue outcome was less than anticipated, largely due to the partial reduction in sales tax rates on some consumption goods and utility services--a move to curb smuggling from South Africa and to soften their adverse impact on output. But the authorities are prepared to regain this lost ground and improve it by strengthening tax collection and administration and broadening the revenue base, particularly of noncustoms receipts.

Unfavorable exogenous factors such as drought, declining mine workers' remittances, and the sharp rise in oil prices owing to the situation in the Middle East, which were partly responsible for deviations in output and revenue performance from program targets, took a toll also on the external front. These circumstances created substantial challenges for my authorities as they tried to attain the external targets of the program. The external current account deficit target was missed, but the result achieved represented a significant reduction from the previous year's level. The balance of payments outcome was less favorable than anticipated, although it was in surplus and registered a sizable improvement over 1989/90.

As regards structural reforms, progress has been made in the implementation of important measures, including the removal of the tax exemption of interest income from treasury bills, the reduction of the time lag in fiscal reporting, as mentioned above, and the establishment of the Investment Promotion Center. Moreover, the corporate tax rate has been lowered and tax holidays abolished. These tax measures should lead to the widening of the production base and the enhancing of the diversification effort, by creating the business climate necessary to attract and retain foreign investment.

The Government has endorsed the drafting of an amendment to the Land Act, with a view to extending formal recognition to informal leasing arrangements and allowing village development councils to register such leases. Another encouraging move was the establishment of the right of widows to hold land titles. Measures designed to help combat overgrazing took effect as programmed.

Land tenure systems, like many other structural problems, are difficult to change in a matter of a few years and, therefore, require long-term solutions. This fact was rightly expressed by one chair, citing my remarks on the same question, when Directors discussed Lesotho's request for the third annual arrangement under the structural adjustment facility (SAF) in June 1990. For any land reform measure to be effective, a change in the attitude of individual farmers and of the people enforcing the reform is necessary. In the case of Lesotho, where the size of the arable land is just 13 percent of total land area and the opportunity for commercial farming is limited, this would mean the creation of the necessary awareness of the purpose of the intended measures, on the part of the village development councils as well as individual farmers, and the gaining of confidence of village councils in implementing them. In recognition of the intricacies surrounding attitudinal change, my authorities have already embarked on a training program for village development councils regarding range management, and they intend to introduce the required training programs in areas of land tenure arrangements as well. As the needed awareness and conviction are established, it will be easy for the authorities to set a faster pace for the reforms than has been the case so far.

During the three annual arrangements under the SAF, the Government has made considerable progress, in terms of both consolidating stabilization and initiating structural reforms. My authorities believe that the favorable results thus far achieved should provide a solid basis for launching the ESAF-supported program submitted today for your approval. The package of reforms outlined in the policy framework paper constitutes a strong program, given the challenges the country is to face as it moves on from stabilization to a phase of sustained economic growth and diversification.

The political will of the leadership and the steadfast commitment of those around it, demonstrated in the course of implementing the policy measures under the structural adjustment arrangement, will continue in a much more strengthened manner to keep the ESAF-supported program on a firm and solid path. This was vividly expressed by the new Chairman of the Military Council when he publicly declared: "In the interest of our country's economy we cannot renege on the structural adjustment program." A high-level delegation led by the new Minister of Finance who, in a different capacity, was instrumental in launching the arrangement under the SAF, was in Washington last week to reassure the management of the Fund and the Bank, as well as their staffs, of the authorities' firm commitment to the proposed ESAF-supported program as well as to the democratization process which is expected to lead to an elected Government in 1992, and to seek the continuing unstinting and unwavering support of the two institutions.

In fact, the authorities have already started to prove their avowed commitment to the program, as reflected in the prior actions taken on many policy fronts, including the updating of the Public Sector Investment Program, the approval for the drafting of legislation for the intended land tenure arrangements and range management, the compilation of the civil service inventory, and the establishment of a committee to chart a program for parastatal reform. With respect to the latter process, my authorities liquidated one nonstrategic parastatal ahead of schedule.

The Lesotho economy faces uncertainties arising from the developments in the mining sector as well as in the political situation in South Africa. In particular, changes are taking place in the mining sector that are altering the role of mining, notably gold mining, in the South African economy owing to a sharp decline in mine profitability, resulting from rising costs and the falling price of gold in dollar terms. In reaction to these developments, increased mechanization is taking place in the mining sector, causing the share of mining in South Africa's nonagricultural employment to decline and, consequently, leading to layoffs of migrant workers, including those from Lesotho, as has been witnessed since 1988. Given the increasingly capital-intensive nature of mining operations as well as the high unemployment rate among South African blacks, it would not be easy to keep the number of Basotho employed in South African mines in the medium term at the present level. Hence, there is the paramount need for measures to help reduce this uncomfortable dependence by expanding the resource base, increasing output and diversification, and promoting opportunities for job creation. My authorities believe that the envisaged ESAF-supported program will provide them with that needed opportunity.

Lesotho will require larger amounts of external financing in the form of grants and concessional lending than in the past, given the existing resource constraints and projected high levels of investment and imports needed to attain the growth objectives under the enhanced structural adjustment arrangement. The authorities are hopeful that these financing requirements will be met with the full support of the Fund and other members of the donor community.

Lesotho maintains a dual exchange rate for the commercial and financial rand. The staff has not recommended approval for the retention of this practice. As the other members of the Common Monetary Area--South Africa and Swaziland--still maintain the same currency practice, it would be impractical for Lesotho to pursue a different course. The use of the financial rand has remained for Lesotho a major attraction for foreign investment, particularly from South Africa, since the imposition of sanctions against South Africa. We would, therefore, urge the Board to grant approval of the practice as it generously did in the past.

Mr. Wright made the following statement:

Overall, the performance of the Lesotho economy during the past year and the authorities' progress in implementing their adjustment program have been encouraging. Inflation was lower than projected, the fiscal deficit was reduced, and the savings-investment gap narrowed. The improved control of recurrent expenditure and the achievement of positive real interest rates were particularly welcome policy achievements. All the quantitative performance criteria of the structural adjustment arrangement were met--a gratifying conclusion to the three-year sequence of structural adjustment arrangements, after a disappointing start.

However, there were some less satisfactory aspects. There have been repeated delays in important areas of structural reform over the past three years; and slower than projected growth last year, together with a smaller than hoped for improvement in the external position, reminds us of the continuing vulnerability of the Lesotho economy to external developments. The heavy dependence on developments in South Africa and the unpredictable process of change in the region, which are highlighted by the developments reported in the staff representative's statement, are pressing reasons for the authorities to sustain and strengthen their adjustment program.

My concerns about this are reinforced by the sensitivity analysis the staff presents in respect of employment of Basotho in South African mines, which shows the potential for serious economic disruption, with the attendant implications for the ability to service Fund obligations. The staff is right to say that any such development would require a tightening of policy, but since the baseline scenario may already be on the optimistic side regarding employment prospects in South Africa--and I note Mr. Monyake's comments--the more that can be achieved soon, the better.

That said, I agree with the basic content of the program, and with its emphasis on reducing the saving-investment imbalance and encouraging private sector manufacturing for export. But there are several areas on which I would like to offer some comments and seek clarification.

In the fiscal area, improving noncustoms revenue remains a high priority. I recognize that impending developments in South Africa will influence decisions on implementing a value-added tax. In the meantime, the recruitment levy on Basotho miners seems to be a substitute for the failed initiatives to reach agreement with South Africa on an income tax on migrant miners. This makes sense, but I would value comment from the staff on how the levy works, and whether it might have an adverse effect on recruitment; I note from the Memorandum of Understanding, for example, a suggestion that the cost of this levy could be passed on to the mining companies.

I would also welcome some clarification on other revenue measures. First, will the reduction in the company tax rate be revenue neutral, as implied in Table 6 (EBS/91/71)? Presumably, collection of taxes on last year's profits is a one-off development; what tax rate will be applied--the new one or the previous one? Second, could the staff tell us why the sales tax on tobacco and alcohol has been reduced?

Expenditure control has, in the past, been more effective than revenue raising. But care will have to be taken that the increase in public sector salaries and the commitment to higher spending in priority areas, welcome as they are, do not lead to an expenditure spiral. The new information provided by the staff reinforces my concern. In this connection, progress on the civil service staff inventory is of particular importance. More generally, I fully endorse the staff's comments on sustaining the improvement in expenditure control.

As the staff states, fiscal policy remains the cornerstone of this program, in large part because of the limited prospects for an independent monetary policy. Regarding monetary policy, the need for interest rates to move in line with those in South Africa has long been clear, and I welcome the steps that have been taken to make the Miners' Deferred Pay Fund more attractive. But such a fund is in reality only a substitute for a competitive banking system which provides efficient financial intermediation.

It is clear that the absence of functioning money and capital markets is a major problem in the Lesotho economy, and I fully endorse the staff recommendations on moving forward with steps to establish such markets. Creating a fairer competitive balance between the attractions for banks of holdings of treasury bills and loans may be an important step in the right direction. I am well aware of the problems of establishing a competitive, market-based financial system in a country at Lesotho's stage of development. Given this and the urgent need for putting savings to work, I can accept that nonmarket institutions must act as a stopgap. But these institutions should be made to operate in as market-oriented a fashion as possible and move continuously toward a truly market-based system.

Similar considerations apply to all the various agencies which, it is planned, will improve the flow of investment funds to enterprises, including specifically those with Basotho ownership. I would welcome reassurance from the staff or Mr. Monyake that these agencies operate on commercial terms, or as close to them as is feasible, and are justified only by some market failure. Is this also true of the Lesotho Agricultural Bank?

Given the lack of a developed money or capital market system, I would also be interested to hear how privatization might be effected. That said, I welcome the efforts being initiated to reduce the budgetary drain of the parastatals, through increased efficiency and, where appropriate, liquidation or privatization.

Within the private sector, I have no doubt that a key development will be continued expansion of manufacturing for export, and the best way to achieve this will be with an economic and policy environment that encourages investment, including from overseas. The macroeconomic framework of the program goes a long way toward achieving this aim, but I have some concerns about industrial policies, which may go beyond the terms upon which finance is made available. The idea of various industrial sectors being "given priority" makes me uneasy. I wonder what criteria will be used and how small enterprises will be encouraged. Do these developments depend on the expansion of export financing envisaged by the staff, and will such financing be provided on market terms?

As in last year's staff paper, incentives to industrial diversification and expansion are considered mainly in terms of capital. I understand that during last year's Board discussion (EBM/91/88, 6/4/90), some comment was made on the importance of competitive wages, given the likely regional competition for investment. Therefore, I welcome the authorities' stated intention to encourage wage negotiations based on productivity rather than inflation, on an annual basis, and to have a bilateral review of minimum wages. Care will be needed to ensure that the public sector, in which productivity is difficult to measure, does not become a leading pay influence after this year's salary adjustments.

Concerning elements of program design, first, I welcome the specification of two of the structural benchmarks as performance criteria. This should increase the impetus to structural reform, which proved to be the weakest area of the structural adjustment arrangement. But I would have liked to see among the benchmarks some reference point for progress either in establishing the committee to formulate a program for parastatal reform, or, much more important, in formulating the program itself.

Second, in view of external vulnerability, some form of contingency mechanism against temporary developments is appropriate. But the retrenchment of migrant workers may prove to be more permanent than temporary, and it will be important not to allow such contingency provisions to cumulate if migrant worker retrenchment continues over the life of the enhanced structural adjustment arrangement.

The steady improvement in macroeconomic performance under the structural adjustment arrangement has provided Lesotho with a sound base on which to start an enhanced structural adjustment arrangement. I hope that the authorities will take advantage of this and increase the pace of structural reform to achieve the greater economic diversification and export growth that will prove to be the key to sustained income growth.

Mr. Santos made the following statement:

The Lesotho authorities should be commended for the generally satisfactory implementation of the three annual programs supported by the Fund under the SAF and the progress they have made so far in improving the overall economic situation of Lesotho. Strong economic growth has been sustained in 1990/91, and the rate of inflation has been kept relatively low. The overall fiscal position is estimated to have shown further improvement during the 1990/91 fiscal year, thanks particularly to stricter expenditure control. Domestic credit expansion was also maintained within the programmed limits.

We welcome these positive developments, which indicate the continuous commitment of the Lesotho authorities to the adjustment process, including the sustained implementation of economic, financial, and structural reforms and measures to alleviate poverty and protect the environment. But as the staff rightly pointed out, in spite of the substantial improvements registered in Lesotho's economic and financial performance, much remains to be done to diversify the economic base and consolidate the progress achieved in the macroeconomic stabilization process. The adoption of a stronger adjustment program aimed at maintaining the momentum for the implementation of appropriate macroeconomic policies and structural reforms and making further progress toward balance of payments viability in the medium term is welcome. There is no doubt that the program constitutes an encouraging step on the road to full realization of the authorities' objectives. We can endorse the general thrust of the policies outlined in the updated policy framework paper, and we support the Lesotho authorities' request for continued Fund assistance under the ESAF and the proposed first annual arrangement thereunder.

We are assured by Mr. Monyake that the Lesotho authorities "will continue in a much more strengthened manner to keep the ESAF-supported program on a firm and solid path." In this connection, they have already taken important prior actions, including the approval of draft legislation for land use and land tenure arrangements, a civil service census under the civil service reform program, and the formation of a committee to oversee parastatal reform. The adoption of these actions augurs well for the implementation of the ESAF-supported program. Nevertheless, technical support, particularly from the Fund and the World Bank, will continue to be essential to support the authorities' adjustment efforts, especially in the fiscal sector whose policy is said to be the centerpiece of the program.

In the fiscal sector, admittedly the results over the past year have indeed been favorable. However, it has to be stressed that if the medium-term objective of turning the fiscal deficit into a small surplus is to be achieved, emphasis should be placed on raising additional revenue while maintaining tighter controls over expenditure. In this regard, we generally endorse the staff recommendations for strengthening administrative and collection procedures and broadening the revenue base. Given Lesotho's geographical constraints, there is no doubt that the impending switchover to a value-added tax system by South Africa will have repercussions on the yield of the existing tax system in Lesotho. We, therefore, agree with the staff that the implications of the switchover need to be carefully studied and the Lesotho authorities response tailored so as to protect revenue performance.

On the external sector, we share the concerns about the fragility of Lesotho's external payments position and its vulnerability to exogenous developments, particularly in South Africa, where the recent layoff of mine workers has had adverse consequences for the Lesotho economy. To help lessen the vulnerability of the economy to these developments, we encourage the authorities to accelerate the implementation of measures to diversify and expand the production and export base of the economy as well as to create job opportunities.

Regarding the staff recommendation on the multiple currency practice--namely, the dual exchange rate for the commercial and financial rand--we agree with the arguments put forward by Mr. Monyake in favor of granting approval of the current practice. However, we would appreciate staff comments on the rationale for bringing this issue to the Board's attention only on this occasion. We support the proposed decision on the enhanced structural adjustment arrangement.

Mr. Tabata made the following statement:

I appreciate Lesotho's efforts to strengthen the economy under the current structural adjustment arrangement. Performance under the second and third annual arrangements under the SAF has been broadly encouraging. Annual growth of real GDP has been maintained at the relatively high level of approximately 5 percent during the past three years. The fiscal deficit has been reduced broadly in line with the program--from 10.4 percent of GDP in 1987/88 to 1.2 percent in 1990/91. Also, the current account has improved because of an increase in receipts of workers' remittances, although the balance of payments situation remains fragile.

Despite these relatively favorable results, the economy of Lesotho has shown various vulnerabilities. It will, therefore, be necessary for the authorities to implement additional policy measures. On the fiscal front, it is essential to ensure and expand an appropriate revenue base; for this purpose, noncustoms revenue must be raised. Therefore, the introduction of the recruitment levy for mine workers seems appropriate. However, other measures remain to be considered, including company tax reform, improvement of income tax administration, and increases in the levels of license fees and administrative charges for certain government services. Also, a restrictive stance should be kept on current expenditure, including containment of the Government's wage bill and restraint on goods and services.

To avoid an excessive burden on public finances, reform of the public enterprises is a matter of urgency. In this connection, this chair welcomes the establishment of the Parastatal Monitoring Unit. The authorities should formulate a reform program, including privatization or liquidation, for all public enterprises.

As regards price movements, while the growth in monetary and credit aggregates has been within the program benchmarks, double-digit inflation has continued. The recent slowing trend in the increase of money supply to about 10 percent will have a favorable effect on prices. To realize more efficient implementation of monetary policy and to strengthen the financial sector, we endorse the authorities' policy of widening the treasury bill market and developing the capital market. These measures to strengthen the financial system are essential for the effective allocation of limited resources to productive investment.

In the external sector, the improvement in the current account during the period of the structural adjustment arrangement is encouraging. However, much uncertainty remains because of heavy reliance on Lesotho's neighboring country. In particular, mine workers' remittances from South Africa, which account for approximately 70 percent of external current account receipts, are likely to decline following the closing of some of the unprofitable gold mines in South Africa.

With respect to the average increase in export volume of 9.3 percent under the proposed enhanced structural adjustment arrangement, I would appreciate it if the staff could elaborate on what kind of commodities would be exported and to which countries. The staff report mentioned that textiles and light manufactures will increase; however, almost every country expects to increase exports of the same kind of commodities.

Furthermore, as the Lesotho economy needs considerable external capital inflows to promote the formation of infrastructure, incentives for foreign investment should be increased by means of financial and structural measures as well as tax preferences. Such measures should include liberalization of the foreign exchange and payment system, effective administration of the Investment Promotion Center, and a broadening of foreigners' participation in the equity of Lesotho's enterprises. I commend the Lesotho authorities for, and encourage them in, their efforts at structural adjustment in the face of a number of geographical and topographical constraints. I hope that the authorities will take advantage of the gains from the current three-year structural adjustment arrangement to achieve further progress under the proposed enhanced structural adjustment arrangement. I support the proposed decision.

Mr. Prader made the following statement:

The close ties between the economies of South Africa and Lesotho expose the latter to the effects of many exogenous factors lying beyond the reach of Lesotho's domestic economic policy. The severity of this undiversified exposure was clearly demonstrated by the sharp fluctuations of Lesotho's export and import growth rates during the 1980s, when the export volume growth rate reached over 40 percent one year and minus 10 percent the next. The sensitivity analysis and comparison of different volumes of worker remittances projected under two scenarios show that relatively small--and therefore not unlikely--changes in the number of Basotho nationals employed in South Africa would greatly change the growth rates of GNP and other aggregates.

These considerations must be borne in mind when evaluating the results of Lesotho's three years under the program supported by the SAF. Unquestionably, Lesotho's poor economic performance during the first year of the program (1988/89) improved remarkably over the next two years. The growth of real GDP is particularly striking, the only question being whether it is sustainable. The robust growth rates were partly the result of a high level of investment, which included the Government's investment in the Lesotho Highlands Water Project. However, Table 5 (EBS/91/71) shows large savings and investment gaps, especially in the public sector, which may severely limit investment-driven growth for the future.

In his statement, Mr. Monyake presents additional potent arguments against undue optimism about the sustainability of high growth rates in Lesotho. First, South Africa's political stability has become more precarious than expected. Second, changes in the mining sector are almost certain to reduce South African demand for foreign workers. And third, South Africa's high unemployment among the black population will depress the wages of those foreign workers who remain there. The scenario presented in Table II (EBS/91/71) reflects the possible impact of these developments. The staff representative is correct in stating that given Lesotho's relatively light debt burden, the main potential obstacle to the program's completion is more likely to be political unsustainability rather than external financing problems.

I support the reforms planned in the fiscal area, and I urge the authorities to accelerate the pace of their efforts to increase the capacity of Lesotho's domestic capital markets, since strong capital markets are a prerequisite both for increasing domestic labor demand and for lessening the risks connected with poor export diversification. I note the authorities' intention to reduce the role of parastatal enterprises in the economy, a move that will permit further cutting of capital budget expenditures. Some of the resources that now finance the perpetuation of inefficiencies in the parastatals might then be redirected to social transfers, where they would serve the more useful purpose of enhancing political support for the program.

Despite the clouding of Lesotho's growth prospects by the situation in South Africa, and the possible erosion of the program's political sustainability, I support the proposed decisions.

Mr. Filosa made the following statement:

I endorse the staff appraisal and my chair supports Lesotho's request for an enhanced structural adjustment arrangement. It is encouraging to note the steadfast progress made by the country in its macroeconomic performance during the third annual arrangement under the SAF and to observe the significant improvements on the structural side. These gains in overall economic performance are a reflection of the authorities' strong commitment to their medium-term adjustment program. The economy, however, remains heavily constrained by an undiversified domestic productive base and an underdeveloped financial system. Its fragility, in particular, continues to represent a most crucial problem. In this connection, I agree with the thrust of the proposed program, which specifically aims at addressing the economy's structural weaknesses.

One of the important components of the program is the set of land reform and land use measures envisaged to foster diversification in the agricultural sector. The staff report notes the emphasis given to the production of certain crops to replace food imports and the Government's intention to explore the potential for private investment in food-processing plants. Similarly, in the industrial sector, priority is said to be given to investment in specific activities, such as textiles, electronics, furniture, and handicrafts. I would be interested in knowing whether specific incentive measures, other than correct and flexible prices, are envisaged in the program to drive investment toward selected sectors.

Another important component of the program's package of structural measures is the privatization of public enterprises. I understand that the establishment of a committee to formulate a privatization plan has recently received government approval. I wonder, however, whether a structural benchmark could not have been included in the proposed enhanced structural adjustment arrangement to link the progress on privatization to implementation of the program.

Finally, on structural issues, given the need to diversify the economy and the existence of unsatisfied demand for medium- and long-term credit, a competitive banking sector is a prerequisite for rapid development in Lesotho. I would thus ask the staff to give a broad assessment of the current status of the country's banking sector--in particular, its degree of internal competitiveness--and I would like to know whether, in its view, part of the program should not have focused on the restructuring of the sector.

I regret the staff papers' lack of detailed information on the functioning of the Common Monetary Area (CMA) arrangement and of an assessment of the arrangement. Many problems remain unaddressed, such as the coexistence of unrestricted intra-area capital mobility with apparently diverging national interest rate structures; and the rationale of, and costs and benefits associated with, the current dual exchange rate system--which incidentally is widespread among members of the arrangement. Unfortunately, the lack of such information limits the possibility of assessing correctly Lesotho's monetary policy. Unless proper attention is devoted to the peculiarities of the CMA arrangement and related issues, appropriate Fund surveillance of the monetary aspects of economic policy in Lesotho will not be possible. Comments from the staff on this point would be appreciated.

In the area of money management, I welcome the effort of the authorities to expand the market for treasury bills. This is a useful structural step, as it will eventually enable the authorities to better manage the system's liquidity and discourage short-term capital outflows. Given the problem of commercial bank excess liquidity, however, I wonder whether some interim and quicker measures, such as an increase in reserve requirements and/or a reduction in the rates earned by commercial banks on their deposits with the Central Bank, could not be adopted in the initial phase of the program to restore control of bank liquidity. I would appreciate some comment on this point.

Mr. Hogeweg observed that following a weak start, the final years under Lesotho's recently completed three-year structural adjustment arrangement had been very encouraging. The requested enhanced structural adjustment arrangement promised to be a useful successor, and he supported it.

He appreciated the staff representative's statement on the commitment of the new authorities of Lesotho to adhere to the program--for which support under the ESAF had been requested--negotiated with the previous Government, Mr. Hogeweg remarked. Of the two major problems that had emerged--mentioned by the staff representative--the second, implications of developments in South Africa, would have existed regardless of the change in Government in Lesotho. But because there were new authorities in Lesotho, he was more concerned about the first problem, government salaries.

He understood that the recent salary increase, which had been taken into account in the program, had met with general dissatisfaction and was partly responsible for the change in Government, Mr. Hogeweg continued. Although it was not stated explicitly, he surmised that the new authorities would give in to wage demands, which would imply that, while the Board was being asked to endorse the program, one of its benchmarks was being breached. The authorities had indicated the areas where they envisaged compensating measures in the budget, but the details of those measures had yet to be worked out, and the Board would be informed perhaps only by the time of the midterm review. That situation would be a most unsatisfactory start, even if it would later prove possible to keep the program basically on track. He would appreciate confirmation that his interpretation was correct, and if it was, some elaboration by the staff as to why it considered approval by the Board of such an open-ended program appropriate. His concerns were increased by the absence of any reference to the issue by Mr. Monyake.

Chart 5 (EBS/91/71) showed the relatively large spread between lending and borrowing rates in Lesotho, and its implications for monetary policy, Mr. Hogeweg noted. Moreover, in many cases the spread was actually larger than shown, because the prime rate did not apply to all borrowers and time deposit rates had been lower than the savings deposit rates shown. There were usually two reasons for such a large spread, which presumably applied in Lesotho: an inefficient banking system and an oligopoly. At the same time, the banking system had excess liquidity, although of course, Lesotho was not unique in that respect. Such a banking system hampered domestic saving and an efficient allocation of resources and made it more difficult to implement monetary policy. In that connection, however, the program contained elements that clearly went in the right direction. He supported the development of a broader treasury bill market as well as the intention to develop an equity market. Creation of such markets might provide more competition in the financial system. In line with the remarks made by Mr. Filosa, he wondered what additional measures could be taken to directly increase competition in the banking system of Lesotho.

Mr. Cirelli made the following statement:

In the past few years, the authorities of Lesotho have made important progress--largely under Fund-supported programs--particularly in the fiscal, inflation, and growth areas. The proposed three-year enhanced structural adjustment arrangement will help Lesotho to consolidate the economic gains made under the structural adjustment arrangement and to accelerate the pace of structural reform. Indeed, it is clear that the authorities should strengthen the momentum of structural reform to guarantee sustainable growth. It is also obvious that the situation of Lesotho reflects to an important extent developments in South Africa, and the vulnerability of the economy to external shocks renders the task of domestic policy more difficult, again underlining the importance of structural reform.

I share the thrust of the staff appraisal. The main focus of macroeconomic policy should be devoted to the fiscal area in 1991/92, with a view specifically to improving the revenue outcome. A broadening of the tax base would be appropriate to raise contributions from noncustoms revenue, and further steps toward improving administrative and collection procedures should be undertaken as well. On the expenditure side, considerable progress has been made in monitoring current and capital outlays, but some scope remains for strengthening control at the commitment stage.

With regard to monetary and credit policies, the authorities recently took the correct decision of adjusting interest rates in line with developments in South Africa; they should ensure that such rates remain positive in real terms. The rise in interest rates on deposits in the Miners' Deferred Pay Fund is another commendable initiative to prevent capital outflows. The expansion of the treasury bill market is welcome; this first step in the Government's efforts to develop a capital market will be particularly useful in creating a more market-oriented instrument for reducing excess bank liquidity and in strengthening control of monetary aggregates.

Concerning structural reforms, the improvement in administrative capacity and the achievement of a more market-oriented economy are two important objectives. To accomplish the first, accelerating the pace of civil service reform is in order, not only to maintain tighter control of the wage bill but above all to establish a merit-based remuneration system to motivate civil service personnel. This is all the more important to avoid a brain drain to South Africa.

Facilitating private investment would greatly contribute to achieving the second objective, particularly through, first, the timely implementation of public enterprise reform, which is essential both to reduce budgetary subsidies and to illustrate the authorities' commitment to creating an environment more palatable to private initiative; second, the simplification of procedures for foreign investment; and third, improvement of the financial system, which is still unable to provide adequate medium- and long-term loans to the private sector. I would be interested to hear from the staff what kind of action is envisaged.

It is necessary to accelerate reforms in the agricultural sector, which could provide employment and revenue to a population that could be adversely affected by the adjustment process. Could the staff provide some information on land tenure reform? This chair expressed some concern last year about the delays that had occurred in implementing this reform. What is envisaged, particularly by the World Bank, in this area?

We are confident in the authorities' commitment to pursue measures to consolidate the stabilization of the economy and to pave the way for sustainable growth in the future. We support the proposed decision while stressing the importance of structural reforms, which should form the basis of the program under the enhanced structural adjustment arrangement.

Mr. Goos said that he welcomed the new Government's commitment to the proposed enhanced structural adjustment arrangement. The arrangement, as presented in the report and if properly implemented, should provide a promising basis for building on the improved performance, particularly in the past year, of the previous program supported by the SAF.

He did not wish to second-guess the seriousness of the commitment of the new authorities or their ability to implement the program, but the information provided in the staff's statement led him to wonder to what extent the assumptions underlying the requested arrangement were still valid and realistic, Mr. Goos commented. More specifically, like Mr. Hogeweg, he was concerned that the new wage policy stance--envisaging wage increases of no less than 40 percent--might undermine fiscal consolidation, which, according to the staff appraisal, would remain the centerpiece of the program. Unfortunately, he did not know the extent of the additional budgetary burden arising from the intended salary adjustment, nor did he have any indication of the scope available to compensate for the burden by reductions in the Government's vehicle fleet and improved tax and customs duty collections. Incidentally, as implementation of those measures was already an integral part of the underlying program, it was difficult to determine how additional savings could be mobilized by adopting those measures.

Similar questions arose from the worsened outlook for remittances, reported by the staff representative, which would trigger activation of the contingency mechanism built into the arrangement, Mr. Goos continued. Again, he did not know the likely impact on domestic and external imbalances, nor was there any information about the additional measures that might be employed to offset the shortfall in remittances. Those questions were all the more worrisome because the program, even as originally designed, might have warranted some further tightening of financial policies. In that regard, he shared the concerns expressed by some World Bank Executive Directors that the program was based on assumptions that appeared to be optimistic, particularly the ambitious rates of growth

projected for export volume over the medium term--on average, 9.3 percent--while real imports were expected to decline over the same period.

Some further tightening of financial policies, including restoration of positive real interest rates on bank deposits, would also have been advisable in view of the unsatisfactory outlook for inflation, Mr. Goos remarked. The rate of inflation, which, according to Table I of the staff report, was projected to hover around 13 percent until the end of the projection period--1995/96--was difficult to reconcile with the program objectives of fostering domestic and external stability, investment, and growth.

His concern about indications of capital flight, as suggested by the substantial worsening of errors and omissions in the balance of payments in the past two years, was heightened by the adverse implications reported by the new finance minister of recent developments in South Africa on investor confidence, Mr. Goos commented. That development would seem to have warranted additional caution in the conduct of financial policies. He would be grateful for the staff's comments on those concerns, and he looked forward to its response to Mr. Hogeweg's question as to why the Board was being asked to approve Lesotho's request even though the program was off track in some areas.

Moreover, he would welcome clarification by the staff of the question posed by other speakers on the proposed nonapproval of Lesotho's dual exchange rate system, Mr. Goos said. Like Mr. Monyake, he failed to see how the country could be expected to pursue a policy course in that area that was independent of the exchange rate regime in place in South Africa. Nonapproval would constitute a departure from the practice followed by the Fund so far.

Mr. Abbott made the following statement:

> Lesotho is a small, poor country facing difficult development challenges. Under its three-year structural adjustment arrangement, economic management gradually improved, and in the third year most of the targets were achieved and the quantitative benchmarks were observed. The policy framework paper and the staff report indicate that the authorities are committed to serious, sensible, and prudent policies that will contribute to steady economic improvement. The proposed agenda of actions is quite comprehensive. The authorities of Lesotho have earned the support of the international community, and my authorities endorse the proposed decisions, including the requested enhanced structural adjustment arrangement.
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> While we are satisfied with the overall program, I would appreciate further clarification from the staff on a few points. The staff report and the policy framework paper include several comments that suggest unnecessary or undesirable state

intervention. For example, the staff report notes the authorities' plan to expand incentive schemes for exports and for foreign investment; it also notes the authorities' intention to provide tax incentives and industrial estates to encourage manufacturing investment. Does the staff have any assessment of the costs and benefits of these incentive schemes?

Parastatal reform is mentioned in the staff report, but the actions taken seem very tentative given the indications that parastatals are a significant drain on public resources. This impression is reinforced in the policy framework paper, where it is noted that some parastatals are considered "strategic" and hence warrant complete state ownership, although others might be considered for partial or complete privatization. Could the staff provide additional insight as to the extent to which parastatal operations in Lesotho are an important economic problem and the authorities' commitment actively to encourage private sector initiative?

In both the staff report and the policy framework paper, there is brief mention of plans to foster a capital market through reactivation of an equity financing scheme that would allow ownership in parastatal companies through a mutual fund. I am unclear as to how this plan would operate, but a mutual fund shareholding by itself would add little to develop a market for the constituent shares. Could the staff elaborate on how this proposal would work?

The policy framework paper states that there is excess liquidity in the banking system owing to a lack of bankable projects. On its face, this seems to be a rather surprising situation for a poor but now rapidly growing economy. In the staff report, there is a hint that the problem may be more one of public sector claims crowding out private sector credit. The staff report indicates that deposits at the Central Bank offer high yields, and I understand that these deposits also carry a tax preference. Could the staff comment on the merits of the argument that there is a shortage of bankable projects? To the extent that there is a shortage of bankable projects, has anything been done to develop measures such as home mortgage schemes for low-income housing?

Mr. Noonan made the following statement:

I would like to associate this chair with the commendations by other Directors of the relatively strong performance by Lesotho under the program supported by the three-year structural adjustment arrangement, and particularly the performance in the last year. The staff's assessment that under the third-year

arrangement most of the specified targets were achieved and the quantitative benchmarks were observed provides encouragement regarding the likely outcome of the proposed enhanced structural adjustment arrangement.

Nonetheless, like other speakers, I am concerned about the fragility of Lesotho's balance of payments and, in particular, its dependence on economic developments and policies in South Africa. I am in broad agreement with most of the remarks of previous speakers, especially concerning public finances and the need to put these on a more robust basis.

I would like to sound a note of caution about the sustainability of growth in domestic product which Lesotho has experienced and expects in the future. Mr. Prader has highlighted the vulnerability of GNP, particularly miners' remittances, to developments in South Africa, but questions also remain about the sustainability of domestic output, part of which is attributable to the agricultural sector. As agriculture accounts for less than one fifth of GDP at factor cost in Lesotho, even significant growth in that sector will not translate into substantial overall growth, although it probably has a higher multiplier effect than growth elsewhere in the economy. Moreover, agricultural land is subject to erosion in Lesotho, thus limiting the potential for expanding output on a sustainable basis.

The rest of real growth is shared by light manufacturing industry and, in recent years, by construction and services. Mr. Tabata has sounded a note of skepticism about the prospects for manufacturing. Much of the growth in construction and services is associated with the Lesotho Highlands Water Project. Although a medium-term scheme, the construction phase of the project will come to an end in the mid-1990s, and it is unclear that it forms the basis for sustained growth beyond that construction phase. It would be reassuring to be able to see more clearly how growth can be sustained in the longer term.

I found the construction of the performance criteria somewhat puzzling. In particular, the quantitative benchmarks detailed in Table I of Appendix VIII of the staff report include two fiscal criteria--one related to the level of recurrent expenditure and the other to the overall fiscal deficit. Both criteria appear to be defined with reference only to the outcome in the second quarter of the fiscal year, rather than to the cumulative performance for the first half. This would seem to imply that a second drawing could still be made under the proposed enhanced structural adjustment arrangement even if cumulative performance were off track.

> Moreover, it seems unusual to have the performance criterion for the fiscal deficit defined as a share of GNP, rather than in terms of a nominal magnitude. This would seem to invite disagreement on the quarterly estimate of GNP, as well as give the fiscal target a certain haziness.
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> A final point on the same issue relates to the quarterly phasing of the fiscal deficit, in particular the extent to which the fiscal adjustment is back-loaded. The projected cumulative deficit in the first half of the program year appears to total 2.9 percent of GNP, implying a substantial turnaround in the latter half. I wonder whether the staff could provide some elaboration and explanation of these issues. This chair endorses the proposed program, on the assumption that there will be a satisfactory response to the concerns raised about public finances.

Mr. Fogelholm welcomed the performance of the Lesotho economy in the past year and the authorities' commitment to put their economy on the path to stable growth. However, he shared the concerns expressed by other Directors--particularly Mr. Hogeweg and Mr. Goos--about the program and the fact that the Board was being requested to take a decision when apparently all the criteria were not being fulfilled. He looked forward to the staff's response.

He also shared the view of Mr. Goos and of some World Bank Executive Directors that the program appeared to be overly optimistic with regard to projected fiscal developments, export growth, underlying diversification of the economy, the current account position, and aid flows, Mr. Fogelholm continued. In that connection, he had not been able to evaluate consistently grants and official aid flows from the information presented in various sections of the report, but they were apparently extremely high. He wondered whether, in view of the scarcity of official aid and resources, it was plausible to believe that donors would continue to support a country with an overall balance of payments surplus of 5 percent or more, rather than redirect those resources to other countries in a more precarious situation. The enormous Lesotho Highlands Water Project absorbed almost 50 percent of projected gross annual domestic investment; he therefore hoped that the project had been properly appraised and shown to be profitable.

On the dual exchange rate, he had some sympathy for Mr. Monyake's request, but as the Fund had taken the same stance for South Africa and Swaziland, it would be illogical not to follow the same course for Lesotho, Mr. Fogelholm observed. The staff appraisal, when commenting on fiscal policy, included the sentence "In this regard, Lesotho should seek technical assistance from the Fund before taking action." While he could support the objective behind that sentence, the wording was problematic.

Mr. Goos observed that, if the projections for aid flows under the program were realistic, then, along with the issue of the extent to which it could be assumed that Lesotho had a balance of payments need, the question also arose as to whether the access proposed under the arrangement was consistent with the guidelines for access under the enhanced structural adjustment facility.

Mr. Kabbaj said that he broadly agreed with the staff appraisal and supported Lesotho's request for an arrangement under the enhanced structural adjustment facility. He could go along with the proposed decisions.

The staff representative from the African Department stated that the new recruitment levy on Basotho miners in South Africa was part of the ongoing effort to raise miners' direct contribution to revenues. The Government had originally suggested that an income tax, as paid by all workers in Lesotho, be extended to the Basotho miners working in South Africa, but the South African Government had stated that it alone had authority over taxation of people working there. Also, the mining company had viewed that proposal as an additional administrative burden. Therefore, the Lesotho Government had decided that, because of the worsening budgetary situation and the need to broaden the tax base, the levy was expedient. Under that proposal, when miners signed or renewed a contract with the mining company representative, they would then be subject to a fee of 100 maloti, collected at the same time as the assessment fee. In that way, the burden was placed directly on the miners, and the levy did not represent an increase in cost to the mining company.

The reduction in the corporate tax from 37.5 percent to 15 percent was revenue neutral, the staff representative remarked. The tax on tobacco and alcohol had been rescinded by the authorities because of tax evasion resulting from a large increase in smuggling, which had affected not only fiscal revenues but also the domestic production of beer and alcohol.

Government agencies were providing loans at market rates, the staff representative said. Currently, the Central Bank was administering a scheme under the World Bank's agro-industrial project, through the commercial banks, charging market rates to borrowers.

While the staff mission had been in Lesotho, it had been informed by the authorities that the establishment of a committee on privatization--a prior action--was under way, the staff representative reported. Given the situation in Lesotho, it would have been very difficult to include privatization of the parastatals as a structural benchmark, although a time frame for privatization had been indicated in the policy framework paper, and proper financial analysis of the institutions' operations would be given priority. Admittedly, the issue facing Lesotho, as well as other countries, with respect to privatization was to find buyers for the shares and to determine what mechanism would be used for the sale.

Textile production had increased considerably when several Asian firms had moved to Lesotho, the staff representative commented. The result had been beneficial, with increased exports of textiles, mainly to Europe but also to North America, expected to continue. Exports of light manufactures were directed mainly to the South African market and to neighboring countries.

Some Executive Directors had asked whether the program was feasible, given developments in South Africa and the recent demand for higher wages, the staff representative recalled. The staff had made it clear to the authorities that wage demands should be resisted as much as possible and that if the authorities would acquiesce to those demands in the interest of preserving democracy, alternative measures would have to be taken to ensure that the fiscal deficit did not rise further. Moreover, the authorities had indicated that, while they would do their best to contain wage demand pressures, savings could be achieved in expenditures that would allow some increase in wages to be granted. Savings would be achieved through a sizable reduction in the vehicle fleet and through a leasing program, allowing for considerably greater cuts in outlays than the staff had envisaged.

Incentives to propel investment in the industrial sector included increased land availability for development, regular assessment of minimum wages to reduce the impact of unanticipated increases in labor costs, provision of industrial and workshop space by the Basotho Enterprises Development Corporation and its assistance to entrepreneurs in preparing bankable projects, as well as the reduction in the corporate tax to 15 percent, the staff representative noted.

The Governor of the Central Bank had recently requested technical assistance from the Fund in respect of laws pertaining to central banking and financial institutions, the staff representative remarked. Technical assistance could probably be broadened to include the banking system as a whole. It had been pointed out that the interest rate paid on deposits with the Central Bank could be used to control liquidity and credit; the monetary authorities were looking into the whole armory of instruments available, including reserve requirements, but for the moment they considered the treasury bill market one of the major instruments.

Although it had been suggested that the program might have warranted further tightening, the dynamic situation in South Africa made it difficult to anticipate developments, the staff representative commented. In the past, the staff's diagnosis had been too pessimistic. Thus, following discussions with the authorities and the mining company representative, the staff had estimated the retrenchment that would be required in 1991-92, reflecting both the fact that most of the marginal gold mines had already been closed, and the preferred position the Basotho miners enjoyed in the mining industry because of their high productivity and cost effectiveness.

Investment in the Lesotho Highlands Water Project and in related activities would be the main engine for growth, the staff representative said. The staff had had to revise its estimates of GDP growth higher over the past two or three years, as a result of underestimating economic growth. Based on recent experience, the staff saw no reason why the forecast rise could not be achieved, provided economic activity in South Africa did not experience a sharp downturn.

The mutual fund shareholding would operate much like a trust, the staff representative explained. Small shareholders would buy shares in the trust, and the funds would be invested in companies. It was hoped that small shareholders would also be able to participate in a similar manner following privatization of some of the parastatals. At present, there were difficulties involved in the treasury bill market; however, the Central Government had recently transferred its accounts to the Central Bank, and that proportion of funds borrowed from one of the commercial banks in the form of direct advances could be channeled into treasury bills, thus strengthening the market.

The suggestion by Mr. Noonan that the performance criteria could have been established on a cumulative basis was a good one, the staff representative agreed; but in the circumstances, it was thought best for purposes of discipline and education to establish them on a quarterly basis. He would, of course, disagree with the statement that the authorities would be able to draw without meeting the performance criteria.

Lesotho had been very fortunate in that for various reasons, including its strategic location, several donors had shown a lot of interest in providing aid, the staff representative from the African Department commented. The aid in the pipeline thus far was sufficiently large to anticipate continuous flows in the future.

The staff representative from the Exchange and Trade Relations Department noted that the financial rand was used in some current transactions which gave rise to a multiple currency practice subject to Fund approval. For example, current transactions, such as travel, above the normal fixed limits could be allowed at the more depreciated financial rand rate. The staff had become aware of that practice in the context of the last consultation mission, and since there was no timetable for its elimination, no approval was recommended. In the same way, similar practices in South Africa had not been approved by the Board.

When considering the program for Lesotho, prospects of severe shocks, mainly owing to the retrenchment of miners, emerged, the staff representative stated. Moreover, if those shocks should worsen, measures would have to be taken to strengthen adjustment--to stimulate growth in GDP, improve the domestic savings performance, and safeguard the level of reserves--so as to protect the economy and make it more resilient. Thus, the need to undertake strong policies under the program was one factor in determining an appropriate access level.

The proposed access, at 120 percent, was one of the lowest for the group of ESAF-eligible countries, the staff representative from the Exchange and Trade Relations Department added. Moreover, the first-year component of total access was less than average--30 percent of quota--with the balance of 90 percent to be disbursed over the next two years. Table 3 in the policy framework paper provided the total identified financing for the program period; in 1991/92, the Fund's share of Lesotho's overall financing requirement of SDR 151.2 million was only SDR 4.2 million.

Mr. Hogeweg commented that his concerns had not been lessened by the staff's response, which supported his impression that additional wage increases would be granted. Otherwise, there would be no reason to mention the Government's compensatory measures with respect to the salary issue. Although identified, those measures had not been elaborated in detail; they had not yet been decided or discussed with the staff. Accordingly, one of the benchmarks of the program, namely salaries, could be breached upon approval of the decision.

The staff representative from the Exchange and Trade Relations Department reported that, in a recent meeting with the Minister of Finance, the staff had said that, before any further wage increase was put in place, it would need to have firm assurance and clear indications of new offsetting measures--either expenditure savings or fiscal resource mobilization. The Minister had agreed not to implement any wage increase before preparing a blueprint of compensating actions. He had also agreed to bring forward the review discussions to apprise the staff of the precise measures to be undertaken. The staff had explained that the balance of the government expenditure pattern should not be drastically altered.

A crucial element of the adjustment program was the role of the Central Government as a source of savings for the rest of the economy, the staff representative noted. The Minister had discussed frankly the social implications of the change in Government, and he had indicated his commitment to keep the program on track and to undertake the measures recommended by the staff in the event of any shocks.

Mr. Fogelholm suggested that perhaps a more prudent approach on the part of the Fund would be to take a decision on the arrangement under ESAF in principle, and in that way reinforce the Minister's position on the salary issue. As there was no immediate balance of payments or reserves problem, a short delay in adopting the decision was feasible.

The staff representative from the Exchange and Trade Relations Department explained that the authorities' process of determining compensating actions and how the expenditures would fit into the overall program design could be time consuming. Following those discussions, the Cabinet would have to meet to discuss a package that would be consistent with the program.

Mr. Monyake reported that the Ministry had stated, in response to press reports, that no decision had been made about extra salary increases for any particular group of government employees. However, because of serious dissatisfaction expressed by various groups whose take-home pay increases were relatively low, the Ministry had commenced a study of various options and their costs. In any such exercise, the Government was fully aware of the budgetary ceilings agreed in the context of ESAF preparations. A decision would not be taken quickly, and when decided, it would be within the framework of the program, as made clear by the Minister. Furthermore, there had been no change of Government in Lesotho; personnel changes had occurred in two or three portfolios, but the same military Government was in office.

The staff representative from the Exchange and Trade Relations Department, replying to a question, explained that the staff had become aware of the multiple currency practice only recently when reviewing Lesotho's exchange arrangements. If that practice had been known earlier, nonapproval would have been recommended then.

Mr. Goos commented that while the staff's recommended nonapproval of the multiple currency practice seemed to be based on equal treatment, reflecting the Fund's nonapproval with respect to South Africa, the situation of Lesotho differed significantly because it was not in a position to act independently and to abolish the dual exchange market. He therefore wondered whether the staff recommendation was appropriate.

According to the staff's statement, the outlook for workers' remittances had apparently deteriorated beyond program assumptions, Mr. Goos noted. He wondered whether that decline would trigger the contingency mechanism built into the program, and if so, what would be the implications--for example, the adoption of any additional adjustment measures.

The staff representative from the Exchange and Trade Relations Department pointed out that while, admittedly, one member of a monetary arrangement could not act unilaterally, Swaziland, also a member of the Common Monetary Area, did not maintain a multiple currency practice. Such monetary arrangements needed to be reviewed carefully to see whether a common set of rules applied to all members.

The staff representative from the African Department said that the program already anticipated a retrenchment of 5,760 migrant workers in 1991/92, and there was no reason to expect a significant deviation. As to the timing of technical assistance, Lesotho did not have the expertise or administrative capacity to undertake the studies necessary to implement measures to offset or complement the impending value-added tax in South Africa. The staff had indicated that the Fund would be ready to provide technical assistance in that respect, taking into account that while Lesotho's needs were pressing, Botswana and Swaziland would also be directly affected by the introduction of the tax in South Africa.

Mr. Fogelholm stated that undoubtedly technical assistance was needed, but the staff should recognize that the authorities might wish to seek assistance from sources other than the Fund.

Mr. Santos suggested that, given the regional nature of the monetary arrangement that prevented Lesotho from taking a unilateral stance on the multiple currency practice, a cautious approach might be warranted whereby approval would be given until the staff had identified clearly the rules applicable in the common area.

The staff representative from the Exchange and Trade Relations Department said that the guidelines were clear. In general, if the practices were not temporary and there was no timetable for their removal, approval would not be recommended. Also, as in the case of Lesotho, approval was not necessary to proceed with the enhanced structural adjustment arrangement.

Mr. Monyake observed that the authorities in Lesotho tended to be very frank in their discussions, sometimes describing their objectives to the Fund before they could concretize their course of action. For example, measures to implement land reform had not yet been determined. The majority of the people lived on the land, and they believed that they and their children had a right to that land without buying it. To change that concept, which was part of their culture and not just a matter of legislation, would be difficult. The authorities would need time and encouragement to pursue those reforms.

Because of the nature of land tenure in Lesotho, large-scale commercial farming was not feasible, Mr. Monyake continued. About three quarters of the population was congregated on the one third of the land where agricultural operations were feasible. Subsistence farming would continue to be the operative activity and, in the absence of alternative employment, could represent a contingency measure for returning miners. If a land tenure system were initiated whereby one person could displace 20 families to operate a commercial farm, a number of farmers would be forced into the labor market, with jobs being virtually nonexistent. At present, ongoing leasing arrangements between operators and owners continued, while the Agricultural Bank provided loans to farmers.

He appreciated the consistent position of the staff on the multiple currency practice, Mr. Monyake remarked. But as pointed out, South Africa was the dominant partner in the Common Monetary Area, and unilateral action by Lesotho was not possible. A more practical staff procedure would have been, under the circumstances, to recommend approval of the practice until it was abolished in South Africa.

Policy reform was a continuous process, not a once-and-for-all change, and for that reason his authorities had decided to proceed with the program supported by the enhanced structural adjustment arrangement rather than stop with the completion of the structural adjustment arrangement, Mr. Monyake

said. A host of challenging issues remained to be addressed, some of which had been mentioned by Directors, including the high degree of reliance of Lesotho on South Africa, the unemployment level, and human resource development, which would remain the focus of attention of his authorities.

The gravity of the situation with regard to Lesotho's reliance on South Africa had been discussed, Mr. Monyake noted. The unemployment situation was worrisome, and it would have posed a much more serious problem for the authorities were it not for the opportunities available in South Africa, particularly in the mining sector. Unemployment was unlikely to be eased in the next few years and would require long-term solutions. Programs to make rural life attractive and thereby check the migration of jobseekers into the cities--and outside the country--as well as programs to broaden the resource base and remove structural impediments to growth and productivity were required to address the unemployment problem on a sustainable basis.

A closely related issue was the need for skilled and trained manpower, Mr. Monyake added. Undoubtedly, education contributed fundamentally to the development of a productive population, and one way of effectively addressing the issue was to devote a large share of government spending to education. He was pleased to see such a need sufficiently reflected in the policy framework paper. Nevertheless, he wished to re-emphasize that while the reforms he had mentioned were crucial, they could not be fully effective unless supported by appropriate and timely external assistance.

The Acting Chairman commented that the authorities' openness, even in discussing tentative plans, reinforced the trust between the authorities on the one hand and the staff, management, and the Board on the other. In turn, management and staff should be frank with the Board, presenting explicitly the considerations leading to the staff's recommendations.

The Acting Chairman then made the following summing up:

Executive Directors agreed with the general thrust of the staff appraisal and commended the authorities for the continued pursuit, under the three-year program supported by the structural adjustment facility, of an adjustment effort focused on economic liberalization, fiscal and monetary discipline, structural reforms to diversify production and exports, and restructuring of the public enterprise sector. Nevertheless, Directors noted the external vulnerability of the economy, particularly to developments in South Africa, and they emphasized therefore the need for intensified efforts to accelerate structural reforms, enhance the efficiency of the economy, and sustain the progress toward a more diversified and resilient economy.

Directors were also concerned about the indications of demands for higher wage increases, which raised questions regarding the ability of the authorities to meet the program targets. In addition to urging wage restraint, Directors

encouraged the authorities to pursue tight fiscal and monetary policies, with several speakers emphasizing that larger than programmed wage increases would need to be offset by additional action, mainly in the fiscal field. Directors welcomed the steps being taken to reform the financial sector, particularly measures to widen the treasury bill market, develop the capital market, shift progressively from direct to indirect credit controls, prepare the basis for open market operations, and provide help to Basotho entrepreneurs in developing bankable projects.

Directors observed that fiscal policy had been a cornerstone of policies in recent years, and they welcomed the sharp reduction in the overall budget deficit during the past three years. They supported the efforts being made by the authorities to further reduce the budget deficit, limit recourse to bank financing, and strengthen the budgetary control process. However, a number of Directors expressed their concern that the fiscal policy program for the current year appeared to be too optimistic. Speakers generally stressed the importance of strengthening and expanding the noncustoms fiscal revenue base, including completion of the company tax reform and improved income tax administration. They noted that the structure of sales taxes will need to be adjusted to remove exemptions and take into account the expected switchover to value-added taxation by South Africa. They pointed out that the overall budget performance would be enhanced by controlling expenditures at the commitment stage and phasing out extrabudgetary outlays, and through regular monitoring of budgetary operations. Directors also stressed the critical importance of making rapid progress with the reform of the public enterprise sector, including a vigorous program of privatization, commercialization, and liquidation.

Cognizant of the vulnerability of the economy to external shocks, especially the risk of further retrenchment of Basotho miners working in South Africa, Directors noted that the medium-term balance of payments could be enhanced by creating a favorable environment for foreign investment, strengthening the incentives for domestic savings and productive investments through appropriate financial sector reforms, and developing the agricultural sector through improvements in extension services, land reform, and range management practices and marketing. Directors also underscored the need for a sustained adjustment effort and prudence in external borrowing.

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 decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Lesotho's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1991 Article XIV consultation with Lesotho, in the light of the 1991 Article IV consultation with Lesotho conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Lesotho maintains the restrictions on the making of payments and transfers for current international transactions described in EBS/91/71 in accordance with the transitional arrangements of Article XIV, Section 2, with the exception of the multiple currency practice arising from the dual exchange system which is subject to Fund approval under Article VIII, Sections 2(a) and 3. The Fund encourages Lesotho to continue to administer the restrictions maintained under Article XIV in a liberal manner and to eliminate the multiple currency practice as soon as circumstances permit.

Decision No. 9734-(91/67), adopted
May 22, 1991

Enhanced Structural Adjustment Arrangement

1. The Government of Lesotho has requested a three-year structural adjustment arrangement under the enhanced structural adjustment facility, and the first annual arrangement thereunder.

2. The Fund notes the updated policy framework paper for Lesotho set forth in EBD/91/122.

3. The Fund approves the arrangements set forth in EBS/91/71, Supplement 3.

Decision No. 9735-(91/67), adopted
May 22, 1991

3. INDONESIA - 1991 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1991 Article IV consultation with Indonesia (SM/91/80, 5/1/91). They also had before them a background paper on recent economic developments in Indonesia (SM/91/88, 5/8/91).

Mr. Ismael made the following statement:

For the second year in a row, Indonesia managed to achieve real GDP growth of slightly over 7 percent after experiencing an average annual growth rate of 5.5 percent from 1983 to 1988. The underpinning of this rapid economic growth has been an investment surge of sizable proportions. Approvals for new foreign investment commitments doubled to $8.75 billion in 1990, while requests for domestic investment tripled to $31.5 billion. However, sharply stepped-up economic activity in 1989-90 has, in the short run, posed the authorities with three troublesome by-products: (1) inadequate investment in infrastructure; (2) overheating of the economy; and (3) increased balance of payments pressures.

Electricity supply, ports, and telecommunications, in particular, are straining under growing domestic demand pressure. In a bid to avoid bottlenecks, the Government has eased import tariffs on generator sets destined for private companies and has allowed private firms to supply electricity to factories on industrial estates. Recently, the Government has also awarded contracts to two foreign companies to supply a combined total of 700,000 new telephone lines, which will help boost Indonesia's target from 1.4 million to 2.4 million new telephone connections under the 1989-94 Development Plan. With the rapid growth in demand for new port capacity, the Government has recently issued new regulations allowing private business to build and manage container terminals, with government agencies remaining responsible for general port administration and customs inspections.

The sources of price pressures were twofold: monetary expansion; and adjusted fuel prices, electricity tariffs, and telephone rates. With the hope that more liquidity would drag down prevailing high interest rates, central bank liquidity credits were left to expand by Rp 2,325 billion during the second half of 1989 and by Rp 1,218 billion during the first quarter of 1990, which indeed reduced interest rates in early 1990 but began to show their effect on inflation after a six-to nine-month lag. On the other hand, SBIs (Bank Indonesia Certificates) were not able to match the growth of liquidity credits, and by end-September 1990 the decline in outstanding SBIs increased monetary supply by nearly Rp 1,000 billion. The increase in the number of banks and the fierce competition between them in the wake of the October 1988 banking deregulation was another factor which brought about the rapid monetary expansion in 1989 and the first quarter of 1990.

A major source of recent balance of payments pressures has been unexpectedly high imports. Non-oil imports surged

32.7 percent to $21.9 billion, compared with 21.3 percent growth in 1989/90. To a large extent, they have been the result of purchases of material needed for building and equipping factories which should support much higher export growth in future years. However, non-oil exports rose by only 6.9 percent in 1990 to $15.5 billion, well below the 18.9 percent growth rate achieved in 1989/90. Finally, anxiety about the balance of payments, fueled by the public's belief that the end of the Middle East crisis would bring a period of low oil prices and subsequent devaluation, prompted increased purchases of dollars in January and February 1991.

Concerned that the rate of monetary expansion would lead inflation to exceed 10 percent, the authorities started to withdraw the central bank liquidity credits in April 1990 in line with their stated policy in January 1990. Although by September 1990 the liquidity credits were reduced by Rp 3,000 billion, the authorities' tight money policy was rendered less effective as many banks resorted to overseas borrowing.

In late February 1991, the authorities responded further by ordering 12 state-owned companies to withdraw almost $4.2 billion of their deposits held in state and private banks to buy SBIs which carried a 22 percent interest and a one-year maturity. Seventy-five percent of the withdrawn deposits was matched immediately with central bank purchases of SBPUs (money market certificates) which ranged in maturity from seven days to 12 months with interest rates of 18.75-23 percent. The result was to make it prohibitively expensive to speculate against the rupiah, while the central bank will have the future option of tightening money supply by not rolling over SBPUs that come due.

Simultaneously, the authorities announced sweeping new rules for the rapidly growing banking sector to make it sounder and more efficient. The new rules include a timetable to meet international--Bank for International Settlements--capital adequacy standards, further contain net foreign currency open positions of commercial banks by cutting the permissible limits on these positions from 25 percent to 20 percent of a bank's capital, ban loans for share trading, and more strongly control foreign exchange trading by limiting the margin trading exposure to ten times a customer's margin deposit with a bank.

The subsequent money supply squeeze has pushed interest rates up to levels even higher than they were before the October 1988 banking deregulation. In turn, the higher interest rates have slowed down sales of consumer goods, which boomed in 1990. Many new property developments have been postponed because of funding shortages, and other projects have had to be canceled outright because they have become less feasible with the new realities of

interest rates. Eventually, with the short time that remained until the end of 1990/91, inflation was contained at 8.7 percent by end-March 1991 against 6.4 percent the year before, whereas the current account recorded a deficit of $4.5 billion or two-and-a half times the level recorded at the end of 1989/90. In the meantime, to maintain Indonesia's international competitiveness under the circumstances, the rupiah has been gradually depreciated by 8.2 percent over the past year.

Indonesia's economic growth is likely to slow to 6 percent in 1991. The main reasons for the slowdown are the tight money policy, infrastructural bottlenecks, an expected drop in international oil prices, and a weakening demand for imports in the major Western economies. The authorities are determined to keep credit tight until the goal of containing inflation is achieved. The aim is to reduce inflation to a maximum of 7 percent a year. The recent wisdom learned anew is that temporarily extra-high interest rates are better than extra-high inflation, which could erode the newly developed ability to compete in export markets. In his budget address last January, the President made it clear that some, at least, of any windfall gains in 1990/91 from higher than anticipated oil prices will be used to bolster foreign exchange reserves. Strengthening the foreign reserve position and combating inflation were specifically cited as priorities to make the country better prepared to meet future developments.

The 1991/92 budget again reflects a sense of realism in regard to what is believed to be achievable by way of revenues and the priorities for expenditures. Among the major items 1/

(a) Exports are projected to reach an all-time high of $29.49 billion.

(b) Non-oil export revenues are projected to reach $18.8 billion, 18 percent higher than in 1990-91, representing 63.7 percent of total anticipated domestic revenues in 1991/92.

(c) Government revenues and expenditures are both budgeted to reach $25.7 billion, calling for an overall increase of 17.9 percent over 1990/91.

1/ Complete actual budget data for 1990/91 are not available at this time. The budget figures as presented here are comparisons between last year's figures and this year's proposed figures. For this reason, the figures and percentages presented might be slightly different from those in the two staff documents.

(d) Based on projected average oil prices of $19 a barrel--up from $16.50 for 1990/91--oil and gas revenues are expected to increase sharply, by at least 39.2 percent; for this reason, the relative share contributed by tax revenues and other non-oil sources--62.6 percent--will register a slight decline from the record high of 65.9 percent projected for 1990/91.

(e) The value-added tax, traditionally the largest source of tax revenue, is projected to increase by 20 percent, contributing $4.35 billion; income taxes are projected to grow by 23 percent, contributing $4.24 billion.

(f) Development expenditures, with the main priority infra-s uctural improvement, will comprise nearly 40 percent of the budget, up 23.3 percent from their proportional share for 1990/91.

(g) After two consecutive years of salary increases, totaling 25 percent, the 1991/92 budget has made no provision for increased wages for civil service employees and members of the armed forces.

(h) Foreign debt repayment as a proportion of routine expenditures is projected to decline to 46.2 percent from 47.8 percent in 1990/91, whereas the Government's debt-service ratio would rise from 24.4 percent in 1990/91 to 26.6 percent.

(i) To meet the immediate financing needs and help fund major development projects, the Government is looking forward to continued strong support from bilateral and multilateral donors.

In conclusion, my authorities concur with the general thrust of the staff appraisal.

Mr. Landau made the following statement:

Indonesia's performance during the second half of the 1980s can be considered a model. It illustrates how a strategy based on external and internal liberalization, backed by appropriate macroeconomic policies, can produce a high rate of growth together with a reduction in inflation. Indeed, during the past few years, GDP growth exceeded 6 percent on average, real investment rose continuously to one third of GDP, and inflation fell to 6.4 percent. The current account deficit has been kept down to 2.1 percent of GDP.

Since the beginning of last year, however, the economy has shown signs of overheating. The expansion of domestic demand has been amplified by a more expansionary monetary policy, but it has also been stimulated by deregulation measures in the investment

field and in the financial sector. Indonesia now has to face new problems of macroeconomic management in a more liberalized context. In that context, the staff argues that macroeconomic policies will have to be strengthened to avoid a further deterioration of the external accounts; however, the authorities appear to be more cautious so as to avoid breaking the momentum of growth.

This leaves open the question of the appropriate policy mix. I would tend to argue that, given the somewhat large uncertainties concerning the reaction to monetary instruments in a context of financial liberalization, the pursuit of a cautious monetary policy should be actively complemented by an appropriate fiscal policy. In this framework, it would be possible to envisage, through progressive reductions in nominal and real interest rates, a continuation of the growth process without endangering price stability in the long run.

Indeed, fiscal policy should continue to play a key role in the present circumstances. Remarkable progress has been made so far in reforming the tax system and increasing non-oil revenues. But additional efforts, such as the extension of the value-added tax coverage and continued improvement in tax administration, would seem appropriate. On the expenditure side, further reductions in subsidies, particularly on petroleum products, would be warranted. Maintaining control over the wage bill should also deserve the authorities' utmost attention.

Stronger action on the fiscal front would allow the authorities to avoid increasing the burden on monetary policy. While there has been a significant tightening of monetary policy, it has not yet brought about a sufficient reduction in credit growth. This could take some time, especially when considering the impact of financial liberalization and the process of reintermediation which has taken place in Indonesia. I would not argue, however, despite the apparently high level of real interest rates, that it is time for relaxation. Future measures should be guided by developments in the rate of inflation and in the external position. In any case, the recent measures taken by the authorities aimed at absorbing liquidity and tightening credit conditions seem to have allowed for increased--although indirect--control over monetary aggregates.

On exchange rate policy and its link with monetary policy, I share the staff's judgment that, in the present circumstances, further depreciation of the rupiah would be inappropriate. Given the overheating of the economy, I wonder whether the real depreciation of 8 percent, during the 12 months through February 1991, was warranted. Finding the equilibrium level for the real exchange rate during this period, given the many transformations

in the Indonesian economy and the rapid gains in productivity, might be, however, a difficult task. I would appreciate comments from the staff on this issue.

I agree with the staff's appraisal: at the very least, the nominal exchange rate should be closely monitored as a main indicator of the appropriateness of the monetary policy stance. I also agree that the conditions are ripe for Indonesia to embark on a strategy of "competitive disinflation," through which a reduction of inflation would allow both an increase in competitiveness and more stability in the nominal exchange rate. I would caution against a policy mix that overemphasizes the use of monetary policy, which could result in an overshooting of the exchange rate.

I encourage the authorities to pursue the far-reaching structural reforms that they have launched. I fully agree with the staff that present concerns should not detract the authorities from this task. In particular, the pursuit of trade and investment liberalization, including the dismantling of nontariff barriers and the elimination of export restrictions, should play an important role in improving the functioning of the capital market and ensuring adequate supervision, as well as in mobilizing private savings. I also note the great importance of the policies designed to reduce poverty, particularly through better access to social services.

Mr. Yamazaki made the following statement:

I commend the authorities for their strenuous efforts to change the industrial structure. These efforts include decreasing the heavy dependence on the oil sector, increasing the weight of non-oil industries, liberalizing trade regulations, restructuring public enterprises, and strengthening the financial sector by, inter alia, deregulation, strict bank supervision, and the establishment of an efficient capital market.

With respect to the decrease in dependence on the oil sector, the share of the non-oil manufacturing sector in total GDP rose from 13 percent in 1986/87 to 15.6 percent in 1990/91--a significant achievement. As for trade liberalization, the authorities removed the import licensing restrictions on as many as 335 products and lowered the tariff ceiling from 60 percent to 40 percent.

Despite these favorable achievements in medium-term restructuring, the Indonesian economy is confronted with various difficulties. The inflation rate has been in the double-digit range and the current account deficit increased from

$2 billion in 1989/90 to $4.5 billion in 1990/91. It is projected to deteriorate further to $6.2 billion this fiscal year.

It is critical to understand why these imbalances occurred. The staff report analyzes the economic situation and policy responses during the period from 1982 through the beginning of 1991. According to the analysis, one of the main reasons for the economic imbalances was the inappropriate implementation of macroeconomic policy, particularly monetary policy, since mid-1989. It is cause for regret that the authorities continued to increase liquidity in order to lower interest rates, even though the market rates had risen, reflecting strong domestic demand. It is also disappointing that, while measures to tighten monetary conditions were introduced in April 1990, several policies allowing an expansion of liquidity had been left unchanged until the end of the year. These included, notably, the Bank of Indonesia's swap facility, in which the premium had lagged behind the differential.

I am anxious to know the reason for the delay in tightening monetary policy, and why these credit expansion policies were allowed to exist until the end of 1990. I would also like to know what policy recommendations were given by the staff from mid-1989 to the end of 1990, and the authorities' response. I would appreciate it if the staff could clarify these points.

As for short-term policies, I support the staff's view that domestic demand should be slow enough to prevent an increase in the volume of non-oil imports in 1991/92. Also, I agree with the argument that both official and private capital inflows will be weakened in the coming years. I am inclined to believe that the authorities might be somewhat too optimistic in expecting the introduction of quick-disbursing balance of payments assistance from aid donors. I would therefore like to stress the paramount importance of self-adjustment efforts in this and coming fiscal years.

As for fiscal policy, it is necessary to eliminate the petroleum subsidy and to raise the domestic prices of petroleum products. In addition, the improvement of tax administration and further extension of the coverage of the value-added tax are a matter of urgency. Also, augmentation of civil service salaries should not be permitted if the authorities wish to control inflation.

The staff mentioned that depreciation of the real effective exchange rate of the rupiah during the past couple of years triggered an increase in investment in export industries and diversified the export base. Therefore, the staff recommends gradual depreciation of the rupiah in the coming years. However,

I have some questions about this policy. In general, for a country that is trying to expand export-oriented industries and whose industrial material and equipment depend heavily on imports, the most important policy direction is to lower import prices, or, at least, to maintain them at the same level. I would appreciate staff comment on the expected effect of the gradual depreciation of the rupiah on the input and output relationship in export-oriented industries, including the projection of other variable and fixed costs. Regarding the medium-term outlook, in view of the critical importance of implementing prudent economic policies, I support the adjustment scenario.

Mr. Posthumus made the following statement:

The Indonesian economy is continuing its impressive record of adjustment and development, as noted by the staff. A liberal exchange and trade regime, the successful diversification of exports, deregulation of the financial sector, and good policies are just a few factors that have supported this impressive record. This is good news, but it is not news because Indonesia's record has been consistent for many years.

However, I will concentrate on those areas that need improvement. Domestic demand pressures, witnessed by a substantial jump in inflation, are by now a matter of great concern for the authorities and the Fund. With the benefit of hindsight, it is clear that the measures taken in the second quarter of 1990 were too little, too late. A thorough analysis in the staff report of the monetary developments of the past few years would have been warranted to obtain the benefit of foresight. Last year, I noted that the accelerating increase of domestic credit over the year ended March 1990 had been preceded by two years of high domestic credit creation as well. It is now much clearer that the inflationary problem was deep seated, and the important question is whether it could have been acted upon earlier. Monetary policy in future has to be conducted in an economy that is changing significantly.

A few factors might explain why a deep-seated inflationary problem was not detected in time, or why its seriousness was underestimated. One factor might be the assumption that the increasing share of broad money in GDP was a corollary of structural reform and not an indication of excess liquidity, as shown in Table 1 of the staff report. In addition, the staff mentions that the expansion in domestic credit far outpaced economic growth over the past two years. However, this has been the case since 1987, as illustrated in Table 3.

A second factor might be that the level of inflation was not considered very high, slowing from 9.2 percent in 1987/88 to 7.4 percent in 1988/89 and 6.4 percent in 1989/90. However, these levels remain high, and inflation of 6 percent and above should not be looked at more benevolently in the case of a developing country than in the case of industrial countries.

A third factor might have been that inflation was regularly accommodated by devaluation of the rupiah to maintain and strengthen Indonesia's competitive position. Thus, the causes of inflation might not have been analyzed sufficiently, and their damaging effects might not have been felt fully.

There is a substantial turnabout in this year's staff report compared with last year's report, which could indicate that the staff now feels that the flexible exchange rate policy conducted so far might have led to an underestimation of inflationary dangers. I fully agree with the staff's observation that a policy of tightening monetary conditions in response to signals in the foreign exchange market will help sustain public confidence in the rupiah and avoid the need for sizable exchange rate action. A strategy aimed at reducing inflation over time to the level of Indonesia's trading partners would preserve competitiveness while maintaining exchange rate stability. I agree with the staff that a devaluation at this time would not be warranted and, in fact, might be damaging to the anti-inflation policy. There was apparently a difference of opinion with the authorities, and I wonder whether the staff papers could not be more useful if they were more frank in reporting such discussions.

Last year, the staff projected that broad money growth of 26 percent would be consistent with the domestic and external objectives for 1990/91. A slowing of private sector credit growth of 25 percent to be attained by phasing out liquidity credits would be required, but the staff had added "provided the phasing out was not offset by the use of other monetary policy instruments." The latter is precisely what happened last year, when commercial banks engaged in large-scale offshore borrowing and swapped the proceeds with Bank Indonesia, and again this year, when the immediate liquidity impact of the forced conversion of bank deposits into Bank Indonesia Certificates was eased by Bank Indonesia acquiring money market instruments. It seems likely that the difference of opinion has been based on concern about the effects of what were perceived as high interest rates on investment and development.

Yet, the measures taken this year have resulted in a tightening of monetary policy, and the Board should support these measures. At the same time, however, I remain concerned that there is still substantial inflationary potential--as an inflation

target of 7 percent a year is not ambitious--that such inflation will be accommodated, and, therefore, that the overheating of the economy might continue for a longer time than is sustainable. Mr. Ismael notes that the substantial tightening of policies is beginning to slow down sales of consumer goods, which at first sight contradicts my fears. The danger is that the tight policies will be abandoned too soon. The widening of the balance of payments gap that results could then lead to financing problems.

The situation should be monitored closely. I would like to learn from the staff whether it considers that sufficient measures have been taken in the monetary policy field. I would suggest that the inflation target should gradually become more ambitious, so that the authorities would continue to follow restrictive monetary and fiscal policies. Doing so might entail short-term costs in terms of economic growth, but it will prevent wrong investment decisions and the need to bring about much sharper correction later. Indonesia has so far profited from cautious financial and economic policies as well as audacious and timely adjustment measures. The experience thus gained will be needed in the years to come, when the challenges both in analyzing developments and in implementing correctional policies will be strong.

I have singled out monetary and exchange rate policy, and I will not discuss other policy elements, largely because I share the staff's recommendations. Indonesia's overall policies generally deserve our full support; however, in the field of monetary and exchange rate policy, the Board should clearly indicate the dangers of letting inflation drift upward.

Mr. Fernando made the following statement:

Indonesia's growth momentum in the past two years could not be sustained without a growing risk to price stability and the external sector. The strains on the external sector arising from a buoyant domestic economy prevailed despite a substantial strengthening of receipts from the oil/gas sector. Given the good track record of economic management and sound policies for much of the 1980s, the recent problems illustrate the need for continuous vigilance to preserve the delicate balance in the policy mix. The margin for maneuver in macroeconomic management is indeed slim and, despite the steady progress, underlines the scope for more intensified structural reform.

In reacting to the overheating of the economy, the staff view is that the burden of adjustment should be shared between monetary and fiscal policy. Although we agree that the policy response should be mutually reinforcing, we tend to think that monetary

policy can play the more effective role and, looking at the genesis of present imbalances, has more room for maneuver than fiscal policy.

In the staff report, specific views are held on the petroleum subsidy and revenue-enhancement measures, while close scrutiny of current expenditures and development spending is urged. After a long period of petroleum subsidies, the authorities finally eliminated them through price adjustments in May 1990. However, subsidies re-emerged as a significant new burden during the Middle East crisis. Although a pass-through of higher international prices would have helped, we recognize that the authorities' hesitancy to act instantly could be justified. Having recently adjusted prices, the volatile nature of the market would have argued for a cautious approach. Further, the budgetary situation and prospects did not suggest a serious imbalance so as to precipitate a sharp upward adjustment in response to higher prices--although this was an important argument for some countries. This view applies to the financial situation of the overall public sector, too, as public enterprises were not a drain on the budget. Thus, public finance conditions afforded some latitude for the authorities.

The staff suggestion to base domestic oil pricing on an international price of $19 a barrel, which would then justify a 15 percent price increase, is shaky. Projections for the budget, balance of payments, and medium-term scenarios are based on a price assumption of $16.50 a barrel. At this level, there seems little reason to take issue with domestic pricing. Nevertheless, clarification from the staff or Mr. Ismael would be helpful in judging the authorities' stance. The assumption of an oil price of $19 a barrel for budgetary purposes raises the issue of domestic oil pricing, while a related point concerns the surplus earned by Pertamina. We would like to know how these surpluses are treated--what amount remains with Pertamina and what amount goes to the Central Government?

With regard to fiscal revenue, we would, on balance, give weight to the authorities' point of view. We note the significant achievements in diversification and in increasing the elasticity of the tax system. The authorities have demonstrated the scope for strengthening tax administration by improving the tax coverage ratio. A major objective of fiscal reform was to simplify the tax structure. Any further discretionary measures should be considered carefully for their effect on administration and taken only if additional administrative burdens do not arise. More generally, Indonesia's satisfactory revenue performance at close to 20 percent of GDP warrants recognition.

The authorities' action to offset the easing of monetary policy comes not a moment too soon. Against a background of steady and substantial improvement in public finance, it is a matter of concern that the conduct of monetary policy left much to be desired. Even though decisions were taken in January 1990 to phase out the central bank's preferential credits, implementation has been marked by ambiguity and delays. Similarly, alongside domestic policies aimed at monetary tightening, the permissive attitude of the bank to foreign exchange swaps, which clearly contributed to domestic liquidity, is reflected in the gaps that exist in the central bank's capacity to play an effective complementary role to other aspects of public policy. The range of direct control measures now employed thus becomes a necessary evil. We hope that they will be lifted soon and that orderly progress in structural reform in the financial sector will resume.

In this context, the issue of interest rates--to which the Indonesian authorities have been very sensitive--is vital. We share their concern that high real rates will dampen private sector enthusiasm. Nevertheless, Mr. Ismael confirms that high interest rates will be preferred if in their absence inflation would remain high. High interest rates will also, through their effect on interest-sensitive components of domestic demand, dampen investment--especially in infrastructure construction, which has contributed directly to a worsening of the trade balance. Thus, early results on the balance of payments front are possible.

More fundamentally, however, we underscore the vital importance of rapid liberalization and enhanced competition within the financial sector as the lasting basis for effective monetary policy and sustained business confidence. To build up the momentum for private sector-led development and then have sharp changes in credit conditions erodes business confidence. Despite the recent rapid development of the stock market, business continues to rely on bank credit for investment needs. The high cost of credit becomes a vicious circle that leads to a squeeze on profits and the reduced ability to reinvest earnings, thus keeping reliance on credit at a high level. In addition, even as the Government curtails infrastructure expenditure in the hope that the private sector will fill the resulting gaps, its actual ability to do so will be conditioned by access to credit on terms that are consistent with the low and long gestation period for returns.

In this context, we welcome the authorities' actions to strengthen the banking sector by enforcing capital adequacy ratios and provisioning for bad debts. We would appreciate staff comment on the situation of the state banks with respect to the distortions that remain in the financial sector--particularly in

the area of intermediation margins and the extent of the nonperforming portfolio.

On the exchange rate, we note the high priority placed by Mr. Ismael on inflation control as a more secure basis for maintaining export competitiveness. We hope that business and labor will maintain the required internal discipline to achieve cost control, as the authorities are not expected to follow a real exchange rate rule.

In some of the tables in the Statistical Appendix in the background paper, classification and disaggregation have not kept pace with structural change and deregulation. Thus, in Table 32 on Bank Indonesia liquidity credits, the catch-all "other" category is the dominant entry for state banks. Similarly, in Table 50 on non-oil/gas imports, the classification throws little light on consumption and investment trends. We hope that the authorities will make extra efforts in this area to provide information that makes it easier to observe recent trends.

Mr. Finaish made the following statement:

Following a period of successful adjustment to severe external shocks, Indonesia enters the 1990s with a strong economy that is expected to reduce macroeconomic imbalances and to correct distortions in the incentive system. The authorities' wide-ranging reform program has elicited a positive private sector response and brought impressive results in terms of economic performance and a diversified export-led production base.

Driven by the continuing growth in private investment, overall economic growth in 1990 has been strong, although with emerging signs that the fast pace of expansion was beginning to place strains on available resources. Real GDP and manufacturing production expanded sharply; the fiscal outturn was substantially more favorable than envisaged; and good progress was made in implementing structural reforms across a broad front.

In the external sector, there was a widening of the current account deficit. Nevertheless, the capital account strengthened considerably in response to a sizable increase in direct investment and other private inflows so that the overall balance of payments reverted to a surplus. However, the continuing strength of domestic demand and emerging capacity constraints resulted in an acceleration of inflation. There is a risk that, if left unchecked, these demand pressures could undermine price stability and balance of payments viability.

The staff states that the major policy challenge facing the authorities is how to "ensure a soft landing from a too rapid rate of domestic demand expansion." I broadly agree with this assessment. Meeting this challenge will require that the authorities implement measures aimed at slowing domestic demand so as to put the economy on a more sustainable growth path. The authorities' recent policy actions on the monetary front are therefore both appropriate and timely. Nevertheless, I would like to make a few brief comments on the recent evolution of Indonesia's balance of payments position.

First, it would seem to me that the deterioration of the external position is an inevitable concomitant of Indonesia's transition to a more open and diversified economy and derives from the underlying strength of the economy rather than from policy errors. The surge in private investment following reforms has surpassed all expectations, and I believe this factor should be recognized.

Second, to the extent that the external deficit has been financed by autonomous private capital flows, as was the case in 1990-91, it should not be a cause for immediate concern unless it is building up a risk of volatile movements in private portfolio investments.

Third, because the surge in imports is closely linked to the rise in private investment and the bulk of import and investment flows is destined to the export-oriented sectors, the deterioration in the current account of the balance of payments should be largely self-correcting, as export capacity is augmented over time. In this regard, it is not obvious to me why the staff's alternative scenario, which calls for an actual cut in import volume in 1991/92, should permit a faster recovery in non-oil exports. If anything, such a cutback in the volume of imports could well deter exports unless, of course, the staff feels that the recent surge in imports is associated with a speculative swing of the stock cycle. Staff comment would be welcome.

In conclusion, while I would not wish to give the impression that there is not a clear need for corrective policy action, I believe that Indonesia's external sector performance in 1990/91 and beyond needs to be seen in its proper perspective. I am confident that the policies that the authorities pursue will offer the promise of a quick recovery in non-oil exports and a return to a sustainable noninflationary growth path.

Mr. Goos commented that the staff report gave the impression that Indonesia had reached a difficult stage in its economic and financial

development. Ironically, and without wishing to minimize the impact of other factors, much of the difficulties could be traced to the success of the recent structural reforms aimed at strengthening private sector activity. The pronounced surge in that activity had indeed contributed to significant excess demand, which called for early correction to avoid further acceleration in the already excessive rate of inflation and destabilization of the external accounts. As the staff rightly stressed in that context, in the absence of a strong policy effort, the current account deficit could be expected to widen further.

As to specific policy areas, he endorsed the thrust of the staff's recommendations, notably that a tighter monetary policy should be supported by additional efforts at fiscal consolidation, Mr. Goos said. Fiscal policy management had been cautionary, and he welcomed in that regard the authorities' decision to sterilize at least part of the windfall profits from the previous oil price hikes. However, if left alone, the necessary monetary tightening was likely to remain ineffective inasmuch as it would probably be undermined by further foreign capital inflows.

At the same time, there seemed to be an urgent need to mop up excess liquidity created over the past two years, as indicated in the report, Mr. Goos continued. Like Mr. Posthumus, he found it striking that the monetary aggregates had expanded significantly faster than GDP in previous years. However, looking at that rate of expansion and the significant devaluations of the rupiah in recent years, he found it puzzling that, together, those developments had not resulted in stronger inflationary pressures than observed. He hoped that the staff's comments would shed some light on those issues.

A more cautious stance on monetary policy would be highly advisable, and he hoped that the central bank law under preparation would provide for rationalization of monetary policy with a view to limiting the responsibility of the monetary authorities to securing price stability, Mr. Goos remarked. In that context, he wondered whether consideration had been given to providing the central bank with independent status. Meanwhile, strict control over liquidity credits and use of the central bank swap facility, especially through more flexible adjustment of the swap premium, would be crucial. The recent negative experience with the policy deliberately aimed at reducing interest rates held important lessons in that regard.

He fully endorsed the staff's recommendations concerning exchange rate policy, Mr. Goos stated. They were, as noted by other speakers, a welcome departure from the previous emphasis on a policy of frequent devaluations. Nonetheless, he was surprised that the possibility of a further exchange rate devaluation was a topic of discussion between the authorities and the members of the mission. Discussion of a possible revaluation would have been of greater merit. It would have been consistent with the fact that the balance of payments problems reflected excessive domestic demand pressures, and that the economy seemed to enjoy a comfortable margin of external

competitiveness after the continued significant decline in the external value of the rupiah over the past few years.

In that context, he was also struck by the staff's view that "policies to curtail the growth in domestic demand would go far in achieving a lasting reduction in inflation," Mr. Goos added. He was not sure what the staff meant by "would go far," when tightening financial policies would seem to be the authorities' appropriate course in the present circumstances; devaluation would certainly be in the wrong direction.

The staff's balance of payments projections were based on an oil price of $16.50 a barrel, Mr. Goos noted. That price appeared to be obsolete following recent developments in the oil market, and he wondered whether the staff had revised its projections and could give new estimates for the balance of payments. Also, he would appreciate comments from the staff or Mr. Ismael on the recent move to separate commercial banking from security or investment business. That move seemed to be at odds with the trend in other countries toward overcoming such artificial segmentation between different kinds of banking businesses and toward establishing a universal banking system.

He endorsed the staff appraisal and was confident, based on the authorities' remarkable record of sound economic management, that they would successfully master the current challenges, Mr. Goos concluded. Doing so would require, first and foremost, a course of tight financial policies in the foreseeable future, even if that implied some loss in short-term growth. In that regard, he had some doubts about the consistency of the current annual growth targets of 6 percent with the urgent need for domestic and external stabilization, including, in particular, the need to bring down inflation. Moreover, success in meeting the current challenges would hinge critically on continued efforts to achieve structural reform. While the authorities had made commendable strides in that area, it appeared from Table 1 of the staff report that there remained significant scope for further deregulation, notably in external trade and foreign direct investment.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/66 (5/20/91) and EBM/91/67 (5/22/91).

4. EL SALVADOR - TECHNICAL ASSISTANCE

In response to a request from the Salvadoran authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/91/159 (5/16/91).

Adopted May 21, 1991

5. REPUBLIC OF POLAND - TECHNICAL ASSISTANCE

In response to a request from the Polish authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/91/158 (5/15/91).

Adopted May 20, 1991

6. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by Advisors to Executive Directors as set forth in EBAP/91/123, Correction 1 (5/20/91) is approved.

7. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/91/127 (5/21/91) is approved.

APPROVED: November 27, 1991

LEO VAN HOUTVEN
Secretary