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Minutes of Executive Board Meeting 85/146

10:00 a.m., September 20, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
	M. K. Bush
	D. C. Templeman, Temporary
J. de Groote	
B. de Maulde	S. de Forges
	T. Alhaimus
	M. B. Chatah, Temporary
	K. Murakami, Temporary
G. Grosche	
	M. Rasyid, Temporary
	L. Leonard
	G. W. K. Pickering, Temporary
A. Kafka	
	H. Fugmann
E. I. M. Mtei	
	B. Jensen
Y. A. Nimatallah	
	G. Ortiz
	J. de la Herrán, Temporary
	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
	A. A. Agah, Temporary
	A. S. Jayawardena
	T. A. Clark
	N. Coumbis
	L. Tornetta, Temporary
	Jiang H.

J. W. Lang, Jr., Acting Secretary
J. K. Bungay, Assistant

Also Present

IBRD: C. Jones-Carroll, Latin America and the Caribbean Regional Office; J. Pratt, Eastern and Southern Africa Regional Office. African Department: R. J. Bhatia, Deputy Director; G. E. Gondwe, Deputy Director; L. M. Goreux, Deputy Director; E. L. Bornemann, E. A. Calamitsis, R. O. Carstens, S. E. Cronquist, A. Jbili, O. Kaba, I. Kapur, M. G. Kuhn, I. S. McCarthy, B. R. H. S. Rajcoomar. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; B. de Schaetzen, S. Kanesa-Thasan, B. J. Nivollet. External Relations Department: C. S. Gardner, Deputy Director. Fiscal Affairs Department: J. Baldet, B. A. Sarr. IMF Institute: M. Mwansa, Participant. Legal Department: G. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; P. L. Francotte, Ph. Lachman. Secretary's Department: B. J. Owen. Treasurer's Department: A. J. Mathuran. Western Hemisphere Department: E. Wiesner, Director; M. E. Bonangelino, O. Gronlie, R. K. Rennhack, E. C. Suss, I. C. Tandeciarz. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: J. Hospedales, G. Nguyen, A. Vasudevan. Assistants to Executive Directors: W.-R. Bengs, A. K. Diaby, C. Flamant, S. Geadah, G. D. Hodgson, L. Hubloue, O. Isleifsson, S. King, S. Kolb, M. Lundsager, R. Msadek, J. K. Orleans-Lindsay, D. J. Robinson, C. A. Salinas, M. Sarenac, A. A. Scholten.

1. ZAIRE - REVIEW UNDER STAND-BY ARRANGEMENT, AND NONCOMPLYING PURCHASE AND WAIVER OF NONOBSERVANCE

The Executive Directors considered a staff report on the first review under the stand-by arrangement for Zaïre (EBS/85/207, 8/30/85), together with a report on a noncomplying purchase and recommendation for a waiver of nonobservance (EBS/85/206, 8/30/85; Sup. 1, 9/3/85; Sup. 2, 9/9/85; and Sup. 3, 9/10/85).

Mr. Alfidja commented that the review under the stand-by arrangement had given the authorities the opportunity to reconfirm their intention to build on the considerable progress made thus far by continuing to implement measures aimed at achieving the program's objectives. While all other performance criteria for 1985 had been observed, the ceiling on the net domestic arrears of the banking system had been exceeded. The Zaïrian authorities had taken measures promptly to reverse the situation and had been able to observe the ceiling for end-June 1985. During the second quarter of 1985, fiscal developments favorably reflected the measures taken in the previous quarter to improve the budgetary outcome.

The authorities had taken exceptional steps on the revenue side, including the liquidation of certain major assets, Mr. Alfidja continued. They had introduced a number of measures to improve revenue performance--notably increasing import duty rates and revising petroleum taxation. The liberalization of the import distribution of petroleum and the intensification of tax collection nationwide was expected to enhance government receipts.

On the expenditure side, budgetary allocations had been reduced, Mr. Alfidja noted. New procedures for controlling the outlays of government agencies on public utilities such as water, electricity, and petroleum had been introduced. The authorities' endeavors to strengthen budgetary discipline had yielded encouraging results, and they would continue their efforts to improve the overall fiscal outcome.

Improving the financial position of the public enterprises and depreciating the currency had resulted in substantial contributions to the Treasury during the first six months of the year, Mr. Alfidja pointed out. Some public enterprises had paid dividends for the first time in several years, while others had reduced their losses considerably, in part by adjusting prices to reflect marginal costs. The management of the public enterprises would continue to be restructured so as to improve performance.

The unexpected and unfavorable developments in money and credit during the first quarter of 1985, as well as technical problems encountered by the Bank of Zaïre, had been quickly reversed during the second quarter, Mr. Alfidja recalled. The vigorous fiscal measures introduced to improve budgetary performance had reduced the Government's domestic financing requirements. As a result, net credit to the Government and the net domestic assets of the banking system had declined sharply.

For the rest of the program period, the authorities would be directing their policies toward containing the rate of growth of credit, and measures toward that end had already been taken by the Bank of Zaïre, Mr. Alfidja stated. The authorities considered that the inflow of foreign capital from official and private sources was inadequate to support the country's ongoing strong adjustment effort, and therefore they would need to count on increased support from creditors, friendly countries, and the international financial community, as well as private investors.

Finally, the staff report had clearly explained the circumstances surrounding the noncomplying purchase that had led to the Managing Director's report and recommendation for a waiver, Mr. Alfidja concluded, and he urged the Executive Board to approve the proposed decision.

Mr. de Groote noted with satisfaction that during the first half of the year, the expansion in the net domestic assets of the banking system and in net credit to the Government had amounted only to about one third of the increase allowed under the program. That had more than compensated for the overshooting of credit targets during the first quarter, so that the program was effectively back on track. It was to the credit of the authorities that as soon as the final data for the end of March had become available, they had reacted immediately by adopting drastic measures to improve the budgetary performance and to curtail domestic credit, thus giving proof that the misreporting had not been deliberate. There might even have been a positive side to the difficulties experienced at the end of March, since the authorities' attention had been drawn to the need to maintain more continuity in credit policies throughout each quarter and to correct the structural causes of the central bank's operational losses.

He therefore found especially welcome the authorities' decisions to impose weekly penalties for excesses over credit limits and to search for more effective ways of avoiding the stop-and-go features of the present credit policies, Mr. de Groote added. The authorities had appropriately increased the rate charged on the central bank's net credit to the Government and had instituted new procedures for closely monitoring the bank's advances to the Government. Even in the most turbulent times, the central bank had succeeded in preserving an image of competence and good management, which was a sure way of restoring confidence in the country's creditworthiness. The staff could perhaps elaborate further on the reasons for the central bank's losses on gold swaps.

For the immediate future, the staff had rightly given priority to ensuring the better functioning of the exchange market to increase the supply of foreign exchange, Mr. de Groote considered. The premium on foreign currency in the parallel market was indeed worrying and seemed to have pushed up domestic prices more than required; it also gave the banking and business community cause for distrust. Hence it was heartening that the authorities were firmly committed to exchange rate flexibility. Such flexibility, useful as it was for rerouting export proceeds through official channels, was not the answer to the underlying structural causes of imbalance between the supply and demand for foreign exchange. Measures such as better control of exports through more efficient customs administration and the elimination of fiscal disincentives for repatriating foreign exchange proceeds through official channels, would help to rectify that imbalance. It would be useful to know if any estimates had been made of the amounts of foreign exchange that were bypassing the banking system. If the envisaged measures were appropriate and if the amounts were large, the balance of payments forecasts for the medium term might need to be revised in a more optimistic direction.

The authorities' rescheduling of private debt with the London Club creditors had wisely established a link between the repayment obligations of Zaïre and the behavior of the price of copper, Mr. de Groote noted. It was an important initiative that he hoped official creditors would find possible to introduce in the terms of their own lending. As he understood it, the link would operate in both directions so that the repayment obligation would be adjusted downward when the price of copper fell to a floor of 66 cents per pound. Perhaps the system would be more logical if it allowed for repayments to be reduced further if the price fell below the floor.

As to the ceilings on credit to the private sector, it might become necessary to allow for an expansion of output, especially in manufacturing industries and agriculture in order to satisfy the needs of the domestic market, Mr. de Groote predicted. Enterprises seemed to have understood that the authorities could not have corrected the balance of payments without controlling overall liquidity. However, with the situation once again well in hand, domestic production could expand without jeopardizing the achievements in prices. In fact, internal prices might stabilize if the supply of locally produced goods could expand quickly. The Zaïrian economy had demonstrated an exceptional resilience in responding to shifts in supply and demand with limited price effects.

Seen in a longer-term perspective, Zaïre's was one of the most convincing examples of the effectiveness of Fund programs, Mr. de Groote stated. At the same time, Zaïre's experience demonstrated the extreme difficulty of restoring a viable current account position, even in a country particularly well endowed with natural resources, owing to the divergence between export receipts and the debt reimbursement requirements.

Zaïre's overall performance had been outstanding since the inception of the December 1983 program, largely because it had implemented already during 1983 a shadow program that conformed to the normal requirements for Fund assistance, Mr. de Groote commented. The forecast for the current account as of end-1983 had been for a reduction in the deficit by about one third from 1983 to 1985, from SDR 340 million to SDR 230 million; however, the projections for 1985 were for a two-thirds reduction, to SDR 150 million. The budget position during the same period would change from a deficit of about 4 percent of GDP to a surplus of about 1 percent of GDP, while inflation would be reduced to one third of its previous rate. Income would increase for the second year in a row, by 3 percent in real terms, following the income reductions of several earlier years. Given that such progress had occurred under unfavorable conditions for Zaïre's export prices and that the deterioration of the country's situation had occurred while export prices were increasing, it seemed obvious that appropriate policies had made all the difference.

Still, to preserve the present rate of growth until 1990, exceptional financing and extensions of debt rescheduling arrangements would continue to be needed, Mr. de Groote said. The external financial constraints would become even sharper after 1990, unless a major effort to develop productive capacity could be undertaken and financed. That effort could be made by Zaïre, a good performer under Fund programs, and a country with abundant natural resources, thereby demonstrating the importance of effective Fund/World Bank cooperation, the need to come up with investment projects that could rapidly yield income, and the necessity of additional financial resources for investment purposes.

Zaïre's development plan could be elaborated to emphasize priority investment options on the basis of a comparative study, Mr. de Groote went on. Zaïre exemplified the advantages of cooperation between the Fund and the Bank. The Fund had consistently made practical suggestions for rehabilitating some enterprises and sectors and had recognized areas for development that could have a rapid impact on the balance of payments position, a subject entirely within its province. The World Bank had identified the same areas as requiring in-depth structural adjustment.

That GECAMINES, the mining company that had accounted for a large share of foreign exchange and fiscal income, and ONATRA, the largest transportation company, would be able to pay dividends to the Government was a clear indication of ongoing progress, Mr. de Groote remarked. World Bank resources were to be made available for the expansion of GECAMINES, for the restructuring of the manufacturing sector, and for the rehabilitation of the transportation network. Other areas that might attract new capital were the gold mines, the INGA power plant, agriculture in general, and manufacturing industries producing for the local consumer. Zaïre's investment code was liberal, and the authorities had wisely decided to centralize all procedures within one office. Private capital had a decisive role to play in the longer-term restructuring of the balance of payments and, indeed, in the needed expansion of income.

It was particularly regrettable that Zaïre's success in repaying substantially larger amounts to its private creditors than obligatory had elicited so little reaction, Mr. de Groote declared. One idea that deserved to be stressed at the upcoming Annual Meeting was that successful stabilization policies in the industrial countries had established favorable noninflationary conditions in the world at large, but that the developing countries could not adapt themselves to the consequences of the new situation without receiving additional resources that they could integrate into revised and workable development programs. The banking and investment communities must be led to appreciate the importance of shifting--especially in countries that succeeded in adjusting their balance of payments--to a phase of income expansion.

It was important for the Board to be fully and quickly informed of all cases of misreporting, a condition that Zaïre had met, Mr. de Groote said. Zaïre's deviations from the agreed performance clauses at the beginning of 1985 had been temporary, and the authorities had taken measures to prevent a recurrence; hence, Zaïre had fulfilled all the conditions for a waiver of its noncomplying purchase of SDR 40 million at the outset of the arrangement.

The Belgian authorities had agreed to increase the National Bank of Belgium's credit line to the Bank of Zaïre in two consecutive tranches, the first to be contingent on the Executive Board's decision and the second to be linked to the observance of performance criteria at the end of September, Mr. de Groote announced. The Belgian authorities' decision would allow Zaïre to cover part of the imports of investment goods so badly needed in the coming months.

Mr. Rye said that Zaïre had made significant progress in two key areas. The efforts that the authorities had made to get fiscal policy back on track after the unintentional backsliding of the first quarter showed that they recognized the critical importance of maintaining a firm fiscal stance. The staff's favorable assessment of those measures seemed justified, although he had some doubts about whether the turnover tax on imports could be regarded as a permanent extension of the tax base. Second, the Board needed to be firm about Zaïre's observance of the performance criteria related to the net domestic assets of the banking system and the net credit of the banking system to the Government. It was gratifying that the performance criteria in both respects had been readily met for the end of June 1985.

Although he broadly agreed with the staff appraisal, he had some questions to raise, Mr. Rye continued. The drastic curtailment of credit to the private sector at the end of June represented a stop-and-go policy that was detrimental and that limited the significance of credit ceilings as performance tests. Some alternative to formulative credit ceilings in terms of net credit outstanding on the last day of the quarter was clearly necessary, presumably some kind of averaging process. Perhaps standards could be developed so that such criteria could be applied more consistently across different programs. In addition, the staff's less than full endorsement of the recently implemented accounting procedures indicated that further improvements were necessary. Finally, the Bank of Zaïre had decided to allow changes in the exchange rate to play a larger role in balancing demand and supply for foreign exchange; did that mean that the authorities would intervene less in the exchange market in the future?

Zaïre's performance had been excellent on most accounts, and the prospects for further progress were good, Mr. Rye concluded. He endorsed Mr. de Groote's comments about the particular need for Fund-Bank cooperation in Zaïre.

Mr. de Forges remarked that he had mixed feelings about the review of the stand-by arrangement with Zaïre: the program was back on track, but the approach taken by the Fund in Zaïre in the past months left him uneasy.

The exchange rate was one of the most important variables in an economy that was as open and free of exchange restrictions as Zaïre's, Mr. de Forges observed. The fact that the exchange rate had depreciated more than had been initially projected explained why a number of other important parameters in the program, particularly the one for the inflation rate, had also differed from the initial projections. The staff had attributed the accelerated depreciation of the exchange rate to the unexpected reduction in export revenues but had made no reference to another important reason: the shortage of foreign currencies that existed because Zaïre had been prevented from making its last drawing under the previous stand-by arrangement and the second drawing under the present one. In view of the minor character of deviations from the program, the Executive Board should have been requested to grant waivers. Zaïre's performance had been all the more remarkable in that since the beginning of 1985, financial assistance from the Fund had been limited to the first drawing under the present stand-by arrangement.

The measures adopted to put the program back on track appeared piecemeal and too detailed, Mr. de Forges pointed out. In dealing with such microeconomic issues as the repair of water meters in military camps, the Fund risked becoming mired in details of policy implementation, to the exclusion of the global framework. Credit ceilings had been established in such a way that the normal structure of interest rates was reversed, with short-term rates being much higher than medium-term ones. However, monetary policy seemed to have been devised in a consistent way, although again in excessive and complicated detail.

Whereas in many other countries, the restructuring of public enterprises too often involved a lengthy series of diagnoses, audits, and preliminary studies, all the main public enterprises in Zaïre had initiated far-reaching reforms in a very short span of time, Mr. de Forges went on. Air Zaïre, with its dramatic reduction in employment, offered a good example of the determination of the authorities.

The World Bank had responded to Zaïre's good performance under difficult external circumstances by making it eligible for the Special Facility for Sub-Saharan Africa and planning a structural adjustment loan, Mr. de Forges concluded. The authorities were to be commended for having taken all the necessary steps to put the program back on track. He hoped that in the future the Fund would be more forthcoming, if unforeseen difficulties were to reappear, in its assistance to a country that was clearly undertaking structural reform.

Mr. Grosche voiced his disappointment that some of the concerns expressed during the discussion of the 1984 Article IV consultation with Zaïre had materialized in the first quarter of 1985. Serious slippages had occurred in the fiscal and monetary areas. Moreover, the first purchase under the stand-by arrangement approved in April had been made on the basis of data that turned out later to be incorrect. That was particularly worrisome since the stand-by arrangement had been approved on the specific understanding that the performance criteria at the end of March would be observed. In fact, the relevant ceilings for domestic credit had been overshot by very large margins.

During the discussion of the guidelines on misreporting and noncomplying purchases in 1984 (EBM/84/152 and EBM/84/153, 10/17/84), his chair had expressed its concern that noncomplying purchases undermined the Fund's credibility and violated the principle of evenhanded treatment of members, Mr. Grosche recalled. Corrective action should be taken immediately in the case of noncomplying drawings. In fact, the Zaïrian authorities had taken a number of commendable measures to avoid the recurrence of misreporting and had taken additional measures to ensure that the program's objectives could be met. As a result, the relevant performance criteria for end-June had been met with substantial margins, an outcome that was welcome, although the performance criterion on credit to the private sector had been met only by means of a drastic curtailment at the end of the period--as Mr. Rye had noted, a detrimental stop-and-go approach.

In view of the corrective actions taken by the Zaïrian authorities, Mr. Grosche said that he could support the recommendation to grant a waiver for the noncomplying purchase. However, the authorities should do their utmost to avoid any recurrence of misreporting in the future. He hoped that the control mechanism recently put in place would prevent such shortcomings in the future, although it was worrisome to note the need for further improvements in the accounting of monetary aggregates.

While it was encouraging that the performance of Zaïre's economy had improved in the second quarter, prospects for the remainder of the year and beyond were not reassuring, Mr. Grosche noted. The balance of payments continued to be under pressure following the downward revision of export earnings. Financing requirements, which would be large over the coming years, would require continued debt relief. To generate substantial amounts of foreign financing and to promote growth, it would be necessary to sustain the adjustment effort and to avoid new slippages.

In the short run, economic growth was expected to be adversely affected by the reduction in imports, Mr. Grosche observed. Nevertheless, the staff had projected that real GDP growth of 3 percent, similar to the rate in 1984, could still be achieved. Moreover, the originally projected target for the overall fiscal position was expected to be met, as a result of the strong corrective measures that the authorities had taken in the second quarter.

The measures taken to improve the performance of public enterprises had started to show results, Mr. Grosche observed. Nevertheless, some weaknesses and uncertainties persisted. Despite the improvement in the fiscal position, which was partly due to exceptional measures that could not be repeated, a revenue shortfall would remain in relation to the original projections for 1985 as a whole, thus requiring additional action on the expenditure side. Progress had been made in better controlling expenditures and in improving the management of public enterprises, but more remained to be done. The government wage bill might exceed the original target for the year, and the operations of Air Zaïre remained quite unprofitable.

Mr. Pickering indicated that there was reason for encouragement in the review of progress to date under the current stand-by arrangement with Zaïre. Despite some important slippages, the authorities had demonstrated commendable determination in taking measures in key policy areas. The new fiscal and monetary measures taken by the authorities in the second quarter of 1985, for example, reflected the authorities' commitment to achieving the program's targets and objectives.

Because the overall weakness in revenue in the first half of the year was worrisome, the series of measures taken by the authorities to enhance revenue performance was welcome, Mr. Pickering continued. However, the reliance on exceptional measures must give way to a more durable performance. Control of government expenditures, which had been a major source of difficulties in the past, was being firmly maintained in most areas. Unfortunately, the large size of public debt payments continued to limit the room for maneuver on the expenditure side and underscored the dangers inherent in undue recourse to debt creation. The staff had noted that the government wage bill might exceed the target, and the authorities needed to act promptly to correct the slippage.

Significant progress had been made in regularizing the external and domestic arrears of the Government, Mr. Pickering stated. Regrettably, however, the external arrears of the Treasury that were not related to external debt had been revised upward from $37 million to $85 million; in contrast, the performance criterion on the net reduction of those arrears seemed rather modest. Since the Executive Board was giving the authorities some room for maneuver by not revising that performance criterion, they should try to exceed the original target if possible.

The various measures taken to improve the public enterprises were also most welcome, Mr. Pickering added. The liberalization of the oil trade and the associated revision of the price structure had allowed the elimination of cross-subsidization among products.

The authorities had achieved the end-June target on net credit to the Government, although that gave rise to two concerns, Mr. Pickering mentioned. First, net credit to the Government had exceeded the target both at the end of 1984 and at the end of March 1985. Such slippages had clearly undermined the authorities' efforts in a number of other areas, which was regrettable. Second, the stop-and-go characteristic of the policies was undesirable; credit limits under any future program should be formulated to de-emphasize the net credit outstanding on the last day of the quarter. Furthermore, the authorities should move promptly to achieve more stable growth in credit, which would meet the spirit of the credit targets.

The authorities had made commendable efforts to restructure official and private credit through the Paris and London Clubs, respectively, Mr. Pickering considered. While the exchange rate had remained in the appropriate range, a number of legitimate questions could be posed about the robustness of the foreign exchange system. The margin between the official and parallel rates was an indication that the current system was not working well. Several measures were being reviewed by the authorities and the Fund staff with an aim toward improving the system. Both sides should continue their efforts to improve the flow of foreign exchange through the official market.

The Managing Director had correctly invoked the guidelines for noncomplying purchases under Fund arrangements and recommendations for a waiver, Mr. Pickering stated. Clearly, the initial purchase had been linked to the authorities' observance of a prior action relating to net credit to the Government at the end of March. While prior actions were not specifically mentioned in the guidelines on noncomplying purchases, the guidelines clearly covered the type of situation that had arisen in Zaïre. It would be preferable to separate to the extent possible the procedures for noncomplying purchases from the review process under stand-by arrangements so as not to delay quick response to a noncomplying purchase. Should such a review of a noncomplying purchase lead to a recommendation for a waiver, it could be handled normally on a lapse of time basis.

Mr. Clark remarked that the current stand-by arrangement had had a difficult start because the authorities had reacted slowly to the worsening external position in the first half of 1985 and because monetary policy had already been well off track by the time the program was approved, even though that had not been apparent because of misclassification of the monetary figures for end-March. However, the authorities had acted to set matters right so that the June performance criteria had been met. There had nonetheless been a cost involved in the authorities' stop-and-go approach to credit policy. He hoped that no further waivers under the program would be requested in view of the experience with Zaïre's previous program.

With the adverse impact of fiscal policy on investment, it was particularly important that the authorities maintain the level of development expenditure, Mr. Clark stated. It was therefore reassuring that the proposed cuts would be fully offset from the resources of the Road Fund.

The performance of exports had recently been disappointing, Mr. Clark considered. He asked the staff whether it could explain the temporary technical factors that had lowered oil exports and predict when they were likely to be reversed. The apparent increase in gold smuggling was a cause for concern. The authorities should bring the official exchange rate closer in line with that of the parallel market.

The authorities were to be congratulated for the recovery and for the larger than expected reduction in outstanding arrears, Mr. Clark said. Rescheduling was necessary for Zaïre, both for fiscal and for balance of payments reasons. However, significant sums had been rescheduled by the Paris Club twice already, extending the debt maturity from 5 to 25 years; a third rescheduling would be difficult. It would be doubly important therefore for the authorities to maintain the pace of adjustment in order to meet present commitments.

Mr. Nimatallah commented that he was encouraged that despite an uneven performance, Zaïre's program was still on track. The authorities had taken important measures to reverse slippages and to improve the management of the public enterprises. Such achievements showed clearly that determination and hard work were the key elements for success in adjustment.

Nevertheless, Mr. Nimatallah continued, it was worrisome that misreporting seemed to be a recurring feature in Zaïre. The authorities should do their utmost to avoid such unacceptable incidents. The causes of misreporting must be removed, and he looked forward to reassurance from the staff on the matter. He hoped that no more waivers would be needed in the future.

The foreign exchange situation was also of concern, Mr. Nimatallah mentioned. The authorities should do more to encourage exports--particularly of diamonds, gold, and manufactured products--perhaps through further currency depreciation, lower export taxes, tax rebates, and possibly other measures. Most important, however, the authorities should intensify their adjustment efforts, take appropriate measures to attract foreign investment, strive to settle their external arrears, and stay current.

Mr. Coumbis stated that economic developments in many areas in 1985 had been worse than originally projected in the program, and the adjustment of the Zaïrian economy, at least in early 1985, had been less successful than in 1984. In fact, lower than expected exports had increased the pressure on the current account deficit and lower than expected government revenue had led to a higher than programmed government deficit. Moreover, the faster than anticipated rate of depreciation of the zaïre and the expected reduction in the volume of imports would contribute to a faster than anticipated rise of prices and to a lower than expected rate of increase of real GDP. External factors, weak export prices, and stagnation in the volume of oil exports had been the main factors behind the unfavorable developments in Zaïre.

Slippages in the fiscal area, mainly during the first quarter, had also been responsible for the worsening of the economic situation in 1985, Mr. Coumbis continued. Nevertheless, it was appropriate to recognize the strenuous efforts of the authorities to bring the program back on track. The end-of-June performance criteria had been observed, and many supply-oriented measures had been successfully implemented, especially in fiscal policy and public enterprises. Measures had been implemented to improve the administrative procedures for revenue collection, to control the expenditures of government agencies on public utilities and petroleum products, to strengthen the control of treasury subaccounts, and to verify all personnel records.

Measures had already been taken to improve the economic position of the most important public enterprises, Mr. Coumbis noted. GECAMINES was expected to make substantial profits in 1985, ONATRA was paying dividends to the Treasury, and the major railway company had greatly reduced its losses. The authorities had wisely returned the importation of petroleum products to the oil companies that marketed them. The authorities' efforts to improve the efficiency of public administration and to rehabilitate the parastatals demonstrated their continued strong commitment to the adjustment of their economy.

During the first quarter of 1985, public revenues had fallen short of expectations, Mr. Coumbis remarked. The authorities had been partially successful in reducing expenditures, especially capital expenditures, to offset the revenue shortfall. The March subceiling on net credit to the Government had been exceeded by Z 560 million. When they learned of the problem, the authorities had taken strong measures to correct it and had succeeded in meeting the performance criteria for net credit to the Government, with a margin of almost Z 1 billion. However, the measures taken were exceptional and, therefore, could not be repeated. Thus, if the shortfall continued in the second semester, the authorities would have to find a more permanent solution. The end-of-June performance criteria for net credit to the Government and net domestic assets had been met with comfortable margins, but they had been achieved through the application of exceptional measures taken at the end of the period. The staff had rightly said that the significance of credit ceilings as performance tests would be enhanced if they were not formulated on the basis of the last day of the quarter; it would be helpful to know what the staff had in mind.

The Bank of Zaïre was planning to implement useful measures to reduce excess liquidity and to keep domestic credit expansion for the remaining period within the original program limits, Mr. Coumbis added. The new procedures implemented by the central bank to improve the monitoring of the Government's net position with the bank should make it possible to avoid a recurrence of the reporting errors made at end-March.

The staff had indicated that there was no reason to change the medium-term prospects for Zaïre, despite the expected shortfall in export receipts by SDR 150 million and the expected deterioration in the overall deficit by SDR 30 million, Mr. Coumbis recalled. To attain a moderate rate of economic growth, Zaïre would continue to need exceptional financing, including debt relief, as well as stringent adjustment efforts for a number of years. Furthermore, Zaïre's financing requirements would increase sharply at the beginning of the next decade, when repayments on recently rescheduled loans would begin falling due.

Mr. Mtei commented that the recommendation for a waiver of nonobservance regarding Zaïre's noncomplying purchase appeared to be in line with the guidelines; the noncompliance had not been deliberate, and the authorities had since adopted appropriate measures to achieve the objectives of the program.

While all performance criteria at the end of June had been observed, the performance of the economy in the first half of 1985 had been uneven, Mr. Mtei noted. Considerable overshooting of the credit targets in the first quarter of the year had been followed by a very sharp reduction in credit to the Government and to the private sector. Growth in the real sector, particularly in the export sector had fallen short of projections, and the inflation rate had accelerated, reflecting the rapid depreciation of the zaïre. The authorities had taken drastic revenue and expenditure measures to bring the fiscal situation back in line with the program objectives and to correct the sharp expansion in credit in the first quarter of the year. The authorities were to be commended for their various revenue-generating and expenditure-saving measures. However, the bulk of the increase in revenue had come from asset liquidations that could not be repeated. He asked the staff how such measures would contribute to a lasting improvement of the underlying weakness in the Government's financial position.

The authorities had also taken steps to improve the performance of the parastatal sector through improved management and higher tariffs and rates, Mr. Mtei went on. Further effort would be needed to make the public enterprises financially viable and able to contribute to government revenue. Although it was not clear from the staff paper, it was to be expected that the World Bank would provide technical assistance to help the authorities rehabilitate the parastatal sector.

The staff might wish to reflect on the uneven performance of bank credit during the first half of 1985 and how it would affect investment plans and the performance of the real economy, Mr. Mtei said.

The external payments position of Zaïre was fundamentally weak, Mr. Mtei declared. Despite rescheduling arrangements, the debt service burden remained high, estimated at 26 percent of GDP in 1985. In the face of the decline in projected exports, imports would have to be reduced, with adverse implications for future growth. The staff had remarked that Zaïre had made substantial payments to foreign creditors in the past two years, although such efforts had not been matched by an increase in capital inflows. Unless the authorities' efforts were supported by substantial external financing, there was little hope of achieving the needed adjustment.

Ms. Bush said that after a somewhat disappointing start, Zaïre's new stand-by arrangement appeared to be back on track. Although end-March performance criteria had not been met, the significant adjustment that had taken place during the spring had enabled Zaïre to meet its June ceilings with quite comfortable margins. The authorities had thus been permitted to make the second purchase under the program late in August. While the actions taken to resume compliance had demonstrated the authorities' commitment to make the program work, a more even pace of policy implementation would permit a smoother adjustment process that could, perhaps, lead to a faster restoration of the desired rate of economic growth. In particular, the ups and downs must have created some difficulty for the private sector, since credit to that sector fluctuated during the course of a quarter.

The measures taken during the spring to ensure compliance with the June performance criteria had been laudable, since the sale of an Air Zaïre DC-10 airplane and 20 percent of its shares in Zaïre-Shell had not been easy steps to take, Ms. Bush observed. It was also reassuring to learn about the improved accounting procedures that should enable the Treasury to maintain tighter administrative control over expenditures. Particularly important was the daily clearing of the suspense accounts, a step that should prevent a recurrence of the reporting problems in March 1985. With Zaïre's difficult balance of payments position, adherence to fiscal targets remained crucial.

Furthermore, the staff report had indicated that the budgetary situation would remain tight during the second half of the year, due to revenue shortfalls in the oil sector, Ms. Bush recalled. Additional steps were being taken to contain current expenditures, especially on government consumption of water, electricity, and petroleum. Savings were already materializing, thus indicating that efficiencies could indeed be generated in various parts of the Government.

Reform of the parastatals was very much part of the effort to generate savings, Ms. Bush went on. The larger role of market forces in the petroleum sector deserved mention, notably the increased competition and the adjustment of prices to reflect changes in the exchange rate. Such liberalization ought to be extended to other sectors under government management. Fund and Bank collaboration in that area appeared to be showing results.

Monetary policy had been somewhat unsatisfactory, with wide swings in credit to the Government having necessitated wide swings in credit to the private sector, Ms. Bush mentioned. Tighter authorization procedures for government spending should foster more even flows of credit, which were essential to support the broadening role of the private sector. The much lower than programmed increase in credit to the private sector for 1985 should not be allowed to continue.

With interest rates freed from control, banks had raised rates on deposits in order to be competitive with treasury bills, Ms. Bush continued. Treasury bills continued to earn a high rate of interest, even allowing for the higher expected rate of inflation in 1985. The continuation for prolonged periods of very high real interest rates on treasury bills was not advisable, since it would become increasingly difficult to scale them back to more modest rates, even if inflation should fall.

Thus, the Government could find itself with a high domestic interest expense in addition to external debt servicing costs. With respect to the gold swaps that had resulted in large losses, it would be helpful if the staff could explain why the Bank of Zaïre had engaged in that practice. The establishment of a permanent internal audit of the Bank of Zaïre was welcome.

Developments in the balance of payments in 1985 were discouraging, with exports having grown less than expected and capital inflows having slacked off, Ms. Bush considered. Additional external arrears had also been discovered. The authorities were rightly planning more flexibility in the exchange rate, since the continuing disequilibrium in the exchange market was an indication that some additional rate adjustment probably was required. Earlier in the year, the Bank of Zaïre had intervened to prevent the zaïre from depreciating; unfortunately, its low reserves would prevent the Bank from continuing such intervention on a long-term basis, and thus more flexibility in the rate was appropriate. The need to diversify exports still remained; price incentives generated by an appropriate exchange rate could most efficiently stimulate export production.

Zaïre's first purchase under the stand-by arrangement, made after Board approval of the arrangement in April, had been contingent on compliance with end-March performance criteria, Ms. Bush stated. The reason was related to the interruption of the previous program, which had prevented Zaïre from purchasing the full amount available to it.

It was unfortunate that government expenditures had not been as carefully controlled as originally thought, Ms. Bush added. The use of suspense accounts implied that the fiscal adjustment so crucial to Zaïre's medium-term recovery was not being administered in a manner that would assure attainment of the fiscal objectives. A more detailed explanation of what had occurred would be appreciated; for instance, had any particular expenditures created the problem? The guidelines normally called upon management's recommendation for a lapse of time decision on a waiver of the repurchase requirement following a noncomplying purchase, an approach that was usually adequate. Nonetheless, the matter of the suspense accounts had called for a fuller discussion, as well as for assurances that the overall program was indeed still on track, before the Executive Board approved the waiver. Fortunately, major steps had been taken in the second quarter to correct the reporting problems. Furthermore, additional steps to reduce expenditures below programmed levels were being taken during the second half of the year to accommodate the projected shortfall in revenues. She therefore supported the proposed decision on the stand-by arrangement and would support the request for a waiver upon satisfactory answers to the questions raised.

Mr. Chatah said that the recommendation of a waiver had been based on the additional corrective measures adopted by the authorities to keep the program on track. According to the guidelines set out in the November 1984 decision, those measures constituted a valid reason for recommending a waiver; however, the guidelines should not be misinterpreted to mean that waivers would be granted automatically simply if a program was kept on track. While the Fund could not always know the precise causes of misreporting, its judgment that a waiver was in order should be based on a broad and careful evaluation of each case.

Although his point was a general one, Mr. Chatah added, Zaïre's misreporting was a source of particular concern, given the stop-and-go approach that seemed to have characterized recent financial policy and also because the approval of the program in April 1985 had hinged specifically on the performance criterion in question. For those reasons, he would be interested in an additional explanation from the staff of the circumstances surrounding the misreporting, and more specifically, whether the use of suspense accounts was an isolated occurrence in a particular period or whether items had been placed previously in such accounts without the corresponding transfers to the Treasury having been made.

The Deputy Director of the African Department stated that over the past two years, the Bank of Zaïre had made substantial progress in its accounting procedures. In 1983, "other domestic assets" were being calculated as a residual, and it had been difficult to ascertain which items were included in that category; by 1984, the various components of "other domestic assets" had been clearly identified, although the systematic monitoring procedure had still not been implemented. That procedure had been initiated in early 1985 with a resident auditor, a Central Banking Department expert from the National Bank of Belgium. Audited accounts had become available six weeks after the end of the first quarter, and the mission had been informed of the problem raised by the suspense accounts when it had visited Kinshasa at the beginning of May. The authorities had introduced a systematic procedure for debiting the expenditures attributable to the Government, which could be lodged temporarily in the suspense accounts that were cleared weekly. The procedure, described in EBS/85/206 and EBS/85/207, was working well.

The Bank of Zaïre could monitor fairly precisely those components of "other domestic assets" concerning either the Government or the Bank of Zaïre, the Deputy Director added. However, the reporting system by commercial banks to the central bank still needed improvement. The Governor of the Bank of Zaïre had requested technical assistance for that purpose, but an expert had not yet been sent to Kinshasa. The procedure for reporting on flows between public agencies and banks in Kinshasa was also in need of improvement.

It was not the first time that expenditures of the Treasury had been placed in suspense accounts, the Deputy Director noted. A similar problem had led to a request for a waiver in June 1984. The problem in 1985 had been compounded by fairly frequent changes in the top management of the Bank of Zaïre and the Ministry of Finance.

The stop-and-go credit policy to which many Directors had alluded had started in September 1984, the Deputy Director continued, because the Governor of the Bank of Zaïre had feared that the ceiling on net domestic credit might be exceeded and because the authorities were not able to monitor other net domestic assets. Credit to the private sector had been cut drastically and, as a result, the overall ceiling had been met with a wide margin. The same stop-and-go approach had been followed in March 1985, but without a sufficient reduction in credit to meet the ceiling. In June 1985, the authorities had cut credit to the private sector very sharply in order to meet the overall credit ceiling with a comfortable margin thereby forestalling any problem that might arise from an unexpected increase in other net domestic assets.

In August 1985, the staff had discussed the problem with both the central bank and the commercial banks, the Deputy Director recalled. The practice of increasing credit at the beginning of the quarter and reducing it in the last week of the quarter was clearly a bad one. The staff had indicated to the authorities that it did not propose to change the formulation of the performance criterion in the current program, but that a more appropriate practice--averaging, for example--should be found when the staff visited Kinshasa in late November 1985.

The fact that the authorities had been unable to make the last purchase under the previous stand-by arrangement because of an excess of net credit to the Government could not be advanced as a reason for the excess at the end of March 1985, the Deputy Director said. Only the general availability of foreign exchange would have been affected.

As to which fiscal measures would have a temporary and which a lasting effect, the Deputy Director observed, the sale of one DC-10 aircraft for $25 million had had an immediate effect on foreign exchange holdings, and it had formed part of a general reorganization of Air Zaïre, including a cutback in nonprofitable operations, which would have a lasting effect. Furthermore, a number of measures that had been difficult to take could be expected to have a lasting effect; for example, the elimination of the PETROZAIRE oil import monopoly and the liberalization of oil imports and of the marketing of oil products were important and difficult measures that could only have been taken in a crisis. The prices of petroleum products had been adjusted at the same time. The tax for the Road Fund had been raised to the equivalent of $0.48 per gallon of gasoline. The authorities had also adjusted the gasoline price according to the location where it was sold, thus taking into account the cost of transportation. The relative cost of petroleum products had been reflected in a relatively larger increase in the price of Gulf Oil Company offshore oil.

A number of measures that had been taken to increase import duty rates as well as to improve customs control would not have an immediate effect, the Deputy Director added. Several important measures had been taken to reduce expenditures on water, electricity, and petroleum consumption, including unusually strict measures relating to spending by the armed forces.

Over the past 20 months, the margin between the official and the parallel rates had fluctuated from between 7 percent and 12 percent, the Deputy Director noted; it had declined from 10 percent in August but the parallel rate had depreciated considerably over the past month. The reasons for the margin between the two rates included the 1/2 percent tax by the Bank of Zaïre on foreign exchange operations and the cost of transactions with commercial banks, which could reach 5 percent for documentary letters of credit. Moreover, the parallel market offered immediate availability of foreign exchange as well as other fiscal advantages associated with unrecorded transactions.

It was impossible to estimate the extent of transactions in the parallel market, the Deputy Director commented. Transactions in gold in the parallel market were sizable because gold was easy to value, unlike diamonds, which had to be valued by experts. The authorities had eliminated the 1 1/2 percent tax on gold sales to reduce the advantages of smuggling, and they were installing an assessor's office on the east border in order to allow the export of gold through official channels. The staff had stressed that the smaller the margin between the official and parallel rates, the less the motivation would be to smuggle. The official rate had depreciated rapidly in recent months, thereby reducing the margin.

External arrears, which had been estimated at nearly $10 million at end-June 1985, had all been paid, the Deputy Director stated. It was true that following a detailed survey of external transactions made by the Department of Defense, the stock of nondebt-related external arrears of the Treasury had been revised upward from $37 million to $85 million. The staff had thought of modifying the performance criterion by increasing the minimum reduction in arrears for end-December but had finally decided against it because the authorities had argued that they had reluctantly agreed in May to the staff position of no possible modification in performance criteria in spite of a worsening in external factors. In their view, if no relaxation had been possible in May, no tightening should be requested later. Nevertheless, the Zaïrian authorities had indicated their intention to reduce external arrears beyond the requirements of the performance criterion for end-December.

With respect to debt repayment to the London Club, the Deputy Director added, the threshold price linking debt payments to the price of copper was proving effective. The copper price had been moving around the threshold figure, and Zaïre's monthly debt repayments had fluctuated accordingly.

The Minute of the Paris Club had been initialed on May 24 but had not been signed until that week, the Deputy Director remarked.

Gold swaps were costly for the Bank of Zaïre, which received the Zaïrian interest rate of 24 percent a year, but incurred the cost of providing foreign exchange, the Deputy Director explained. When the price of gold had declined at end-1984, for example, the Bank of Zaïre had had to cover the difference, thereby incurring losses. Other losses incurred by the central bank had included interest due, which had been paid in bulk after six months instead of quarterly.

A large share of artisanal gold production had been smuggled across the border; it was probably worth about $30 million or $40 million, the Deputy Director noted. According to the latest data available, the volume of diamond exports through official channels was somewhat higher than in the previous year, but the price of diamonds was lower, reflecting the general problem facing the diamond market.

It was clear that Zaïre needed to diversify its exports, a difficult, lengthy task, the Deputy Director commented. The World Bank was helping to improve the manufacturing sector; an industrial loan of about $100 million would be submitted to the Executive Board of the World Bank in the first half of 1986; the purpose of the loan would be to facilitate the operations of small and medium private enterprises by increasing the supply of foreign exchange in the interbank market. At a recent meeting of a consultative group on GECAMINES, a target of $250 million had been set, of which $70 million would come from the World Bank. The June audit of GECAMINES showed that there had been no recurrence of the problems experienced in June 1984 with uncompensated sales. Zaïre and the World Bank were working on SONATRAD, a new national trading corporation that had been established in early 1985 to improve procedures for purchasing the inputs and materials imported by the public enterprises while preserving transparency in the transactions. The International Finance Corporation was also playing a very active role in Zaïre.

Oil was produced by two companies in Zaïre with the bulk of the production located offshore, the Deputy Director explained. Technical factors, rather than a slowdown in exports, had led to the stagnation in production. Gulf Oil had attempted unsuccessfully to force more oil out of some wells by injecting water into them. The company had decided to drill new wells, but delays had occurred in the delivery of equipment such as the drilling platform. Onshore oil production by FINA and Shell, however, was proceeding according to schedule. Some prospects for oil existed on the eastern border of Zaïre, but start-up operations would not begin until the early 1990s.

Commercial banks were often charging lower interest rates for medium- than for short-term loans because competition among banks was greater in one case than in the other, the Deputy Director of the African Department said. Commercial banks did not have to compete among themselves to attract customers wishing to obtain short-term loans, because short-term loans fell under the credit ceilings given to them by the central bank and because each commercial bank was generally close to its credit ceiling. On the other hand, commercial banks were competing to extend medium-term loans because those loans did not fall under their credit ceilings but were subject to specific approval by the central bank. Interest rates on treasury bills had been adjusted to the rate of inflation; they had been reduced several times from August 1984 to April 1985 when the rate of inflation had been lower than anticipated; but, as the rate of inflation had been rising recently, they had been raised in June 1985 and were to be raised soon by a further 2 percentage points, as were the preferential rates on crop credit and the rediscount rates.

The Deputy Director of the Exchange and Trade Relations Department recalled that Zaïre's failure to observe a subceiling at end-1984 had to be seen in the context of the problems that had arisen during the 1984 program. In the discussions that had ensued in January-February 1985 regarding the most constructive approach to take, the question had been whether it was sensible to try to extend the program period beyond March 1985. The set of indicative ceilings for end-March could have been translated into performance tests, and the program could have been extended, thereby keeping the program on track if the fiscal accounts had come back into compliance as of the end of March. The alternative procedure had been adopted--namely, to allow the program to terminate in March but to attach particular importance to the end-March 1985 criteria.

In accordance with the Fund's guidelines on misreporting, Zaïre had taken steps to improve the accuracy and completeness of its reporting. Nevertheless, a waiver of nonobservance would only be requested if the problem was minor and if appropriate measures had been introduced to get the program back on track. The approach taken had been intended to encourage the necessary action by the authorities to come back into compliance by the time of the June performance test. Performance had been in compliance with the program by June, and the staff had been able to ask the Board to grant a waiver, against the background of a record of progress and not of failure. That progress was the justification, from the staff's standpoint, of not asking for reviews at an earlier stage when policies had not yet been adequately adapted.

In response to Mr. de Groote's suggestion that the time might have come to take a less strenuous view of credit expansion, the Deputy Director observed that the program for 1985 called for a large increase in total credit of 32 percent, of which 16 percent was to the Government and 16 percent was to enterprises and households. A deliberate attempt was being made to direct credit into the private, productive sector. Prices had been rising faster than expected, by 25-30 percent, just as the depreciation of the zaïre had been more rapid than expected. Hence, the outer limit of credit expansion had probably been reached.

Many types of ceilings had been used as performance criteria in different programs, such as average weekly numbers or continuous ceilings, the Deputy Director of the Exchange and Trade Relations Department noted. While the staff could explore a number of different ceilings, to see which would be the most effective for Zaïre, it was important that performance tests be seen as benchmarks of general progress, including the financial strength of the economy, and not as an end in themselves.

Ms. Lundsager stated that the staff's comments had been reassuring; thus, her chair could support the waiver.

Mr. de Groote observed that it had to be recognized that in the face of slippages in credit to the public sector and the necessity to control overall liquidity, the authorities had not made effective use of credit for the development of private sector activities and, therefore, of general supply. The issue was not one of overall ceilings but the reorientation toward and the effective use of credit by the private sector. The authorities needed to expand the use of private credit within the existing ceilings.

The Deputy Director of the African Department commented that the staff had looked at the average level of credit to the private sector on a month-by-month basis. At the end of the quarter, credit to the private sector had been much lower than the target, but the average for both the first and second quarters had been only slightly below the target for the end of each quarter.

The Chairman remarked that Executive Directors clearly wished Zaïre to eliminate its stop-and-go credit policy and the staff to devise performance criteria that would not lead the authorities to follow such a policy.

Mr. Alfidja stated that the success of the adjustment process in Zaïre would continue to depend not only on Zaïrian determination but also on favorable developments in the external environment. The determination was there, but the authorities continued to be disappointed about the slowness with which both public and private finance was flowing into Zaïre.

The Executive Directors then took the following decisions:

Review Under Stand-By Arrangement

1. Zaïre has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Zaïre (EBS/85/74, Sup. 3, 4/25/85) and paragraph 4 of the letter of the President of Zaïre of March 25, 1985 with annexed memorandum, attached to the stand-by arrangement, in order to review the progress made under the program.

2. The letter of the President of Zaïre dated August 29, 1985 together with the annexed memorandum shall be attached to the stand-by arrangement for Zaïre, and the letter of March 25, 1985 with annexed memorandum shall be read as supplemented by the letter of August 29, 1985 with annexed memorandum.

Decision No. 8096-(85/146), adopted
September 20, 1985

Report on Noncomplying Purchase and Waiver of Nonobservance

The Fund notes the report of the Managing Director set forth in EBS/85/206 (8/30/85) on the noncomplying purchase made by Zaïre on April 29, 1985 under the stand-by arrangement for Zaïre (EBS/85/74, Sup. 3, 4/25/85), and decides to waive the nonobservance.

Decision No. 8097-(85/146), adopted
September 20, 1985

2. ECUADOR - 1985 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1985 Article IV consultation and review under the stand-by arrangement with Ecuador (EBS/85/202, 8/23/85; Cor. 1, 9/18/85; and Sup. 1, 9/18/85). They also had before them a report on recent economic developments in Ecuador (SM/85/255, 9/6/85).

Mr. Kafka made the following statement:

My Ecuadoran authorities are in broad agreement with the staff's appraisal and recommendations for the review under the stand-by arrangement, although they have quite a number of differences on matters of fact and analysis.

The report shows a success story. The economic situation in Ecuador has been turned around in a decisive fashion from the one that prevailed a few years ago; there has been great progress in the last 12 months. The average increase in GDP output in the 3 years preceding 1985 was about 1 percent, while now a steady rate of GDP growth of over 2 1/2 percent is foreseen, still modest but at least permitting the maintenance of per capita income. The latest monthly figures indicate that since March the annualized rate of inflation has averaged 19 percent, compared with an average rate of 33 percent in 1984, or a December 1983 to December 1984 rate of 25 percent. There has been a significant improvement in the fiscal accounts and the overall balance of payments--which would be in equilibrium if one considers the total elimination of arrears--would otherwise be in surplus. Debt rescheduling agreements have been negotiated with private banks and with the Paris Club for multi-year periods, in the case of the Paris Club the first time that this has been done in recent years. Moreover, a significant new money loan has been agreed from commercial banks, for the elimination of arrears. A substantial improvement in public sector finances will be registered this year. These successes have been made possible by significant improvements in all areas of economic policy.

In the fiscal area the already insignificant public sector deficit registered in 1983/84 will give place to a considerable surplus this year. This represents a major effort both on the expenditure and revenue sides, particularly in view of a substantial reduction, as compared to the original expectations when the program was approved, of petroleum revenues owing to the fall in petroleum prices. On the revenue side, however, non-petroleum revenues have grown more than expected. The increase in efficiency of expenditure control of a general nature will enable the authorities to maintain an adequate level of investment expenditures so as not to risk a reduction in the already low expected rate of growth. Lower amortization payments in view of a better outturn than originally expected of the rescheduling negotiations will also be helpful. Also important is the dent made in the revenue earmarking system of directing to the budget all additional revenue resulting from the transfer of oil exports to the intervention market.

In the monetary area, the improved state of confidence created by the decisive action in the fiscal and other fields has led to very favorable responses of the public which translate into a significant increase in the holding of financial assets. The growth of M2, particularly certificates of deposit, has been remarkable. The successful sale of certificates of deposit has continued despite the fact that the freely determined interest rate between April and August has declined from a range of 25-29 percent to one of 22-27 percent. In view of the declining rate of inflation, the authorities see no need at the moment further to increase the permitted level of controlled rates or to take measures to increase the flexibility of rates. In their opinion, arguments about real rates are often vitiated by a confusion regarding the concept; the economically relevant real rate is the difference between the nominal rate and the expected rate of inflation, not between the former and the simultaneous rate of inflation. It is legitimate to assume that the 19 percent average annualized rate of inflation since March, which would be sufficient to make the controlled rates positive in real terms, is probably an overestimate rather than an underestimate of the expected inflation rate. It should also be noted that the Government not only has the power but is already selling stabilization bonds, the balance outstanding of which has indeed increased from S/. 1 billion in January to S/. 2 1/2 billion in August.

Average wage adjustments this year at 24 percent will be 30 percent below the average rate of inflation that prevailed last year. The authorities consider that the 24 percent rate of wage adjustment is a respectable achievement for this year and foresee no difficulty in proceeding to lower adjustments in

1986. Like the staff, they attribute importance to the fact that the average increase in the wage bill at 20 percent will this year be no higher than was expected in the program.

The authorities remain committed to a flexible exchange rate policy that will fully protect Ecuador's competitiveness in international markets as well as stimulate import substitution. They are pleased with the increase in nontraditional exports over the period January-June, which has been substantially higher than a year earlier, 22 percent as against 4 percent over the same period in 1984. They also note that the parallel market rate has fallen significantly during the period January-August 1985. For the moment, they are therefore satisfied with the level of the intervention rate.

It is significant that practically all transactions have been shifted to the intervention market except a number of quantitatively minor exceptions. The forthcoming unification of the official and intervention markets will remove the last exceptions. The authorities also wish to draw attention to the significant measures of liberalization that have already been taken with respect to exchange restrictions, in particular the permission of profit remittances higher than foreseen by Decision 24 of the Andean Pact. In the trade field also, important liberalization measures were taken in 1985 with the removal of the remaining import prohibitions and the advance import deposit requirement.

My Ecuadoran authorities wish to emphasize that the volume of arrears at mid-August 1984 represents the calculated net outstanding, after considering an extension granted by banks, while a bank loan to liquidate the arrears was obtained only recently.

The authorities are pleased at the cooperation already established and the plans for further operations with the World Bank.

Mr. Jensen said that he agreed with Mr. Kafka. Ecuador had been adopting and successfully implementing broad-based stabilization programs which, since mid-1983, had been supported by stand-by arrangements with the Fund. The present administration was working to strengthen the country's external position, to reduce inflation, and to create the conditions for sustained economic growth. Those objectives were being achieved through the pursuit of a flexible exchange rate policy together with continued implementation of appropriate fiscal and monetary policies.

The recent adjustments on the domestic front had been impressive, despite problems beyond the authorities' control, Mr. Jensen commented. Due to a reduction in the export price of oil, total public revenue as a proportion of GDP was expected to be about 3.3 percentage points lower than the initial projection, yet the authorities remained committed to having the public sector generate a surplus of 2.2 percent of GDP. Accordingly, the actual adjustment effort would be even greater in terms of GDP than had been envisaged under the program. Public sector expenditures would not increase by 2 percent of GDP as originally intended but instead would be below the 1984 level. Developments in the monetary field also demonstrated the authorities' continued commitment to sound financial policies, which had resulted in strong and steady growth and a recovery in the demand for financial assets on the part of the general public. The introduction of more freely market-determined interest rates had been instrumental in that success.

Ecuador's external policies had also been consistent and firmly implemented, Mr. Jensen observed. Unification of the exchange rate had been a key element of the stand-by arrangement, but it had appeared that Ecuador, like many other countries, might face considerable difficulty in achieving such a sensitive objective by a particular date. Ecuador had proved the contrary: for all practical purposes, the measures taken on August 28 amounted to the unification of the exchange markets. It would be helpful to learn the weighted value of the transactions in the balance of payments converted at the intervention rate and to know the extent of the resulting implicit additional depreciation of the sucre.

Ecuador was also demonstrating the importance of that foreign investment in achieving overall viability of the external accounts, Mr. Jensen indicated. He asked whether recent data were available on the values of incremental foreign investment in particular areas.

As for the authorities' external debt strategy and management, Mr. Jensen considered, they had been pioneers in the manner in which they had completed agreements with both official and private creditors. In a major break from previous annual exercises, they had successfully secured with official creditors the restructuring of maturities covering a consolidation period through 1987. They had arranged a multiyear rescheduling arrangement with commercial banks through 1989 and $200 million in new monies, which had been fully disbursed earlier in September. That agreement was also a positive innovation in that it was not tied to the second and third purchases from the Fund or to the completion of the review. Unnecessary delays in disbursements could thus be avoided. Fund management and staff had taken a helpful stance in encouraging some of the commercial banks to participate in the multiyear rescheduling arrangement without linkage to the purchases from the Fund.

Some Executive Directors had expressed doubts at EBM/85/39 (3/11/85) about certain conditions concerning the actual and future debt relief sought by Ecuador from different creditors, Mr. Jensen recalled. He hoped that recent discussions on the role of the Fund in assisting members in their dealings with commercial banks and official creditors had dissipated some of those concerns in order to retain essential flexibility for the Fund in such a crucial area.

Mr. Rye noted that Ecuador's performance under the current stand-by arrangement might be described as generally satisfactory, with qualifications. All quantitative performance criteria relating to the second and third purchases had been observed. The broad program objective for the year--a balance of payments in equilibrium--seemed well on the way to realization. Public finances had been strengthened enough to be in surplus for 1985, and monetary as well as credit policies seemed sufficiently under control to be supportive of the balance of payments and of revised inflation targets. Ecuador's failure to reach the original target for the rate of inflation of 20 percent had been disappointing; the decline currently expected--from about 30 percent to 22 1/2 percent by the end of 1985--was a modest objective.

At the time of the Board discussion of the stand-by arrangement, Mr. Rye recalled, he had said that the Ecuadoran authorities had undertaken bold steps toward adjustment in the context of that country's political and social system that augured well for the future and that having gone so far, the authorities ought to be able to move ahead more forcefully. The time had ind.ed come for Ecuador's authorities to take the more forceful actions that the Board had considered necessary to adjustment: the unification of the exchange system, the lifting of trade and exchange restrictions, and the lowering of the rate of inflation. In that earlier discussion, Executive Directors had described the unification of the exchange system as a central or crucial element of Ecuador's program. Unification had been seen as the necessary condition for improving and then sustaining the country's supply capabilities, particularly in the non-oil sector and the level of demand. Moreover, exchange rate unification had been expected to take some of the edge off speculation on price movements. Those views had acquired added force. Half-measures and excessive gradualism had helped to nurture speculation and had contributed to the inadequate decline of the rate of inflation and to uncertainty, not to mention exchange losses and inefficiencies in resource allocation.

That Ecuador had moved much closer to the unification of the exchange system was therefore welcome, even though it gave rise to a question, Mr. Rye considered. The staff had noted that because of "certain transitional provisions," the Central Bank would continue to sell exchange at the official rate for certain transactions. The cryptic phrase "certain transitional provisions" had been explained as reflecting "mainly legal obligations of the Central Bank to provide foreign exchange at the official rate." The authorities had undertaken to move the official rate to the level of the intervention rate by October 21. He asked why that could not have been done before. Provided he received a satisfactory answer, he could support a waiver. However, if the unification did not take place by October 21, 1985, Ecuador should not be able to make further purchases.

Wage developments were worrisome, Mr. Rye said. Although the recently granted 28.8 percent increase in the basic legal minimum wage on public sector outlays fell close to the originally envisaged 20 percent rise because of delays in implementing it, its effect on wage formation could only be negative. As a signal of government policy, it would certainly not have a favorable effect on inflationary pressures. Renewed efforts to reduce inflation should be undertaken, and they should be more decisive and more ambitious than had been thought appropriate when the program had first been designed.

In his comments on inflation and interest rates, Mr. Kafka had been unquestionably right that the expected rate of inflation, not the annualized rate, was the appropriate denominator for calculations of real interest rates, Mr. Rye remarked. There were always problems in assessing expected inflation rates, however. It was difficult to reconcile Mr. Kafka's statement that "the 19 percent average annualized rate of inflation since March...is probably an overestimate rather than an underestimate of the expected inflation rate," with the 24 percent rate of wage adjustment in 1985. It seemed inconceivable that Ecuadoran workers were looking forward with confidence to growth in real incomes of more than 5 percent, especially in the light of the recent sluggish performance of the economy.

Ecuador had achieved much in recent months, particularly in reversing the financial situation of the public sector and in bringing the balance of payments into equilibrium, Mr. Rye concluded. Domestic financial savings beyond the program's expectations had been realized, partly through some flexibility in interest rate policy, which could be even bolder, and partly through a positive response by the private sector to the exchange rate actions taken to date. The authorities were to be commended for their success in concluding multiyear rescheduling arrangements for their commercial and official external debt. However, restraint in the public sector's net use of external credit, as well as sound financial and exchange rate policies, had to remain the major guidelines in Ecuador's debt management.

Mr. de la Herrán recalled that when Ecuador's economy had begun to deteriorate recently, the new Government had been courageous enough to reinstitute policies that had been introduced in 1982. The net result was that they had observed all performance criteria under the current stand-by arrangement and many of the goals had been achieved with considerable margins.

Although Ecuador's fiscal position was quite comfortable and was expected to show a surplus in 1985, maintaining that position would require strict control of expenditures, Mr. de la Herrán said. As with most economic activities in Ecuador, fiscal developments were affected greatly by oil price fluctuations, and projections should thus be made with great caution. Serious departures from targets could occur because of unexpected changes in oil prices that were beyond the authorities' control. For example, a decline of 2.9 percent of GDP in petroleum revenue represented a reduction of nearly 20 percent and could lead to important changes in the fiscal stance.

As Mr. Kafka had pointed out in his statement, the fiscal surplus expected for 1985 reflected a great effort by the authorities, Mr. de la Herrân noted. Heavy dependence on oil exports required the utmost flexibility on the expenditure side in order to accommodate any sudden drops in public revenue. He shared the staff's concern about public sector wage policy. The authorities should perhaps maintain a more cautious stance since inflation was not yet under control, and current expenditures seemed to be rigid in the short run.

The effects of downward shifts in oil prices were even more acute for the balance of payments, Mr. de la Herrân continued. Despite recent increases in nontraditional exports, petroleum exports still accounted for more than twice the rest of the export value in U.S. dollars. Efforts should be directed at achieving a solid external position based on a higher degree of competitiveness, appropriate external debt management, and, above all, a more transparent exchange rate and exchange system. The new loan of $200 million that had been agreed finally would alleviate substantially the problem of arrears.

The unification of the exchange system was recognized as a key feature of the program, and the agreement to fix October 21 as the date for unification was a positive action, Mr. de la Herrân considered. Albeit late in coming, the recent measures taken in that respect were welcome and would prepare the way for complete unification. The few transactions still carried out at the official rate should not be a major obstacle.

Mr. Leonard noted that Ecuador had made important progress in reducing its internal and external imbalances during the past two years and had continued to do so in 1985. Despite a reduction in world petroleum prices, the public sector was still expected to show a surplus exceeding 2 percent of GDP, while the overall balance of payments was expected to be roughly in equilibrium; those were important and positive signs. The authorities were to be commended for having met all the quantitative performance criteria under the program.

Because the unification of the official and intervention exchange markets, which was already virtually complete, would be fully completed before the end of October, the proposed waiver was justifiable, Mr. Leonard said. He was slightly troubled, however, by the statement in the staff report that Ecuador would not make purchases after October 21 while the official rate and the rate prevailing in the intervention market did not coincide. If the implication was that there was some possibility of slippage in the unification process, the question was how much significance the staff attached to the Ecuadoran undertaking in that respect.

There was no room for complacency in policy implementation, Mr. Leonard stated. In the current environment of a weakening international petroleum market, Ecuador's heavy dependence on the oil sector posed a number of risks, both at present and in the medium term. If their hard-won gains were not to be lost, the authorities would have to stand ready to take any additional measures demanded by the circumstances--as they themselves recognized.

The authorities had already made efforts to offset the effect of lower oil revenues on the fiscal situation and should be prepared to take further steps as required, Mr. Leonard noted. Expenditures must be firmly controlled. The effort to limit public sector wage increases in conformity with earlier projections was welcome; nonetheless, the 1985 award, while restricting the average increase in wages to no more than the 20 percent programmed for 1985, would have a substantial carryover effect into 1986. As a result, the actual increases that could be given in 1986 would have to be correspondingly curtailed to preserve fiscal balance and keep inflationary trends in check. Cuts in investment outlays--which had already been made--were the easiest means of limiting expenditures in the short term; however, they could not be repeated for long without impairing the country's development plans. Therefore, more lasting cuts in current outlays should be sought.

The vulnerability of the budget to changes in petroleum revenues had been demonstrated in 1985, reinforcing the need for diversification of the tax base, Mr. Leonard stated. The authorities had made welcome progress in the assessment of foreign trade taxes through better valuation procedures. They had also reduced revenue earmarking by ensuring that the increase in oil revenue resulting from the shifting of oil exports to the intervention market was transferred fully to the budget. Nonetheless, earmarking was an unnecessary impediment to achieving the fiscal targets, and the authorities should move even more expeditiously in dismantling the existing remnants of the system.

Inflation was one aspect of Ecuador's recent performance that merited more emphasis in the staff report, Mr. Leonard suggested. Performance in 1985 had been poor, with the 12-month rate accelerating to 30 percent in January and remaining at that rate through June. The current position was not entirely clear. In his statement, Mr. Kafka had mentioned an annualized rate of inflation of 19 percent since March, whereas the staff had reported that the year-on-year figure in August had slipped just below 29 percent. Both figures might be correct, but further clarification would be useful. In any case, the rate of inflation was still too high. Although the authorities had pointed to bad weather as a cause of the deterioration and the staff had emphasized the need for a restrictive wage policy to achieve a significant reduction in inflation in 1986, more might have been said about monetary developments and their impact on prices. For example, the staff report had stated that M2 had grown by 53 percent, or some 18 percent in real terms, during the 12-month period ended May 1985 and that it was expected to grow by a further 42 percent in 1985. To the extent that that represented increased savings, it would be likely, on balance, to have a counterinflationary effect. However, if M1, like other monetary aggregates, was growing rapidly, it was difficult to see how stricter control of wage policy alone could help to moderate the inflationary trend, even if the public sector was making net deposits with the central bank.

The staff's detailed discussion of monetary policy left as many questions as it gave answers, Mr. Leonard considered. The more definitive staff appraisal made it clear that the exchange rate actions and increase in interest rates had been largely responsible for the growth in savings. It would be interesting to learn to what degree that had resulted from a shift from parallel market activity into activities or instruments that the authorities could influence more directly.

The authorities should manage the flexible exchange rate policy in a fashion that would not only maintain Ecuador's competitive position but also encourage the growth of nonpetroleum exports by reversing the loss of competitiveness experienced since 1981, Mr. Leonard indicated. Nonpetroleum exports in 1985 were projected at virtually the same dollar amount as in 1982, which suggested that more should be done to improve competitiveness, if developments in the external account were not to be a source of further weakness. Indeed, in the medium-term scenario nonpetroleum exports were projected to rise only marginally by 1990 from 32 percent to 33 percent of total exports. More ought to be done to reduce Ecuador's heavy dependence on oil. The authorities should also move ahead with their planned reduction and simplification of import tariffs.

The proposed revisions of foreign investment regulations were a positive step that should help reduce Ecuador's reliance upon debt-creating flows, Mr. Leonard concluded.

Mr. Templeman commended the Ecuadoran authorities for their good performance to date under the stand-by arrangement approved in March 1985. All quantitative performance criteria had been met, real economic growth continued at a modest pace, the current account deficit of the balance of payments remained fairly small, the public sector was expected to show a small surplus in 1985, and progress was being made on the liberalization of trade and foreign investment. There was still room for improvement, however, with regard to inflation. Moreover, the medium-term balance of payments and debt situations remained vulnerable, particularly to a drop in oil prices.

Nevertheless, it seemed as if the authorities either had not fully understood the implications of measures that they had promised to take in a number of areas or they later had changed their minds about the precise way to go about it, Mr. Templeman said. The subsequent need for waivers or corrective measures and the resulting delays in purchases under the stand-by arrangement had tended to undermine the authorities' credibility. The most important example was the failure to implement the exchange rate unification on schedule, with the resulting delays in disbursement of the second and third purchases. His authorities could concur reluctantly with the waiver relating to the failure to unify the exchange markets on schedule and with approval of completion of the midterm review so that the second and third drawings could be made; the unification was largely in effect, and the disbursement of the next purchase would be made contingent on the implementation of full unification no later than October 21.

He noted that the proposed decision would approve until the end of the stand-by period the multiple currency practice caused by the incomplete unification; he would have preferred to grant that approval only until October 21, after which, approval would no longer have been necessary.

Further comment from the staff or from Mr. Kafka concerning the adequacy of the exchange rate and the policy intent of the authorities would be helpful, Mr. Templeman said. The staff report mentioned that despite some real effective depreciation of the sucre, the rate had still not fully offset the loss of competitiveness experienced over several years through 1981.

The exchange rate could be an important tool over the medium term in achieving a sustainable balance of payments and foreign debt position, Mr. Templeman said. The staff report had indicated that balance of payments developments were essentially on track for 1985, despite the downward slide in oil prices, and that if good policies were maintained, the external balance should remain viable through the 1980s. However, the staff had also pointed out that larger debt repayments would begin falling due in the 1990s as the effects of recent debt restructuring subsided. Ecuador had already benefited from nearly $5 billion in debt relief over 1982-85, including the first official multiyear rescheduling arrangement. He noted the terms of the agreement reached with the Paris Club, under which Ecuador was to have with the Fund either a continued stand-by arrangement or enhanced surveillance under a comprehensive and satisfactory economic program, including quantitative and quarterly targets and limits. The medium-term scenario contemplated only a modest rate of economic growth, averaging 2 3/4 percent over the period 1986-89 and a rather small international reserve buildup to one and one-half months of imports. The ratio of debt to GDP would be about 47 percent in 1990 and the debt service ratio about 40 percent. Clearly, policies affecting the balance of payments and foreign debt management must remain very cautious.

In respect of the liberalization of trade and foreign investment, the authorities were wisely planning to reduce the minimum financing requirement further and to eliminate the barter requirement soon, Mr. Templeman observed. A specific timetable would be helpful for those items. The plans under the tariff reform to lower maximum rates and reduce the dispersion of rates, as well as the steps being taken to modify regulations governing foreign investment, were welcome, as was the cooperation of the World Bank in the liberalization effort.

The increase in interest rate ceilings late in 1984 and the growth of sales of certificates of deposit by the banks at market rates seemed to have had a favorable effect on private financial savings, Mr. Templeman remarked. The ratio of gross national savings to GDP in 1985 was expected to rise to more than 20 percent, compared with the original forecast of 14.5 percent. More realistic interest rates seemed to be having a favorable effect on short-term international capital flows. However, despite the achievement of positive real rates for some monetary instruments, the authorities still needed to follow a flexible policy with regard to adjustments in controlled interest rates and with regard to the movement toward more market-determined rates.

The original target of a surplus in public sector operations of nearly 3 1/2 percent was apparently not likely to be achieved, Mr. Templeman noted. A smaller surplus of about 2 1/4 percent was more likely, with the shortfall in oil revenues accounting for most of the less favorable outturn. Under the circumstances, the revenue situation should be closely monitored along with spending so that any necessary fiscal adjustments could be made. The authorities also needed to tackle the problem of inelasticity in non-oil revenues and to achieve further progress in reducing revenue earmarking.

The Ecuadoran performance in the wages and prices area gave some cause for concern, Mr. Templeman added. For political reasons, wage restraint was understandably difficult to achieve, although the authorities' determination to deal with the problem was evident from the presidential veto of the original proposal to raise the basic minimum salary by over 50 percent. However, the compromise settlement, at nearly 29 percent against the overall wage target of 20 percent, was disappointing. The authorities needed to educate the public to the danger that large nominal wage increases might well lead to small or negative real increases. The continued pressures for large nominal wage increases might explain why the rate of inflation seemed to be stuck at the 20-25 percent level. He inquired whether the forecast of a rise of the consumer price index of only 22 1/2 percent was still realistic for 1985.

Ecuador's economic performance under the current stand-by arrangement had been quite good to date, Mr. Templeman concluded, despite a number of weaknesses, vulnerabilities, and slippages. The authorities should continue to pursue their economic adjustment and reform efforts with determination.

Mr. Grosche observed that Ecuador was the first country for which official creditors had granted a multiyear rescheduling arrangement. The pursuit of sound economic policies was thus very important not only for ensuring that all relevant provisions under both the private and official multiyear rescheduling arrangements could be fully implemented but even more so for providing a positive signal to the markets that multiyear rescheduling arrangements would in fact assist countries to resume normal financial market relations. It was therefore reassuring to note that the current stand-by arrangement was largely on track and that economic performance had been broadly satisfactory.

Also encouraging was the fact that the authorities had made some progress in addressing the structural weaknesses of the economy, Mr. Grosche indicated. The marked improvement in the private capital account in 1984 and 1985 was particularly impressive. The policies pursued so far had led to a return of confidence and had induced a reversal of earlier capital outflows. The authorities were implementing measures designed to attract foreign investments that should help to strengthen Ecuador's medium- and long-term prospects.

Less satisfactory developments included the disappointing price performance and the large increase in minimum wages, Mr. Grosche said. The most worrisome development, which would affect the medium- and long-term prospects of the economy, was the current and prospective further weakening of the price of oil, Ecuador's main export commodity. Despite the encouraging improvements in the performance of the nonpetroleum sector, it was clear that Ecuador continued to rely heavily on oil for export as well as for budgetary revenues. The staff report had included downward revisions in the economic projections because of the lower oil prices; however, recent developments raised doubts about whether those revisions had been sufficient. Financing gaps might occur even earlier than forecast; hence, the authorities should be prepared to adopt corrective measures, if necessary. It would helpful to know whether the authorities had prepared a set of contingency plans; the staff's assessment of the effects of the very recent oil market developments on Ecuador's future prospects would also be useful.

It was disappointing that the authorities had not fully complied with one of the obligations under the arrangement--unification of exchange rates--which was a key feature of the program, Mr. Grosche stated. Given Ecuador's overall satisfactory progress, however, and the fact that the unification should be completed by October 21, he could support the proposed waiver so that Ecuador could make the purchase it had not been entitled to in May.

Mr. Murakami indicated that Ecuador had made substantial progress in reducing both domestic and external imbalances during the past two and a half years under the previous and the present stand-by arrangements.

The overall balance of payments had been favorable during the first half of 1985, Mr. Murakami observed. In spite of the revised current account deficit that was larger than originally envisaged, the original target of an overall balance of payments equilibrium for 1985 was still expected to be achieved. However, the 12-month rate of inflation had accelerated in early 1985 and had remained at around 30 percent throughout the first 7 months of the year. The rise was due partly to bad weather and its adverse effects on food production, and recent information indicated that prices had risen by only 0.2 percent in August, but it was still worrisome, under the circumstances, to know that the authorities had granted a minimum wage increase in excess of the program's target.

The recent weakening of oil prices would have an impact on public sector revenue and the external current account position, Mr. Murakami noted. Future developments in those areas thus should be carefully monitored.

Reflecting the authorities' adoption of strong revenue and expenditure measures, the financial position of the public sector had improved substantially in the past two years, Mr. Murakami said. However, even during the period 1983-84, nonpetroleum revenue had continued to perform poorly. The decline in economic activity in 1983 had adversely affected the tax revenue from income and profits in that year, but there had been a growing incidence of tax evasion. In view of the large uncertainties with regard to the future movements of petroleum revenues, the nonpetroleum revenue base should be further strengthened. Dismantling the practice of earmarking petroleum revenue would increase the margin of flexibility of the authorities in fiscal policy and might help them to promote expenditure restraint more effectively.

The recent strong growth of domestic savings was due mainly to the introduction of new certificates of deposit with interest rates determined freely in the market, demonstrating the importance of interest rates in mobilizing domestic savings, Mr. Murakami remarked. The authorities should thus consider making other adjustments in controlled interest rates, which had remained negative in real terms.

The measures taken during the preceding month to unify the exchange rates were welcome, and the unification of the exchange rate markets should be completed without delay, Mr. Murakami added. The pursuit of a flexible exchange rate policy in the unified market was even more important, and it was encouraging to know that the authorities intended to implement such a policy by October 21.

The multiyear rescheduling arrangements between Ecuador and its commercial and official creditors would significantly reduce its debt service burden throughout the remainder of the 1980s, Mr. Murakami concluded. The authorities should take advantage of the breathing spell offered by the rescheduling to maintain and strengthen their adjustment effort so that the country could obtain necessary financing on a voluntary basis after 1990, when a large financing gap was expected to re-emerge. In that context, great importance should be attached to the role of the Fund in its enhanced surveillance procedure.

Mr. Nimatallah said that Ecuador's economy had improved considerably in the context of the present stand-by arrangement with the Fund. The overall balance of payments had moved into equilibrium, and all the program's quantitative criteria had been met. However, Ecuador's economy remained highly vulnerable to developments in the oil market. In 1985, oil revenues were projected to account for one half of budgetary revenues and for more than two thirds of merchandise exports. Given the present uncertainties in the oil market, Ecuador's large debt obligations, and its long-standing structural weaknesses, the authorities should intensify their adjustment efforts, aiming ultimately to diversify the economy and reduce its dependence on oil.

Despite the noticeable improvements in the overall position and in public finances, a number of structural measures were still needed to strengthen public finances further, Mr. Nimatallah advised. The authorities could increase nonpetroleum revenues as a proportion of GDP by strengthening tax collection procedures, particularly to reduce evasion of income and corporate taxes. The system of revenue earmarking appeared to be more of a hindrance than a help, as it severely reduced the flexibility of fiscal policy. The authorities should abandon the system. Such measures would help control expenditures and would enable the authorities to implement additional adjustment measures as necessary.

The increase in public outlays on salaries was within programmed projections, Mr. Nimatallah noted. The authorities had tried to limit the size of the wage settlement. Nevertheless, the increase in the basic minimum wage, although at a rate 30 percent less than the inflation rate of 1984, was disappointing because it did not help to achieve the desired reduction in the rate of inflation to 20 percent or below. Further wage increases should be more supportive of the effort to control inflation.

Although it was regrettable that the unification of the exchange markets had not yet been completed, it was encouraging to note that the authorities had promised to complete the unification by October 21, Mr. Nimatallah stated. He would support granting a waiver, to enable Ecuador to make drawings, but he hoped that no further waivers would be needed. The authorities' intention to manage the exchange rate flexibly would help restore and strengthen Ecuador's external competitiveness.

Mr. Clark remarked that Ecuador had made particular progress in improving its fiscal position and reducing the current account deficit, but he echoed the concern of earlier speakers about Ecuador's delay in unifying its exchange markets.

The improvement in the financial position of the public sector was welcome, Mr. Clark added. Despite the upward revisions for 1984 and 1985, the overall public sector balance was still expected to move into surplus from a deficit of nearly 7 percent in 1982. The deterioration in the revenue projections for 1985 did, however, reinforce the need to secure firm control over public expenditure, keeping it within the program limits. The share of capital expenditure in total expenditure had fallen from about 24 percent in 1982 to just over 17 percent in 1984, and the authorities should try to shift the areas in which cuts were made so as to arrest that decline. In that context, the system of revenue earmarking seemed to make the reallocation of expenditure more difficult and hence the system ought to be dismantled.

The authorities had taken recent if somewhat belated and incomplete measures toward unification of the exchange market and were committed to move the official rate to the intervention rate by October 21, Mr. Clark noted. The authorities would need to maintain the level of competitiveness thereafter by adopting a flexible exchange rate policy.

The large increase in minimum wages that had been granted in March had contributed to a higher rate of inflation in 1985 than expected, Mr. Clark noted. It was important for the authorities to grant a significantly lower increase in 1986.

The restoration of Ecuador's external viability depended on the maintenance and strengthening of private capital inflows, Mr. Clark considered, highlighting the need for the authorities to sustain confidence in their policies. An adjustment of the interest rates that were currently controlled and further steps to increase the role of market forces in setting interest rates would be essential.

The situation facing the authorities was likely to remain difficult even without a further sharp fall in oil prices, Mr. Clark predicted. The staff's medium-term projections showed substantial financing gaps in the late 1980s. The level of reserves also remained low and was projected to rise to only one and a half month's imports by 1990. Firm adjustment measures should continue if a buildup of reserves was to be achieved without further Fund support.

Mr. Tornetta considered that a moderately positive assessment could be made of Ecuador's performance so far under the stand-by arrangement. Sizable progress was in prospect on the fiscal front, as government finances were expected to pass from an overall deficit equal to 0.4 percent of GDP in 1984 to a surplus equal to 2.2 percent of GDP in 1985. Despite the observance of the quantitative performance criteria, Ecuador's fiscal performance would not be as positive as had been foreseen in the original program, partly due to circumstances beyond the authorities' control. Balance of payments developments had also been satisfactory. The authorities had not been able to realize their commitments, however, in important areas such as exchange rate policy and wage policy. The rate of inflation had remained at relatively high levels; although it had not tended to decrease during the program period, he noted from Mr. Kafka's statement that it might have begun to decrease in the past few months.

The fiscal problems appeared to be related to rigidities on the revenue side, Mr. Tornetta suggested. Lower than expected revenues from the petroleum sector, which still accounted for more than half of total government revenues, had been partly responsible for the likely shortcoming in the fiscal position. The recent weaknesses in the oil market and the uncertainties surrounding future price developments suggested the need for a more flexible recourse to alternative revenue sources. However, nonpetroleum revenues had followed a decreasing trend in past years; although the staff and the authorities seemed to hold different opinions about the performance of nonpetroleum revenues, it was clear that the responsiveness of that source of revenue remained less than satisfactory. Consideration should also be given to the composition of expenditures because adjustment had relied too heavily in the past on the curtailment of capital expenditures.

The growth of monetary aggregates had been particularly steep; during the year ended in May 1985, money had increased by 53 percent and quasi-money by 134 percent, Mr. Tornetta commented. Liquidity increases had been very high in real terms as inflation during the period had reached 29 percent. Liquidity creation had been fostered by larger than expected capital inflows as well as by shifts in the portfolios of private investors from assets that had not been included in monetary aggregates to assets pertaining to the banking system. The latter development had been favored by the issuance of certificates of deposit and by better yields on bank-related assets. It would be interesting to know from the staff in what part liquidity creation might be attributed to those two causes in order to assess the different effects on velocity. While increases stemming from capital inflows pointed to an effective liquidity creation, those deriving from changes in portfolio preferences away from assets not included in certain monetary aggregates were partly of a statistical nature. The latter increases, if permanent, could cause a structural decrease in velocity. Dealing briefly with the causes underlying price developments, the staff and had attributed inflation to exchange rate factors and the impact of a drought on food prices; but monetary developments might have also had an important role in fueling price increases. Tighter control of liquidity creation seemed warranted to avoid undesirable consequences on inflation and on the external position.

Even though important progress had been achieved toward the exchange market unification through the shift of a growing amount of transactions from the official market to the intervention market, that unification had been slow and incomplete, Mr. Tornetta noted. Delays did not seem related to external or unforeseen events. Because the reasons for granting a waiver in such circumstances were not clear, further clarifications from the staff would be appreciated. However, in view of recent developments and of the reassurances provided by the authorities, he would be willing to go along with the request for a waiver and to support the proposed decision.

Ecuador intended to ask for a new stand-by arrangement at the expiration of the current one and for enhanced surveillance procedures thereafter, Mr. Tornetta remarked. The country's record of adjustment under Fund programs would certainly be an important element in the consideration of its request for enhanced surveillance. Therefore, the authorities should persevere in their adjustment efforts.

The Executive Directors agreed to resume 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/85/145 (9/18/85) and EBM/85/146 (9/20/85).

3. IVORY COAST - TECHNICAL ASSISTANCE

In response to a request from the Ivorian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/85/243 (9/16/85).

Adopted September 19, 1985

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/243 (9/18/85) and by an Assistant to Executive Director as set forth in EBAP/85/242 (9/17/85) is approved.

APPROVED: June 2, 1986

LEO VAN HOUTVEN
Secretary