INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/33

10:00 a.m., February 22, 1983

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	M. K. Diallo, Temporary
	C. Taylor
	G. Ercel, Temporary
	A. Le Lorier
	M. Teijeiro
	C. Dallara
M. Finaish	
	Jaafar A.
	H. Suzuki, Temporary
	M. Casey
	D. I. S. Shaw, Temporary
A. Kafka	
	G. Grosche
	C. P. Caranicas
	A. S. Jayawardena
	S. El-Khouri, Temporary
J. J. Polak	T. de Vries
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
F. Sangare	E. I. M. Mtei
	M. Toro, Temporary
	I. Fridriksson, Temporary
	Jiang H., Temporary

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

Also Present

African Department: J. B. Zulu, Director; L. M. Goreux, Deputy Director; O. B. Makalou, Deputy Director; A. Basu, E. L. Bornemann, N. Calika, C. V. Callender, S. E. Cronquist, Z. Ebrahim-zadeh, C. N. Egwim, J. M. Jimenez, G. Namakandou, S. M. Nsouli, M. Reichardt, D. J. Scheuer, R. T. Stillson, N. E. Weerasinghe. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Kanesa-Thasan, M. Nowak, E. J. Zervoudakis. Fiscal Affairs Department: H. R. De Zoysa, M. Holmes, R. D. Kibuka. Legal Department: Ph. Lachman, A. O. Liuksila, J. M. Ogoola. Middle Eastern Department: A. S. Shaalan, Director; S. Kawar, K. Nashashibi, M. Yaqub. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: E. A. Ajayi, J. R. N. Almeida, L. Ionescu, M. A. Janjua, H.-S. Lee, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, H. Arias, R. Bernardo, J. Bulloch, M. Camara, W. Moerke, J. A. K. Munthali, V. K. S. Nair, C. A. Salinas, J. Schuijer, J. C. Williams.

1. UGANDA - 1982 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1982 Article IV consultation with Uganda, together with a proposed decision concluding the 1982 Article XIV consultation, and a review of the stand-by arrangement (EBS/83/5, 1/10/83). They also had before them a report on recent economic developments in Uganda (SM/83/23, 2/4/83).

A Deputy Director of the African Department made the following statement:

> Following the measures taken last November, sales of foreign exchange at the second window have increased substantially. Weekly sales, which averaged only $1.1 million during the first 12 weeks, rose to $2.1 million in the last 7 weeks of 1982 and $2.4 million in the first 7 weeks of 1983. If sales remained at the level of $2.4 million a week during the next 18 weeks, the $88 million target set for the program would be reached, corresponding to average sales of $2 million a week from August 27, 1982 through June 24, 1983 (Table 1, see Annex I).
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> The margin between the rates of exchange prevailing at the two windows has been progressively declining. The second window rate (in terms of Uganda shillings per U.S. dollar), which exceeded the first window rate by 200 per cent during the first three weeks of the dual exchange system, exceeds it now only by 106 per cent. This resulted from a progressive depreciation of the first window rate from U Sh 99 per US$1 to U Sh 111 per US$1 and an appreciation of the second window rate from U Sh 300 per US$1 to U Sh 230 per US$1. Simultaneously, the rate at the parallel market has been appreciating from about U Sh 360 per US$1 to U Sh 270 per US$1.
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> Profits from sales at the second window are estimated at U Sh 3.7 billion for the period August 27, 1982 through February 4, 1983. For the first five weeks of 1983, profits amounted to approximately U Sh 1 billion.
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> The cost of living index, which had increased by 10 per cent from September 1982 to November 1982, fell by 5 per cent in December and remained unchanged in January 1983. The decline was mainly due to a fall in prices of food.
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> All performance criteria have been met for December 31, 1982. As shown in Table 2 (see Annex II), the reduction in external arrears in the second half of 1982 was much greater than required under the program. If the second decision proposed in EBS/83/5 is approved, Uganda will make its third purchase under the 1982/83 arrangement for an amount equivalent to SDR 25 million.

Mr. Sangare made the following statement:

I should like to express the appreciation of my Ugandan authorities to the staff for the frank and constructive discussions during the 1982 Article IV consultation and the review of the stand-by arrangement. These discussions and the staff's assessment of developments in the Ugandan economy, including the performance under the stand-by arrangement, have been clearly set out in the well-balanced set of papers before the Board today.

In the last decade, the economy of Uganda has experienced declining output and rampant inflation, aggravated by wide budgetary deficits, expansionary monetary policies, and widespread shortages of essential commodities. This situation was compounded by the ravages of war and, by the time the new Government assumed office in 1980, the economy was on the verge of total disintegration. It therefore became apparent that strong and concerted action would be required in order to rehabilitate the economy. Accordingly, my Ugandan authorities embarked upon a stabilization program that has been supported by two consecutive stand-by arrangements with the Fund, the most recent of which was approved by the Executive Board on August 11, 1982. Thus far, the authorities have been largely successful not only in terms of satisfying performance criteria under these arrangements with the Fund, but in making progress toward establishing the basis for sustained economic growth.

The 10 per cent growth rate in real GDP recorded in 1981/82 is expected to be repeated in 1982/83. Agricultural output is projected to rise by 9 per cent, reflecting higher output of both domestic food crops and export crops. With regard to the latter, it is expected that coffee production in 1982/83 will increase by 10 per cent; tea by 58 per cent; tobacco by about 200 per cent; and cotton by 500 per cent. Significant gains are also expected in the industrial sector for a number of essential commodities, such as edible oil, hoes, sugar, textiles, and cement, as a result of improved access to foreign exchange, which made it possible to import new equipment and spare parts. In the meantime, the rate of inflation as measured by consumer prices has dropped precipitously from over 100 per cent in 1980/81 to an estimated 25 per cent in 1982/83, despite the depreciation of the Uganda shilling.

Notwithstanding these achievements, my authorities are convinced that much remains to be done. To this end, they are continuing to implement appropriate measures along the lines set in the two-year Recovery Program adopted at the beginning of 1982/83 with the aim of further improving agricultural and industrial production, as well as transportation facilities. The Program calls for a total investment of $737 million, of which 30 per cent has been earmarked for agriculture--indicating the high priority that the authorities attach to this sector--29 per cent to industry and tourism, and 21 per cent to transportation. The remaining 20 per cent will be allocated to telecommunications and social services.

As regards the agricultural sector, the Government intends to expand and improve extension services, increase supply of seeds and agricultural implements, and introduce new crops and production techniques. Meanwhile, existing coffee processing plants, cotton ginneries, and tobacco curing barns are being rehabilitated. Steps are also being taken to increase milk and meat production through improved breeding techniques, expanded use of artificial insemination, and rehabilitation of existing ranches.

In the manufacturing sector, the intention is to promote the processing of agricultural products for export and the development of import substituting industries. In this connection, steps are being taken to improve credit allocation and procurement procedures and provide additional capital resources. Meanwhile, the return to former owners of a number of nationalized industries should help to strengthen private sector confidence in the economy and thereby encourage greater participation by private entrepreneurs.

Being a landlocked country, the authorities are aware of the fact that transportation bottlenecks that have inhibited the smooth flow of import and export traffic could frustrate or neutralize the efforts being made in other areas to expand the productive capacity of the country. Accordingly, they are in the process of augmenting the capacity of the railway and rehabilitating its facilities. Work is also under way to improve port services at two of the major transit terminals.

On the fiscal front, the revised budget estimates for 1982/83 indicate that the overall deficit as a percentage of GDP will be around 2.0 per cent, compared with the original ta et of 2.3 per cent or 3.2 per cent in 1981/82, reflecting a larger increase in revenue than had been anticipated, as a result of improvement in tax administration. Nevertheless, the authorities are aware of the need for further improvement, particularly in recognition of the fact that the exchange profits now accruing to the Treasury will only last until the exchange rate is unified. They remain optimistic, however, that the underlying tax base will continue to expand, and there should be a substantial increase in revenue when the exchange rates are unified. They are also considering the possibility of introducing export taxes on other commodities while being mindful of the need not to adversely affect production for export.

On the expenditure side, the authorities also believe that there is room for further improvement. Although expenditures were drastically reduced in September 1982, there is concern that increased government transactions at the second window under the dual exchange rate system, higher prices for petroleum products, and the prospective increase in wages and salaries in the second half of 1982/83 will lead to higher expenditures. The authorities, however, believe that these increases can be accommodated within the limits of the current program. In this connection, a detailed review of the 1982/83 expenditure estimates is under way with the assistance of an advisor from the Fund. This is being supplemented by the establishment of a Payments and Control Committee that will monitor expenditure developments with a view to effecting better control. The authorities have also established an Aid Coordination Committee that will, inter alia, examine all externally funded programs with a view to improving the utilization of external aid. Furthermore, proposals to strengthen the Ministry of Finance will be discussed with a World Bank mission due to arrive in Kampala this February. In addition, the Salaries and Wages Commission is to undertake a study with the assistance of the World Bank, whose recommendations should form the basis for future increases of public sector wages.

With regard to state enterprises, the authorities have taken the decision to abolish some and sell others or return them to their previous owners. Some of the owners have already taken up 49 per cent interest in some of these corporations. Moreover, all state enterprises are now required to submit financial data to the Ministry of Finance on a regular basis and commercial banks are encouraged to undertake a thorough examination of their financial statements to ensure the repayment of loans not guaranteed by the Government. For the long term, a comprehensive study of some 50 corporations, including the Uganda Electricity Board and the various agricultural marketing boards, is expected to be launched this month with the help of the World Bank. Inter alia, the study will pay close attention to the management problems of these corporations as well as the tariff structure of utility companies. In the meantime, tariffs in respect of electricity, railways, and air travel were raised by 50 per cent, 100 per cent, and 40 per cent, respectively, between July and December last year.

Monetary and credit policy in 1982/83 has been to contain inflationary pressures while providing adequate credit to productive sectors, mainly for crop financing and imported inputs that are required to support the Recovery Program. Accordingly, credit ceilings for the private sector have once again been increased substantially this year. On the other hand, the upward revision of credit to the Government remains consistent with the increase in money supply and balance of payments and growth objectives. Treasury bill rates were raised last November by an average of 2.5 percentage points, to a maximum of 12 per cent in order to encourage nonbank financing of the budget deficit. Lending rates have also been raised, with a maximum of 20 per cent set for commerce and unsecured loans. Interest rates on deposits have not increased since June 1981, at which time the adjustment was considered to have brought interest rates broadly in line with the rate of inflation for 1981/82. The authorities maintain that a further increase in deposit rates at this time would not have a significant impact on savings mobilization due mainly to lack of banking facilities in rural areas. The authorities are therefore encouraging banks to expand their mobile banking facilities. With regard to the Uganda Development Bank, the authorities have strengthened its capital base and intend to increase its role in the banking sector by allowing external loans to be channeled through it to priority projects in agriculture and industry.

In the external sector the objective has been to consolidate the gains made in 1981/82 while laying the basis for a sustainable balance of payments position in the medium term. The authorities have sought to achieve these objectives mainly through diversification and expansion of the export sector. Thus, the continued depreciation of the exchange rate at the second window as well as the permission granted by the authorities for the exportation of small-holder crops should further encourage the growth of exports. Furthermore, the importation of necessary inputs should also assist in the production of other nontraditional exports. Uganda's balance of payments situation is expected to improve considerably in the medium term as investments and policies being implemented in the context of the financial program and the Recovery Program are expected to have a substantial impact on exports by 1984/85.

With regard to external arrears, the authorities continue to show determination to eliminate such arrears by 1984/85. To this end, external arrears were reduced by $11 million between June and September 1982, an amount higher than the program target. In the meantime, the authorities have managed to secure debt rescheduling in the amount of $30 million from Tanzania, $10 million under the Paris Club, and $36 million in suppliers' credits. They intend to continue to seek debt relief in order to spread the burden of debt servicing in line with their capacity to generate foreign exchange.

The dual exchange rate that the Board approved under the program experienced some teething problems in respect of the performance criterion on the minimum amount of foreign exchange sold at the second window. The authorities have since implemented a number of corrective measures to reduce the cost of importing through official channels as well as bureaucratic delays in processing import licenses. Reflecting these improvements, sales of foreign exchange at this window by the Bank of Uganda were over $25 million on December 24, 1982, well in excess of the modified ceiling. My authorities are committed to eliminating the dual exchange rate before the middle of 1984.

In conclusion, I should like to state that my Ugandan authorities have thus far taken all the agreed measures in order to achieve the program's objectives. They have also indicated readiness to implement further measures should it become necessary. I should therefore ask Directors to adopt the proposed decisions on pages 35 and 36 of EBS/83/5.

Miss Diallo observed that the serious economic and financial imbalances that had been experienced by Uganda in recent years, and that had led to the current stand-by arrangement with the Fund, had been reviewed in August 1982. The authorities had taken a number of important measures since that time to correct the imbalances, and their determination to restore financial stability and establish a sound basis for strong and sustainable growth was reflected in the satisfactory performance during the first six months of the stand-by arrangement. All program targets had been met, and all quantitative performance criteria had been observed throughout the review period. As a result, the inflation rate had been reduced from more than 100 per cent in 1980/81 to about 25 per cent in 1982/83; the real rate of growth of GDP had reached 10 per cent in 1981/82, reflecting a substantial increase in agricultural and industrial production; interest rates had been increased substantially with a view to promoting an efficient intermediation system; and tight fiscal and monetary policies had brought about a significant improvement in Uganda's balance of payments.

Despite the favorable developments she had mentioned, the basic economic structure of Uganda remained weak, Miss Diallo continued. The authorities were conscious of the need for a continued strong economic and financial policy stance and for structural changes, and she hoped that the appropriate adjustment would be effected so that the conditions necessary for continued support by the Fund would be met.

As she understood it, there was a link between the reduction of external arrears and the consistency of the program, Miss Diallo remarked; an indication by the staff of the impact of a larger reduction in external arrears on other elements of the program would be welcome. In its opening statement, the staff had suggested that external borrowing by Uganda had been below expectations; she wondered whether the low level of borrowing was consistent with the other program targets and whether the actual level of net domestic credit was compatible with supply-side objectives. In conclusion, she could fully support both the proposed decision concluding the 1982 Article XIV consultation and the decision on the review of the stand-by arrangement.

Mr. Grosche stated that he too could support the proposed decisions. The authorities deserved commendation for the satisfactory results achieved thus far under the stand-by arrangement and for their continued efforts to meet the objectives of the program.

On the external side, Mr. Grosche continued, a further improvement in the balance of payments was expected in 1982/83, mainly because of a shift in the capital account from deficit to surplus; the current account deficit was expected to widen. External equilibrium continued to be a matter of concern, and exchange rate policy remained of crucial importance. He welcomed the intention of the authorities to unify the exchange rates at a level that fully reflected the prevailing scarcity of foreign exchange, but he wondered whether the unification could not be completed somewhat before the middle of 1984, especially given the suggestion by the staff that the margin between the rates of exchange prevailing at the two windows had been progressively declining. Whatever date was decided, the authorities should in the meantime keep the system under constant review and progressively shift transactions from the first to the second window.

In previous Executive Board discussions on Uganda's economy, several Directors had mentioned that a further upward adjustment in interest rates would be necessary, Mr. Grosche recalled. However, according to the staff report, rates on deposits had not been increased since June 1981. The authorities had justified their reluctance to raise deposit rates further, but the staff apparently felt that they "should continue to keep interest rate policy under review." Perhaps the staff could elaborate further on the appropriateness of the current interest rates.

A number of improvements were called for in the budgetary performance, Mr. Grosche considered. On the revenue side, the authorities were committed to finding other sources of revenue to compensate for those that would no longer be significant once the unification of the exchange rates had been achieved. He would appreciate hearing from the staff more on the nature of the measures anticipated and whether they had been taken into account in the somewhat optimistic revenue forecasts put forward by Mr. Sangare. On the expenditure side, he was concerned about the growing discrepancy between disbursements and commitments as well as by other factors that were generating upward pressures on expenditure. In the circumstances, he would welcome any technical assistance that the Fund or other institutions could provide to improve expenditure control mechanisms. Finally, like others, he commended the authorities for their willingness to implement any further measures that might be necessary to achieve the program's objectives.

Mr. Taylor considered that Uganda was, in one sense, a test case for the success of the Fund's policies in Africa. The progress being made attested to the effectiveness of the close cooperation between the Fund and the World Bank in cases in which structural adjustment was required over a lengthy period; it was also a sign of the usefulness of ample and continued technical assistance by both institutions.

The Ugandan authorities faced a Herculean task in rebuilding their shattered economy, and progress thus far had been good in adverse circumstances, Mr. Taylor continued. The authorities had successfully completed purchases under the 1981/82 stand-by arrangement, and he was pleased to see that the current stand-by arrangement remained on track. Some sharp price increases introduced in the course of the first stand-by program had helped to keep real wages at a low level; over time, it would be important to provide for some recovery in real wages in order to strengthen domestic demand and to provide the resources for increased savings, while avoiding a return of inflation. The rate of inflation had been necessarily high during the first stand-by arrangement, and it was encouraging to see that it had been reduced to the relatively low level of 11 per cent for the year ended June 1982. He hoped that the report of the Civil Service Salaries Review Commission would provide helpful guidance to the authorities.

On the fiscal side, Mr. Taylor noted that the authorities had achieved a substantial reduction in the budget deficit, which was projected to decline to 21 per cent of total expenditure in the current fiscal year. The reduction had in part resulted from reduced spending because of the economy's low absorptive capacity, but it was pleasing to see that it had also resulted from an improvement in tax administration and a substantial increase in revenue. The authorities were to be commended for having implemented all the major recommendations contained in the 1980 Fund Tax Report and for persevering with improvements in the tax administration in the current fiscal year; revenues should benefit from the broadening of the tax base as recovery and production progressed.

It was difficult to strike a balance in the area of public expenditure, Mr. Taylor considered. On the one hand, the authorities would naturally wish to press ahead with improvements in agriculture, industrial production, and the transport sector as envisaged in the Recovery Program; on the other hand, they would need to redouble their efforts in other areas to control public expenditure in order further to reduce the deficit without adding too much to the tax burden. He welcomed the presence in Uganda of a budget advisor--under the Fund's technical assistance program--to help with the comprehensive assessment of expenditure in 1982/83. He agreed with the staff that the search for economies should center in the areas of government wages, security expenditure, and the management of parastatal corporations. Noting that the Government had expected to undertake an in-depth study of the parastatal sector, he wondered whether Mr. Sangare or the staff could provide up-to-date information on the progress of that study. One area of the public finances meriting particular attention was that of domestic payments arrears, which had increased during the previous fiscal year. He would appreciate hearing from the staff more detailed information on the present level of arrears and whether the authorities had given any thought to a timetable for their elimination.

The measures taken by the authorities in the area of credit policy--notably the increase in interest rates during 1981--had contributed to the reduction in the rate of inflation and to a marked increase in the rate of domestic savings, Mr. Taylor observed. As the recovery proceeded, it would be important to keep interest rates under review with the dual objective of containing inflationary credit creation and further stimulating private savings. The authorities might seriously consider a further increase in interest rates if circumstances warranted. On the supply side, efforts were being made to reduce structural distortions in the economy and to strengthen competition by improving transport and marketing distribution. Despite the high cost of some imported inputs, the agricultural sector was making an impressive contribution to economic recovery; more realistic producer prices were having the desired effect, and he urged the authorities to ensure that those prices remained sufficiently remunerative. The diversification of exports was also a welcome development. In particular, the investment in the cotton industry had been helpful, because cotton--being an annual crop--generated a relatively quick return.

Turning to external policy, Mr. Taylor welcomed the establishment of the Aid Coordination Committee. It would be most desirable for Uganda to make efficient use of available aid, not only to retain the confidence of donors but also to prevent any avoidable shortfall in investment, thus safeguarding growth prospects and the momentum of reconstruction.

The dual exchange rate system appeared to have operated smoothly since the changes implemented in November 1982, Mr. Taylor continued. Clearly, it had taken time for the authorities to learn how to operate the system to the best effect; however, as the initial difficulties had been ironed out, it was time to begin thinking about reunification of the exchange rate. He therefore welcomed the authorities' stated commitment to eliminate the dual system before the middle of 1984. He noted that the official and commercial rates had already converged to some extent, which was a good indication that the arrangements were working in the right direction. To operate a dual exchange market as part of a Fund program was a novel exercise, about which much needed to be learned. He would welcome an assessment by the staff of the success of the venture thus far, as well as an indication of whether any thought had yet been given to alternative revenue sources to replace the exchange profits when the two-tier system was eventually merged.

The progress made in liquidating external payments arrears was welcome, and he noted the planned overall reduction of $63 million, including rescheduling over the period of the current stand-by arrangement, Mr. Taylor commented. However, his authorities felt that a faster reduction of arrears would help external confidence and might even release new credit for the economy. If export receipts turned out to be higher than currently projected, the authorities should be able to speed up the reduction of arrears without too much difficulty.

The staff's concise assessment of Uganda's exchange restrictions was helpful, Mr. Taylor remarked. In current circumstances, it was appropriate for the Fund to approve those restrictions, including the dual exchange rate, at least until the end of October 1983, by which time it was to be hoped that a follow-on stand-by arrangement would have been presented to the Board. Finally, he could support both the staff appraisal and the proposed decisions.

Miss Le Lorier observed that the case of Uganda was a striking example of the rapidity with which the implementation of sound economic and financial policies--together with assistance from the international community--could reverse a badly deteriorating situation and put an economy back on track toward recovery. The Ugandan authorities should be commended for their achievements and efforts thus far, which augured well for the future.

Producer prices for food crops had been freed since May 1981, resulting in a restoration of self-sufficiency in food, Miss Le Lorier continued. Producer prices for major export crops were still determined by the Government, but they had been raised substantially in the course of 1982, and had apparently provided the farmers with sufficient incentives to promote a sharp increase in production. Nonetheless, some of the prices listed in Table 3 of the staff report remained lower in November 1982 than the level of international prices would seem to permit. The discrepancy was particularly striking in the case of coffee, for which the international price was more than four times the producer price, and for cocoa, for which the same ratio was about 6:1, indicating that there remained a sizable levy on export crop producers, a point that was confirmed by the share of export taxes in government revenues. As further increases in production would depend upon higher yields--which implied a greater use of agricultural inputs--it was crucial that producers should be provided with sufficient returns; moreover, if producer prices were less than those prevailing in neighboring countries, an unwanted revival of smuggling could occur. New steps would need to be taken to broaden the tax base and strengthen the fiscal administration in order to maintain the revenues of the public sector, and, at the least, further depreciations of the official exchange rate should be immediately and fully reflected in producer prices.

Turning to the exchange rate system, Miss Le Lorier remarked that the results already achieved under the dual market established in August were noticeable, with the gap between the exchange rates at the two windows having narrowed considerably. She could support the objective of achieving a reunification of the exchange rate, although she was uncertain about the appropriate timing. Most imports continued to be financed at the first window, and it seemed possible that a rapid further depreciation of the official exchange rate might have strong inflationary and disruptive effects. The inflation rate for 1982/83 had been projected at 25 per cent, and it would be interesting to know whether that estimate took into account the effects of a reunification of the exchange rate and whether the projection remained valid in light of recent developments. She would also be interested in hearing further elaboration from the staff on the various elements that should be taken into account in assessing the desirability of eventually accelerating or postponing the unification of the two markets. For instance, should the persistence of a parallel market have a bearing on the timing of the reunification? On the fiscal side, there would be a loss in revenues related to the disappearance of exchange profits; on the other hand, there could be a gain in revenues because of increased export duties. On the expenditure side, both the higher than anticipated rate at the second window and a depreciation of the rate at the first window had thus far worked in the same direction and generated upward pressures on expenditures. Hence, further analysis of the consequences of a reunification for the fiscal situation would seem warranted. On the whole, she favored flexibility in the timing of the reunification and considered the date of mid-1984 as more of a target--dependent upon the validity of current assumptions--than a deadline.

Pragmatism and flexibility should be maintained in the design of the adjustment effort in Uganda, Miss Le Lorier considered. The staff had pointed to weaknesses in competitiveness and to the high profit margins of middlemen; it had also remarked on the need to improve wages and salaries of civil servants while reducing their number, the weakness of the still fragile banking sector, and the need for eventual government intervention to enhance the rehabilitation of the economy. She was confident that the staff, in dealing with those matters, would continue to show imagination on the occasion of later reviews of the current program and in negotiating any follow-on programs.

Mr. Dallara recalled that, during the initial discussion of the stand-by arrangement in August 1982, he had stressed that the process of restoring Uganda's economy to a path of long-term growth and a sustainable payments position would take a number of years and perseverance on the part of the authorities. He was pleased to note that, since August, the authorities had shown a determined effort to restore economic stability, and the economy had responded positively to the Government's policies. Levels of production in key sectors were continuing to rise, and the prospects for further progress looked good, so long as there was a continued willingness to make further policy changes as necessary. Given the record of achievement to date under the program, he could support both proposed decisions. The Memorandum on Economic and Financial Policies for 1982/83 was generally well designed and should serve to promote the adjustment effort.

Regarding the exchange rate regime, Mr. Dallara said that he was pleased to note that the modified performance criteria related to the volume of sales of foreign exchange at the second window had been met at the end of December. Moreover, the exchange rate policy, in conjunction with producer pricing and other policy changes, appeared to be having the desired result of stimulating production and exports and generally promoting a more efficient allocation of resources. He welcomed the additional measures that had been adopted to eliminate the disincentives to the full utilization of the second window by participants.

He was also pleased to see that a timetable for the unification of the two rates had been established, Mr. Dallara continued, but he was concerned about the pace at which the two markets were to be unified. Like Mr. Grosche and others, he would encourage the authorities to accelerate the pace of unification, especially since the differences between the two rates had been narrowing. Unification earlier than mid-1984 could provide an additional incentive for exports, which could further strengthen the balance of payments. It was appropriate that the approval of the exchange restrictions on payments and transfers, together with the multiple currency practice involved in the application of the dual exchange arrangements would be granted only until October 31, 1983. Ideally, those practices--and the dual exchange rate system itself--should be eliminated by that time.

Turning to supply-side measures, Mr. Dallara observed that producer prices had generally been satisfactory, with impressive changes made in a number of areas. However, he would appreciate some further assessment of the adequacy of current price levels; Table 3 on page 8 of the staff paper provided useful data on the percentage changes in producer prices, but it did not relate those changes to world price levels. He supported the staff view that producer prices for 1983 would need to be monitored closely. Noting that Uganda's 1982/83 coffee quota had been reduced, he wondered what impact that reduction would have on export earnings. Also, given the suggestion by the staff that the lack of competition had allowed some consumer prices to remain too high, he wondered what specific steps the authorities had in mind to deal with that deficiency.

Performance on the fiscal side had on balance been somewhat better than expected, Mr. Dallara remarked. However, fiscal policy should remain a central part of Uganda's adjustment effort because, in spite of the progress made thus far, significant weaknesses remained. He welcomed the implementation of virtually all the recommendations of the 1980 Tax Report prepared by the Fund. It was imperative that the underlying tax base be expanded; while the authorities were obviously in agreement with that view, he was not entirely reassured that they had fully come to grips with the problem of potential revenue loss from the exchange profits tax once the dual exchange rates were eliminated. He encouraged them to deal with the matter at an early stage, since the problem was clearly related to the pace at which unification of the two rates could be achieved.

Encouraging the commercial banks to take a more active role in assessing the credit risks of the parastatals should be helpful, Mr. Dallara considered. Such market-driven discipline would help to strengthen the economic performance of the parastatals, which remained a major problem area, both for the budget and, in general, for economic efficiency. He welcomed the plan to undertake a comprehensive study of the parastatals; in the meantime, however, the authorities should take additional measures to tighten the management and accountability of the parastatal enterprises. Another aspect of the budget meriting concern was expenditure control, an area in which progress seemed to be lacking. The staff had thoroughly outlined the nature of the problem and the need for action, and he hoped the authorities would follow the staff's advice.

On monetary policy, Mr. Dallara agreed with others that the issue of deposit interest rates required further examination, although the objective should be ultimately to raise those rates to more appropriate levels. He would be interested in hearing whether the staff had any comment on the contention of the local commercial banks that the additional resources likely to be generated by raising deposit rates could not be used profitably under existing restraints. Finally, he supported Uganda's adjustment efforts thus far, which reflected a determination on the part of the authorities as well as a positive response by the economy to an increasingly appropriate array of price signals. However, continued diligence and further action would be necessary.

Mr. Polak said that he also wished to commend the Government of Uganda for its efforts toward liberalization and the expansion of supply and for its success in reducing inflation. Still, he had difficulty in determining from the staff paper precisely what had been achieved. A reference had been made to Uganda's move toward self-sufficiency in food, and the staff had indicated that coffee production had increased by more than 50 per cent and that the production of cotton, tea, and tobacco had doubled. On the other hand, it was apparent that tobacco production at present was only 11 per cent of what it had been in 1971/72. In future, it might be useful if the staff could provide not only an indication of improvements over the previous one or two years but also some picture of how Uganda was progressing toward the levels that had been achieved in the late 1960s and early 1970s. Any progress was welcome, and he encouraged the authorities to continue along the path of the previous year; the Fund, for its part, should provide what technical assistance it could to contribute to their efforts.

Turning to the exchange rate system, Mr. Polak recalled that there had initially been some difficulties encountered in making the dual rate system effective. In particular, there had been problems in moving an adequate net supply from the first to the second window. However, steps had been taken to overcome that difficulty, and he noted with satisfaction that the spread between the two windows was narrowing. Everyone, including the Ugandan authorities themselves, seemed to be agreed that the split rate was only a temporary measure, representing primarily a tax on some major exports and a subsidy on some important imports. The question of whether the tax on coffee, in particular, ought to be collected through the dual rate system or in another way was a matter that urgently deserved consideration. Certainly, the merger of the two markets should be pursued, but not in a way that involved severe controls on payments and receipts currently going through the second window. Some deregulation had already been necessary with respect to imports and exports at the second window in order to draw payments and receipts into that window from an unnamed but, nevertheless, existing third window, namely, the parallel market. He understood that the second and third markets were at present quite close, which was an indication of how important it was that the second window should pick up all business not allowed to go through the first window. As the exchange position improved, it should be possible to narrow sharply the difference between the first and second windows; once that had been done, a full merger could take place. In the meantime, much could be achieved by transferring more imports from the first window to the second window.

Commenting on the matter of debt rescheduling under the Paris Club, Mr. Polak welcomed the December 1982 arrangements. He noted that bilateral agreements would have to be reached with a number of countries, and payments made to those countries by June 30, 1983. Uganda would be expected to take the required steps in a nondiscriminatory manner with respect to all the creditor countries involved. During the recent Paris Club meeting, it had been suggested by the representatives of Uganda that there were certain complications with respect to the claims of one of the creditors. He hoped that an effort would be made to resolve the issue promptly so as to avoid the risk of an impasse at a later stage that might complicate Fund assistance to Uganda. In conclusion, he could endorse the proposed decisions.

Mr. Casey stated that he too could warmly support the proposed decisions. New projects, injections of capital, and various measures on the supply side were the elements usually thought of as appropriate in an effort toward rehabilitation and reconstruction; and certainly the Ugandan authorities had followed that standard approach. However, it was interesting to note that demand management and macroeconomic policies had also helped crucially in the rehabilitation. Enlightened exchange rate policy had served to link the demand and supply sides of the economy, promoting a synergistic or mutually reinforcing effect that was aiding the reconstruction effort. Uganda had become self-sufficient in food and had achieved real gro rates of 10 per cent while reducing inflation to 25 per cent, despite the massive devaluation and the establishment of the second window. It was noteworthy that prices were expected to decelerate further as more supplies came on stream through a strengthening of marketing forces and an alleviation of transport difficulties and other physical bottlenecks.

While the financial program was not an extended arrangement, Mr. Casey continued, structural adjustment under the program had been remarkable and clearly validated the role of the Fund in that area. He welcomed the catalytic effect of the Fund program on Paris Club and other debt rescheduling and the promotion of greater World Bank involvement in the economy. He was certain that, in time, bilateral aid donors would also be encouraged to do more as their doubts about Uganda's implementation capacity were eased. When the authorities began to make full use of the technical assistance being provided in a number of areas, and when entrepreneurs who had emigrated some years previously returned to the country, Uganda's implementation capacity would improve. It was important to attract concessional flows and ensure that they were put to the best possible use.

The economy was adjusting well under the program, Mr. Casey observed; indeed, it was overperforming in relation to the program criteria. Finance and human capital were being mobilized, and prospects for the future seemed bright, although more needed to be done before the rehabilitation process was complete.

On the external side, the suggestion that the overall balance of payments might be in surplus in 1984/85 seemed optmistic, Mr. Casey commented. He noted that coffee still accounted for 90 per cent of total exports and was constrained by international quotas. Moreover, it was not clear that diversification in manufacturing was occurring at a sufficiently rapid pace, as could be seen from Table 10 of SM/83/23. Some of the manufacturing subsectors were far from recovering to levels of output that had been witnessed in earlier days. However, a unification of the exchange rate toward the depreciated rate should help diversification as well as the balance of payments and the arrears problem. It could also help to bring the debt service ratio to a level below 27 per cent. Hence, he welcomed the commitment of the Ugandan authorities to eliminating the dual exchange rate before mid-1984 as well as the recent developments in the dual rate set out in the staff's opening statement. While agreeing that there appeared to be a tendency for the exchange rates to converge, he was unclear whether the convergence was toward an average depreciated rate; in fact, the rates could conceivably be converging in the opposite direction, although he was certain the authorities would not wish that to happen.

In the area of fiscal policy, he agreed with the staff on the need to curb government spending, particularly on parastatals and security, Mr. Casey remarked. Trends in public sector wages were complicated, as others had noted, by the need to attract skilled personnel, and a wage fund approach seemed to be a desirable course of action in the circumstances. On the revenue side, trade-related taxes and the exchange profits taxes together accounted for almost 65 per cent of total revenue; by comparison, income tax accounted for only 5 per cent. Hence, the revenue position might not be sustainable, even though the Government could receive more trade-related and grant revenue by further depreciating the exchange rate at the first window. To improve the situation, the authorities should perhaps supplement their efforts to strengthen revenue by looking at the possibility of attracting more borrowing from the nonbank public. Treasury bill rates remained negative in real terms, even though they were currently at 12 per cent. He wondered whether the inflation rate had fallen permanently to the level of 11 per cent or whether the underlying rate was still about 25 per cent.

The stance of monetary policy for 1982/83 seemed generally appropriate, Mr. Casey said. The 36 per cent growth in total domestic credit appeared excessive at first glance, although it was well down from the previous year. In any case, there was bound to be a catch-up effect involved in the process of recovery. The growth in net credit to the Government was at a respectable level of 16 per cent, and the growth in money supply also seemed reasonable, although he noted that velocity had a tendency to move erratically. He was a little worried about the level of interest rates, which did not seem sufficiently high to mobilize savings. Perhaps increased branch banking and the provision of mobile banking services in rural areas would improve the situation; however, a more flexible interest rate policy would also be of help. Finally, like others, he wondered about the adequacy of producer prices, particularly for those commodities that were produced for export.

Mr. Caranicas remarked that, following ten years of war and social upheaval, the Ugandan economy had made remarkable progress in the areas of inflation, agricultural production, and manufacturing. The authorities were to be commended for their efforts to solidify that progress.

A number of speakers had touched upon the matter of interest rates in Uganda, Mr. Caranicas recalled. It was difficult to say whether higher interest rates on deposits would increase savings, although, since their adjustment--when interest rates had fallen broadly in line with the rate of inflation--there had been some small increase in savings. He tended to agree with Mr. Sangare that a further increase in deposit rates at present would not have a significant impact on savings mobilization; nonetheless, interest rate policy in Uganda should be kept under review.

On the matter of state enterprises, Mr. Caranicas said that the novel approach taken by the authorities looked interesting; some enterprises had been abolished, others had been sold, and still others had been returned to their previous owners. The question arose in many developing and developed countries of how to encourage state enterprises to become more self-sufficient so as not to burden public finances, and the approach taken in Uganda, if successful, might serve as a model for other countries. He had also been impressed by the courage of the authorities in raising tariffs on electricity, air and rail travel, and so on.

On a technical matter, Mr. Caranicas agreed with Mr. Polak that it might be useful in future if the staff could provide a wider picture of production that would give the value of various crops and show the progress being made in the recovery of production over the years since the early 1970s.

A Deputy Director of the African Department, remarking first on the dual exchange rate system in Uganda, recalled that only 20 months previously the ratio between the exchange rates at the parallel and official markets had been 30:1. During the 1981/82 program, an attempt had been made to narrow the gap, but that effort had been only partly successful, with the ratio falling from 30:1 to 4:1. Full success had not been achieved because foreign exchange had been rationed in the official market and it had thus been impossible to eliminate the parallel market. Under the dual exchange rate system, foreign exchange had been auctioned weekly at the second window without any rationing; and that approach, after some initial difficulty, had proved satisfactory. At present, the rate in the parallel market exceeded the second window rate by only about 20 per cent, and the volume of transactions conducted at the parallel market had been considerably reduced.

If the foreign exchange system were reunified too rapidly, it would be very difficult to avoid rationing of foreign exchange at the official market, which could lead to a revival of the parallel market, the Deputy Director continued. Hence, it might be best to proceed cautiously by continuing to narrow the margin between the second and first window rates. That margin had already declined substantially, with the ratio falling from 3:1 in September 1982 to 2:1 in February 1983. During the same five-month period, the parallel market rate and the second window rate had declined by about 25 per cent each. The second window rate was unlikely to decline much more, however; and a further narrowing of the margin between the first and second window rates would have to result from a depreciation of the currency at the first window.

Several questions had been raised about alternative sources of government revenue to replace the profits from the dual exchange system that would no longer be made after reunification, the Deputy Director recalled. A new revenue source might not in fact be required, because the depreciation of the currency at the first window would raise the proceeds of both import taxes and export taxes. At present, at both the first and second windows, import taxes were based on the first window rate; consequently, a depreciation of the currency at the first window would increase the tax base and government revenue. The depreciation at the first window would also increase export tax proceeds, even if producer prices were raised proportionally to the rate of depreciation of the currency at the first window.

The matter of appropriate producer prices for the main export crops had also been raised by several speakers, the Deputy Director noted. At present, for example, coffee producers were receiving approximately one half the world market price valued at the first window rate. Because it would be undesirable to change the minimum producer price too frequently during the crop year, the authorities had decided that the next adjustment in agricultural prices would be made for the next crop year in connection with the 1983/84 program. An Agricultural Policy Committee had been established in Uganda to study the appropriate level of producer prices for export crops, and the World Bank was to provide the staff with a preliminary study before the mission scheduled in May. It was clear that the minimum export price for coffee, cocoa, cotton, and tobacco would need to be raised substantially in 1983/84, but the precise amount of the increase would depend upon the realization of expected changes in the first window rate. If the ratio of producer prices to world prices were to remain the same, a depreciation at the first window would increase the shilling value of the export tax by the rate of depreciation.

The quota for coffee had been reduced by about 14 per cent, and the price to the farmers had thus far been sufficient to mobilize enough coffee to meet the quota, the Deputy Director said. In the case of cotton, the 1982/83 crop was expected to be two or three times larger than that of the previous year. As for tea, the current price might be too low to attract enough labor for collecting all the leaves in the tea estates, and it had thus been suggested to move tea exports at the second window.

The question had been raised by Mr. Caranicas and Mr. Polak about the relationship between levels of production achieved in recent years and those that had been recorded in the early 1970s, the Deputy Director recalled. Despite recent progress, the levels of production, particularly the levels of per capita production, fell far short of what they had been in the early 1970s. The staff had taken note of Mr. Caranicas' suggestion to provide a weighted index of production, using commodity production valued at world prices in the reference year.

Turning to external arrears, the Deputy Director observed that the reduction in arrears--which had been far greater than that required under the program--had not had a significant adverse impact on other objectives of the program. Although the reduction had resulted mainly from rescheduling of suppliers' credits, reduction through cash payments had also been higher than required under the program. At present, the level of external arrears to Fund members was of the order of $100 million; while significant, the amount was far less than it had been 18 months previously when the problem of external arrears had appeared almost insoluble. In response to a question raised by Mr. Polak in connection with Paris Club rescheduling, he observed that the Ugandan authorities had already initiated a procedure to clarify the validity of the claim made by one member.

With respect to domestic arrears, the Deputy Director considered that a distinction should be made between old and new arrears, the former being those on which payment had come due for at least two years. A systematic inventory of the old arrears was currently under way, with an assessment of the validity of contested claims. The staff felt that, if the U Sh 3 billion shown in Table 5 (EBS/83/5) were to be repaid, the bulk of the valid old arrears would be cleared. New arrears were those accumulated during the program period. The authorities were concerned about not exceeding the subceiling on net credit to the Government, and they had delayed some payments as a precautionary measure. As it turned out, net credit to the Government at the end of December had been significantly below the subceiling. By keeping net credit to the Government within the limits set in the program period for end-June, any arrears accumulated during the first half of the program period could be repaid during the second half.

Many questions had been raised on interest rates in Uganda, the Deputy Director noted. Mr. Grosche had mentioned that, according to the report, interest rates had not been raised since June 1981, but that had been a misprint in the staff report. As shown in the table on page 85 of SM/83/23, rates of interest had been raised several times in the period December 1980-November 1982; the most recent increase had occurred in November 1982 when the ceiling on the lending rate for commerce and unsecured loans had been raised to 20 per cent. It was not easy to calculate the real interest rate because the rate of inflation had been far from steady. Between June 1981 and June 1982, the recorded increase in the consumer price index had been only 11 per cent, but the underlying rate of inflation had been higher. The staff had projected a 25 per cent inflation rate for 1982/83, and the increase recorded between June 1982 and January 1983 was somewhat more than 10 per cent. It was comforting to note that the cost of living index had declined by about 5 per cent between November 1982 and January 1983.

It could be said that most interest rates in Uganda in real terms remained negative and should perhaps be raised, the Deputy Director remarked; however, it was unclear whether increasing the rates would in fact alleviate the problems experienced by the banks in mobilizing deposits. Sending mobile banks to rural areas had been tried as one way of increasing deposits, but the approach had been hampered by the potential for burglary and internal fraud. Wages in Uganda remained very low, and people found various ways--some of them illegal--of supplementing their salaries. One solution to the problem would be to increase wages, perhaps by reducing the size of the public sector so as to increase the salaries of those remaining; however, on political grounds, sharp reductions in civil service personnel could not be made.

Commenting on budget policy, the Deputy Director of the African Department observed that the Expropriated Property Bill had been enacted with a mid-April deadline for filing claims. The bill should help to improve the parastatal sector by clarifying ownership and making it easier to obtain credit. A full study of the parastatals in Uganda had been initiated; the terms of reference had been agreed with the World Bank and had been publicized, and it was expected that a firm would shortly be selected to complete the study.

Mr. Sangare remarked that the Ugandan authorities were well aware of the need to speed up the unification of the two exchange rates; at the same time, they realized that too rapid a pace toward unification could revive the black market. Hence, their efforts were directed to narrowing the rates between the first and second window while reducing the effectiveness of the third window or black market rate. Monetary and credit policies were being tightened to reduce liquidity and discourage transactions in that market.

It should be borne in mind that the dual rate scheme in Uganda was relatively new, and difficulties of implementation were only natural, Mr. Sangare continued. Nonetheless, the authorities had been successful in a number of areas. The volume of transactions at the second window had been increased, and the ratio of rates at the first and second windows had narrowed from 3:1 at the beginning of the program period to 2:1 at present. Moreover, the profits to the Government from transactions had greatly strengthened revenue, an important development considering the difficulties encountered by the Government on the fiscal side in controlling expenditure. The decision to depreciate the shilling and to eliminate administrative regulations had in general exerted pressures on government finances; in spite of those pressures, however, the authorities had clearly indica[illegible] that they would remain within the program targets. Toward that end, they had established a Coordination Committee with the assistance of the Fund and the World Bank and a Committee on Payment and Control. Efforts were also being made to strengthen the Ministry of Finance, and studies were under way that would facilitate the assessment of salaries and staffing in the public sector.

On the matter of interest rates, Mr. Sangare considered that the current level of interest rates in Uganda was in line with the rate of inflation. Income levels were low in Uganda and many people lived in the rural sector so that, for reasons of security, it was difficult to raise substantial savings even if the rate of interest was high. Hence, for the time being, the level of interest rates was not a particularly important element in the effort to increase savings, although the authorities had indicated their willingness to keep the interest rate under close review.

With respect to the problem of debt, Mr. Sangare recalled that reference had been made by some speakers to the desirability of treating all creditors in the same way. The authorities had indicated during the meetings of the Paris Club that they would remain committed to treating all creditors in the same way, and he had recently been instructed by his authorities in Uganda to restate that commitment. While seeking to clarify the amounts or even the existence of certain loans, the authorities were ready to repay the agreed amounts without any discrimination among creditors.

The Acting Chairman made the following summing up:

Directors agreed with the thrust of the views expressed in the staff appraisal and warmly commended the authorities for having implemented bold adjustment measures in the context of the two consecutive financial programs. In particular, they observed that the implementation of the dual exchange arrangement and the accompanying liberalization of the exchange control regime had already improved the efficiency of foreign exchange allocation. Directors noted that flexible pricing policies in conjunction with exchange rate measures and tight fiscal and monetary policies have resulted in a significant increase in agricultural production, a reduction in the domestic inflation rate, and a narrowing of the imbalances in the fiscal and external accounts. They welcomed the reduction in Uganda's external arrears.

Directors also welcomed the intention of the authorities to unify the exchange rate system during 1983/84 at a rate that fully reflects the prevailing scarcity of foreign exchange. In the meantime, progress toward reunification should be continued by transferring more items to the second window and by following a flexible exchange rate policy. The authorities were also urged to make further progress in reducing external arrears.

Noting Uganda's heavy dependence on coffee, Directors emphasized the need to accelerate export diversification in the medium term through appropriate producer pricing policies. As past experience had amply demonstrated, it was crucial to provide producers with adequately remunerative prices, taking into account world price levels. They also considered that producer prices for the next crop year would need careful review.

Several Directors pointed to the need for greater efforts to mobilize domestic resources, inter alia, through appropriate wage policies and a flexible interest rate policy aimed at the establishment of positive real rates. Directors noted the authorities' intention to utilize other sources of revenue to replace the exchange profits tax once the exchange rates were unified; they urged an early identification of alternative sources of government revenue and expressed the need for further improvements in tax administration. They also underlined the importance of further strengthening expenditure control. The authorities' efforts thus far to improve fiscal policies and their readiness to take additional measures to that end were welcomed. Several Directors stressed the urgency of an in-depth review of the financial prospects and operations of parastatal organizations.

Some Directors observed that, in view of the shortage of foreign exchange, the authorities should increase their efforts to monitor external aid and to ensure that use of such aid is accelerated and directed to the high priority areas. Finally, the Fund's technical assistance activities in Uganda were warmly supported.

The Executive Board then took the following decisions:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision relating to Uganda's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1982 Article XIV consultation with Uganda, in the light of the 1982 Article IV consultation with Uganda conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. As described in EBS/83/5, Uganda maintains exchange restrictions on payments and transfers for current international transactions including payments arrears, and a multiple currency practice, all of which are subject to approval under Article VIII, Sections 2(a) and 3, respectively. The Fund welcomes the schedule for the elimination of payments arrears presented by the authorities and the intention of the authorities to eliminate the multiple currency practice as soon as possible. In the meantime, the Fund grants approval until October 31, 1983, of the retention by Uganda of the exchange restrictions on payments and transfers for current international transactions and of the multiple currency practice involved in the application of dual exchange arrangements by Uganda.

Decision No. 7329-(83/33), adopted
February 22, 1983

Review Under Stand-By Arrangement

1. Uganda has consulted the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Uganda (EBS/82/125, Supplement 1 and EBS/82/196, Supplement 1) and paragraph 2 of the letter of May 13, 1982 attached to the stand-by arrangement, in order to review the progress made in the context of the program and reach understandings with the Fund on suitable performance criteria in light of paragraph 35(g) of the Memorandum attached to the letter of May 13, 1982.

2. The letter of November 6, 1982, from the President and Minister of Finance setting forth the economic and financial policies which Uganda will pursue during 1982/83, together with the attached Memorandum on Economic and Financial Policies for 1982/83, shall be annexed to the stand-by arrangement for Uganda, and the letter dated May 13, 1982, together with the attached Memorandum thereto, shall be read as modified and supplemented by the letter of November 6, 1982.

3. Accordingly, Uganda will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Uganda's currency in the credit tranches beyond 25 per cent of

quota or increase the holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota, during any period in which any of the performance criteria set out in paragraphs 31(a), (b), (c), and (e) of the Memorandum attached to the letter of November 6, 1982 is not observed, or if at any time the performance criterion set out in paragraph 31(d) of that Memorandum is not observed. Moreover, the references in paragraph 4(e) of the stand-by arrangement for Uganda to paragraph 35(e) and to paragraphs 10 through 15 of the Memorandum attached to the letter dated May 13, 1982, shall be changed to references to paragraph 31(e) and to paragraphs 2 through 5, respectively, of the Memorandum attached to the letter dated November 6, 1982.

Decision No. 7330-(83/33), adopted
February 22, 1983

2. SOMALIA - 1982 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1982 Article IV consultation with Somalia, together with a review under the stand-by arrangement for Somalia and the program for 1983 (EBS/83/15, 1/19/83; and Cor. 1, 2/7/83). They also had before them a report on recent economic developments in Somalia (SM/83/27, 2/7/83).

Mr. Finaish made the following statement:

In the latter half of the 1970s, the economic performance of Somalia was adversely affected by several developments, largely exogenous in nature, which gave rise to considerable pressures on prices, the budget, and the balance of payments. Recognizing the consequent need for adjustment, the authorities initiated a series of corrective measures in 1980. The improvement in the country's economic performance since then, despite continuing external difficulties, is largely attributable to these measures, and bears testimony to the appropriateness of the authorities' firm approach to the task of adjustment. This improvement is reflected both in the trends in production as well as in the reduced levels of internal and external financial imbalances.

The adjustment measures have been carried out within the framework of successive stand-by arrangements with the Fund. The program for the calendar year 1980, the first in the series, mainly emphasized restrained demand management, which contributed to a significant easing of financial pressures. This was followed by the 1981/82 one-year program, which supplemented policies of financial restraint with important structural measures to enhance production and move toward a sustainable external position. The structural measures included a 50 per cent devaluation (except for certain essential imports), abolition of the issuance of licenses for own-exchange imports, substantial increases in the producer prices for most agricultural products and in the consumer prices of petroleum products, and improvements in the performance of public enterprises and in development planning. The demand management measures comprised a substantial reduction in the budget deficit and a tightening of monetary policy, including a larger allocation of credit to the private sector and an increase in interest rates.

Although considered ambitious by many Directors, the program was fully implemented and the performance of the economy turned out to be better than that envisaged. The overall deficit of the Central Government during 1981 was substantially narrowed, the rate of inflation was reduced and improvement in the external financial position considerably exceeded the original projection.

Efforts aimed at a further improvement in domestic economic performance and attainment of a viable external position over the medium term are being continued at present, through a combination of demand and supply policies, under an 18-month stand-by program that started in mid-1982. A number of important measures were announced before the program came into effect. These included the unification of the dual exchange rate and a shift to an SDR peg involving substantial additional devaluation, further upward revision of the interest rate structure, liberalization of marketing and pricing policies, and complete elimination of external arrears. Financial policies envisaged for the remainder of 1982 were fully implemented, and the performance criteria for end-September were adhered to.

Reflecting the continuing adjustment efforts, the domestic and external financial positions showed further improvement in 1982. Restrictive expenditure policies and a substantial increase in revenues made possible a further significant reduction in the overall deficit of the Central Government. The budget, excluding loans in kind, recorded a surplus of 4.5 per cent of expenditures against a projected deficit of 4.8 per cent and a deficit of 11.5 per cent in 1981. The authorities not only refrained from bank borrowing but were able to reduce their net indebtedness to the banking system by 6 per cent. With continued restraint in monetary growth and improvements in the supply situation, the increase in consumer prices was limited to 24 per cent against an increase of 44 per cent in the previous year. In the external sector, a current account surplus of $10 million is estimated against the program projection of a deficit of $63 million. Aided by the devaluation and unification of the exchange rate, exports increased by 40 per cent, including sharp increases in both livestock and banana exports.

These favorable developments are expected to continue during the calendar year 1983. The fiscal reform measures are expected to further reduce the central government deficit by about 10 per cent of total expenditures. The growth of expenditures is to be sharply curtailed to 6 per cent through stricter expenditure control procedures and limits on increases in government employment and wages. This would be supplemented by significant measures on the revenue side, including the imposition of new taxes, restructuring of several existing taxes, and improvements in tax administration. The projected strengthening of the budgetary position will allow government indebtedness to the banking system to be reduced further by 13 per cent. Total domestic credit is projected to grow by only 5 per cent, compared with 11 per cent in 1982. In line with the policy of encouraging the private sector, nongovernment credit will expand by 18 per cent. As a result of these policies, the rate of increase in consumer prices is projected to be halved to 12 per cent.

With respect to the balance of payments, the current account is expected to show a small surplus for the second consecutive year. In order to encourage the inflow of private remittances and capital through the banking system, and to curb private capital outflows, several measures have recently been taken. These include a temporary bonus scheme providing a premium above the official exchange rate for remittances and capital inflows effected by Somali nationals, priority in the granting of import licenses to those remitting foreign exchange under the bonus scheme, and a rationalization of interest rates on nonresident accounts.

The authorities recognize that the achievement of their longer-term objective of sustained growth at satisfactory rates would require a considerable increase in investment above the present levels. The current investment strategy lays a good deal of emphasis on resource mobilization, encouragement of private enterprise, and improvements in investment planning. The investment activity is at present being carried out within the macroeconomic framework of the 1982-86 Development Plan. The Plan attaches high priority to the development of agriculture and infrastructure. The authorities intend to pursue a flexible policy with respect to its implementation, adjusting that to the availability of domestic and external investible resources. Currently, greater emphasis is being placed on the completion of ongoing projects and a fuller utilization of the existing productive capacity. The authorities are also collaborating with the World Bank in the programming of investment under the Plan. However, as noted by the staff, raising investment to more satisfactory levels would require a substantial increase in external financing. In this connection, the World Bank is organizing a Consultative Group meeting of donor countries for Somalia in March of this year.

Another important area of the authorities' attention is the performance of public enterprises. Efforts initiated in 1981 to improve the efficiency and profitability of these enterprises are being continued in 1983, and the authorities remain committed to keeping in operation only economically viable units. An intergovernmental commission has been set up to make recommendations in this respect, paying due regard to the important social services provided by some of the enterprises.

In summary, the Somali authorities have demonstrated strong political will in recent years in implementing a wide range of corrective measures, both for demand management as well as structural adjustment. These far-reaching measures, some of which involved difficult policy choices, have been undertaken under a series of stand-by arrangements without the benefit of the continuity, flexibility, and other advantages of a medium-term program. Also noteworthy is the fact that the pace of adjustment has been vigorous in spite of a difficult economic and geopolitical setting. The authorities intend to continue their adjustment efforts over the medium term. Needless to add, an important requirement for this would be provision of external financial assistance at a level that is commensurate with the scope of the adjustment efforts and the needs of the economy.

Mr. Grosche stated that he could support the proposed decisions. He had been impressed by the seriousness and determination with which the Somali authorities had been implementing comprehensive adjustment measures over the previous two years. Policies had been pursued effectively, and all quantitative performance criteria through end-September 1982 had been met. Substantial adjustment--both internal and external--had thus been achieved, in part because of continued good weather conditions and larger than anticipated foreign aid. Nonetheless, much remained to be done, particularly in view of the unsustainable debt ratio, which would rise from 9 per cent in 1982 to 31 per cent in 1983 and to 34 per cent in 1986.

The program for 1983 reflected the commitment of the authorities to continue the adjustment process, Mr. Grosche commented. The policy measures envisaged seemed appropriate and, while they entailed some difficult choices, he was confident that the authorities would do their best to implement them. The pursuit of a liberal marketing and pricing policy--which had already had beneficial effects on the agricultural sector--should promote a widening role for the private sector. The willingness of the authorities to close enterprises that were not financially viable was to be commended, and the report on the financial position of the public enterprises, which was being prepared by the intragovernmental commission, was to be welcomed. However, given the sensitivity of the social issues inherent in closing public enterprises, he was sympathetic toward the Government's view that a cautious approach would be necessary.

He could support the proposed fiscal measures in the program, Mr. Grosche continued. The authorities' intention to reduce the overall deficit of the Government to 16.5 per cent of total expenditure was an ambitious target and implied a further tightening of fiscal policy. In present circumstances, the main tool for fiscal restraint should be an austere expenditure policy, although he wondered whether an earlier implementation of changes in the tax system in accordance with the recommendations of the 1980 Tax Survey might not have alleviated some of the burden of a tight fiscal policy. In the area of monetary policy, he was pleased to note that the rate of credit expansion for 1983 would be consistent with the Government's objective of encouraging private sector activity. He agreed with the authorities that changes in the existing interest rate structure were probably not necessary at present; interest rates had been doubled in the previous two years, while the rate of inflation had been declining significantly.

A serious problem facing the Somali economy in 1983 was the potential for a continued outflow of private capital, Mr. Grosche noted. There seemed to be some difference of view between the staff and the authorities on that matter, with the authorities arguing that capital outflows stemmed less from economic factors than from the uncertainties associated with the border conflict; still, they had implemented a number of incentives aimed at attracting private capital inflows and reducing capital outflows, and those measures were to be welcomed.

With regard to the medium-term prospects for the economy, Mr. Grosche considered that it was crucial for Somalia, like any developing country, to have a realistic development perspective that could serve as an operational basis for investment decisions. In that regard, he was concerned about the indication in the staff paper that the World Bank considered the 1982-86 Development Plan to be neither an operational document nor a policy framework for Somalia's development. On the other hand, it was encouraging to note that the authorities were collaborating with the World Bank in preparation for the Consultative Group meeting scheduled for March 1983 and were prepared to formulate, with the assistance of the World Bank, a three-year investment program within the context of the Five-Year Development Plan. He would appreciate hearing from the staff whether the prospect of technical assistance by the World Bank implied that the authorities would follow the Bank's recommendation to replace the current development budget.

Mr. Shaw considered that the Somali authorities had demonstrated strong political will and courage in implementing the adjustment measures of the program. He agreed with the staff appraisal and could support the proposed decisions, including the requested approval of the multiple currency practice, although he wondered whether the practice was the optimum way of attracting remittances. The program targets--which had apparently been considered by Executive Directors to be ambitious at the outset--had been exceeded; because it was so rare for members with difficult adjustment programs even to meet expectations, let alone exceed them, the implementation of the program would have to be classified as successful.

Despite the progress achieved thus far, however, further measures would need to be taken to replace capital outflows, and he could therefore support the continuation of the bonus scheme, which provided a 33 per cent premium above the official rate for workers' remittances. Still, he hoped that the measure would be only a temporary one, designed to stop the capital outflows due to noneconomic factors; a more appropriate longer-term policy approach would be to adopt a flexible interest rate policy that would produce positive real rates over time. He recognized the limitations on using the interest rate as a policy tool in countries like Somalia, but evidence seemed to indicate that foreign exchange deposits at competitive international rates were attracting remittances. He would be grateful for any further comment by the staff on the effect of real positive interest rates in Somalia.

The authorities were to be commended for maintaining a unified exchange rate policy, Mr. Shaw remarked. The pegging of the shilling to the SDR had apparently provided some benefits, although the reduced value of banana exports as a result of the Italian lira devaluation made him wonder whether the SDR basket was the most appropriate. Also, he assumed that livestock exports were valued in currencies other than SDRs.

Also commendable was the elimination of external arrears by end-1982, Mr. Shaw said. The effort of the authorities to re-establish their credit standing should help to attract foreign capital in the medium term, although Somalia's access to capital markets was likely to remain limited for some time.

Turning to the investment program, Mr. Shaw observed like others that the World Bank had had some doubts about the Five-Year Development Plan and had asked the Somali authorities to prepare a public investment program within a shorter time frame. It was not clear what particular difficulties the World Bank had had with the Five-Year Development Plan; he could only guess that it had not been formulated within a macroeconomic framework. While that problem seemed to be addressed in the investment program, the existence of a $566 million financing gap would seem to indicate some remaining financing problems. An in-depth analysis of investment programs was not normally required in the context of the review of a stand-by arrangement, but he would appreciate some further comment by the staff or Mr. Finaish on the matter; their remarks could be particularly relevant if the authorities were to contemplate an extended arrangement at the conclusion of the present stand-by arrangement. One of his concerns was related to the statement in SM/83/27 that recurrent costs for several large projects had been only partially considered in the Plan. That deficiency could have significant downstream implications on the fiscal side for later programs. Finally, he noted that 75 per cent of Somalia's exports were in the form of live animals and that only one project in the current investment program provided for abattoir facilities; perhaps the value of exports could be increased if additional processing plants were created.

Mr. Prowse said that, like others, he could support the proposed decisions. The achievements of the Somali authorities in the face of international recession and local political difficulties were impressive. The external balance had improved, and the fiscal deficit, domestic liquidity, and inflation had all been reduced. Those successes, together with the recent history of Somalia's relationship with the Fund, could serve as a good example for other countries.

Despite the achievements he had mentioned, the outlook for Somalia could not be characterized as promising, Mr. Prowse continued. Large private capital outflows continued to be a problem; he could therefore support the bonus scheme for workers' remittances on a temporary basis, with the proviso that the costs and benefits of such a scheme were continually reviewed by the authorities. Another short-term problem concerned the growth in debt service costs in Somalia, which were projected to rise from 2.5 per cent in 1979 to 9 per cent in 1982, 31 per cent in 1983, and 39 per cent in 1987, even without the contracting of any new external commercial debt.

The rate of population growth was at the root of a number of problems confronting Somalia, Mr. Prowse considered. A high rate of real growth in GNP would be necessary if living standards were to be raised and, in that regard, both Mr. Finaish and the staff had pointed to the importance of raising investment to much higher levels. He wondered how investment could be increased without greater access to external resources or an increase in the debt ratio. Workers' remittances and the reflow of capital from Somali nationals abroad was one possibility, but there clearly remained a need for external assistance. In the absence of an increase in such assistance, and even taking into account an expected sustained recovery in the export sector and a resumption of remittances through banking channels, the sustainability of the balance of payments would imply a stagnating or declining per capita income over time, which was certainly not the sort of adjustment effect that the Fund would find desirable. Hence, even if the policy program was maintained and the proposed adjustment measures were implemented, Somalia would need the continued flow of assistance. In that context, he had noted with satisfaction the decision to organize a meeting of the Consultative Group in March. Experience showed that such a group could be useful in mobilizing aid and coordinating and directing it to its optimum use. The public investment program recommended by the World Bank should also be helpful in that regard.

The staff had made reference in its paper to underinvoicing of exports, Mr. Prowse recalled. He was unclear precisely what the benefits or costs of such underinvoicing were, and he welcomed the proposed study of the matter that was due to be completed later in the year. Since the underinvoicing was apparently at government expense, he wondered whether it amounted to an export subsidy and whether it was appropriate or affordable. He hoped the study would cover those issues, although he would appreciate any comment from the staff in the meantime on what the appropriate policy position should be on the underinvoicing of exports.

Finally, he wondered whether there was any scope for technical assistance from the Fund in the establishment of a set of national accounts. Among the low-income countries, only Somalia, Democratic Kampuchea, the Lao People's Democratic Republic, and Afghanistan did not report GNP figures in the World Development Report. Given the Fund's involvement in a third stand-by program with Somalia, the time would seem to be ripe for overcoming the deficiency in the provision of national accounts figures.

Mr. El-Khouri remarked that it was encouraging to discuss a case like that of Somalia where adjustment had been proceeding smoothly for some time. It was clear from the very helpful Table 3 of the staff report that the authorities had achieved significant success in implementing the provisions of both the previous and current stand-by arrangement. Hence, he could share the staff's view that the authorities had carried out their adjustment efforts in 1981 and 1982 with seriousness and determination, and he could warmly support the proposed program for 1983, which represented a continuation of the adjustment effort.

The 1983 program aimed at a further tightening of monetary and fiscal policies, Mr. El-Khouri noted; and the budget situation was projected to improve considerably, mainly as a result of austere expenditure policy. It was also expected that the Government would further reduce its indebtedness to the domestic banking system. He could support the quantitative performance criteria concerning credit policy for the first half of 1983 and noted that the projected decline in domestic liquidity for the whole of the year was indicative of the strong financial adjustment effort by the authorities.

The main problem to be faced by the economy in 1983 was the expected large-scale capital outflow, Mr. El-Khouri observed. To stem that flow and encourage the inflow of remittances through the banking system, the authorities had instituted a bonus scheme, which provided for a 33 per cent premium above the official exchange rate for remittances and capital inflows from Somali nationals abroad. The scheme seemed to be an ingenious and appropriate way of dealing with a problem that affected only one aspect of the balance of payments. In view of the temporary nature of the measure, he had no difficulty approving the resulting multiple currency practice through end-1983. He assumed that the authorities would carefully monitor the impact of the scheme, weigh the costs and benefits carefully, and abolish the scheme once it had fulfilled its purpose.

It was clear from the staff report that there was some divergence of view between the authorities and the World Bank staff regarding Somalia's Development Plan, Mr. El-Khouri noted. Like others, he would appreciate hearing more about the latest developments in Somalia's relations with the World Bank and the prospects for a convening of the Consultative Group as scheduled. Finally, Somalia's performance under the previous and current stand-by arrangements had been highly successful, and there was much to be learned from its experience in implementing other programs with the Fund. He had no difficulty supporting both proposed decisions.

Mr. Dallara stated that he was in broad agreement with the staff appraisal and could, like others, support the proposed decisions. During the previous two years, Somalia had undertaken a number of far-reaching policy reforms, and it was clear that the authorities were seriously committed to the adjustment program. It was to be hoped that 1983 would witness further significant adjustment and a more stable economic environment with improved growth prospects and a more sustainable balance of payments position.

While weather conditions and Fund financial assistance had clearly aided the adjustment process in Somalia, it was the commendable determination of the authorities to reduce inflationary pressures and to bring budget expenditures more closely in line with revenues that had been the major element in the economy's improved performance, Mr. Dallara continued. The changes made in liberalizing pricing policies and the supportive and complementary changes in marketing policy were also to be welcomed. As a result of the efforts, the inflation rate had dropped dramatically, as had the overall fiscal deficit, and the current account had moved into surplus even though a deficit had been expected.

An array of measures had helped to strengthen the balance of payments, Mr. Dallara observed. In particular, exchange rate changes had been adopted, and decisions had been taken to allow the full effect of the devaluation and the unification of the rate in July 1982 to be passed through to all imported and exported commodities. Somalia's external public debt position had, unfortunately, become a source of concern because of the recent buildup in arrears and the high debt service ratio. He was therefore pleased that the Government had been able to eliminate its arrears by mid-1982; while some additional arrears had been incurred in September 1982, they too had been eliminated. It had been prudent of the authorities not to have contracted any new nonconcessional loans in 1982.

Turning to the program for 1983, Mr. Dallara said that he could support the efforts of the authorities to pursue a more restrictive and ambitious fiscal policy, since progress in the fiscal area was a central element in the effort to move toward a more stable economic environment. He encouraged the authorities resolutely to implement the recommendations of the 1980 IMF Tax Survey in order to enhance the medium-term prospects for fiscal integrity.

In the area of monetary policy, the upward adjustment in interest rates on July 1, 1982 should, together with the lower rate of inflation, have a positive effect on resource allocation, domestic savings, and savings from nationals abroad. Like others, however, he remained concerned by the continuation of negative real interest rates and he hoped it would be possible for the authorities to make further upward adjustments in the rate structure during 1983. Noting that interest rates on external accounts had been rationalized, he encouraged the authorities to keep those rates under close review in order to ensure that they remained competitive.

The problems faced by the authorities in the external sector had clearly been exacerbated by the substantial outflow of private capital in recent years, which raised serious questions about the sustainability of the balance of payments in the medium term, Mr. Dallara remarked. On a related presentational matter, he welcomed the staff's estimate of unrecorded private transfers in 1982. He had found the data to be helpful in evaluating the nature and extent of the problem of outflows, and he hoped that the staff would produce similar data in other cases, including those involving requests for drawings under the compensatory financing facility.

He could support the measures taken by the authorities to deal with with the problem of private capital outflows on the understanding that those measures would be temporary in nature, Mr. Dallara commented. The bonus scheme provided for a 33 per cent premium above the official exchange rate for workers' remittances and capital inflows made by Somali nationals, and he wondered whether the staff had any evidence of the impact of the scheme thus far; he understood that the bonus scheme would bring the effective rate for relevant transactions very close to the prevailing market rate. While recognizing that the bonus scheme had been designed to deal with a particular problem that was partly noneconomic in nature, its establishment did raise a question about the appropriateness of the exchange rate in general. The authorities had taken a number of important steps during 1982 in managing the exchange rate, but the staff had provided very little analysis about the adequacy of the rate for the period ahead. Like others, he was concerned about the loss of foreign exchange resulting from the practice of underinvoicing livestock exports; while recognizing that unique difficulties underlay the authorities' decision not to deal directly with the issue at the time, he was pleased that the Government planned to undertake a study of the marketing process.

The projected rise in the debt service ratio to 31 per cent in 1983 was worrisome, Mr. Dallara commented. It was imperative that strict control over the contracting of new commercially based debt should be maintained and that the authorities should persevere in their efforts to obtain relief from foreign creditors.

Despite the substantial progress that had been made toward internal and external economic stability for Somalia over the previous two years, the medium-term prospects remained very much in doubt, Mr. Dallara noted. He agreed with the staff that a realistic investment plan supported by foreign aid would be necessary if the balance of payments was to reach a sustainable position in the medium term. For donors and creditors seriously to consider increasing foreign assistance to the level that appeared to be needed, the Somali authorities would have to formulate a comprehensive and workable development strategy. It was regrettable that such a strategy had not been incorporated in the 1982-86 Development Plan, which the World Bank had concluded did not constitute an operational document or provide a policy framework for Somalia's development. He understood that further discussions between the Bank and the Somali authorities were taking place on a three-year public investment program, and he joined the Fund staff in hoping that rapid progress could be achieved in that area.

Mr. Caranicas recalled that Somalia's current 18-month stand-by arrangement had been approved by the Executive Board barely 7 months previously. The staff had described developments since that time, showing that the authorities had maintained their courage in implementing the required corrective measures and pursuing the program's adjustment strategy. He could therefore support the staff appraisal as well as the proposed decisions.

The balance of payments performance thus far under the program seemed satisfactory, Mr. Caranicas continued. The overall deficit was estimated to be on target, currently at a level of $37 million. The current account had moved into surplus, compared with an expected deficit, mainly because of an impressive performance in merchandise trade. Net service flows had also shown an unexpected surplus. One disappointing feature of Somalia's external payments position was the problem of private capital outflows, which had proved to be persistent. Given the outlook for 1983, it was imperative that effective measures be implemented to stem the capital outflows and to channel private transfers through the domestic banking system. In that regard, the policies adopted or envisaged by the authorities seemed to be appropriately directed. While the outflow was to a large extent dependent upon investors' perceptions of political instability in the country, it might be reversed in the short term if the bonus scheme recently instituted to encourage workers' remittances and capital inflows were to be successful. The incentive mechanism of the selective import licensing scheme should also help to alleviate the problem. Nonetheless, indirect supportive measures on the domestic front would be necessary, including, for example, upward revisions in domestic interest rates and the opportunity offered to residents to open dollar-denominated accounts in Somalia's banking system.

A deceleration of domestic credit growth in 1983, in addition to curtailing excess demand pressures, should reduce money balances held by residents and thus inhibit the existing leeway for finacing capital outflows, Mr. Caranicas commented. He would appreciate hearing from the staff some tentative estimate of the predicted budget cost of the bonus scheme. He would also welcome an explanation of the turnaround in net official capital flows from an originally estimated plus $25 million to the latest estimate of minus $25 million.

The medium-term outlook for Somalia's external position remained uncertain, Mr. Caranicas considered. Outstanding debt exceeded $1 billion and, even if Somalia did not contract any new loans in 1983, the debt service ratios through 1985 were calculated to range between 30 and 40 per cent of total exports. Some payments arrears that had emerged during 1982 had been rescheduled or canceled, and the balance of payments was expected to run a further deficit in 1983, financed mainly by drawings on the Fund. If the momentum for growth was to be maintained, investment would need to be increased, and the current account would likely again swing into deficit, leading to additional accumulation of external debt. Hence, a "Catch 22" situation seemed to exist in the simultaneous search for external balance and domestic growth. There appeared to be no room in the short run for sustainable growth without severe adverse effects on the country's external position.

The transition to a more viable pattern of growth through a public investment program would require improvements in import substitution and export performance in order to sustain high growth rates while meeting external balance requirements, Mr. Caranicas observed. Also necessary was a restructuring or cancellation of some portion of Somalia's external debt. In that regard, he welcomed the intention of the authorities to explore the existing potential for debt relief action, and he hoped that donors would be prepared to provide more concessional aid to help the courageous adjustment efforts of the authorities over the medium term. As Mr. Finaish had noted, "An important requirement [for adjustment] would be provision of external financial assistance at a level that is commensurate with the scope of the adjustment efforts and the needs of the economy."

The staff representative from the African Department observed that, during 1982, hostilities had broken out between Somalia and Ethiopia. The authorities believed that the associated uncertainty had resulted in a large capital outflow. When the staff had visited Somalia in December 1982, it had carefully examined the factors that might have affected the capital outflow, and both the staff and the authorities had agreed that most of it had been motivated by uncertainty. It had also been agreed that, if the balance of payments position for 1983 was to be maintained at a reasonable level, economic measures would have to be taken to contain the outflow, and various possible measures had been examined. The capital outflow had been limited to a small part of the foreign exchange market--the parallel market--in which the Government had little direct influence; however, that market had been financed mainly by workers' remittances. It had therefore been decided that appropriate financial incentives might be introduced to encourage workers to rechannel the foreign exchange through the official market rather than through the parallel market so as to limit the availability of foreign exchange for capital outflows. The bonus scheme had thus been introduced, making the cost of capital outflow quite expensive and providing a 33 per cent premium for transfers and capital inflows by Somali nationals from abroad through the banking system.

The bonus scheme entailed a cost to the budget of approximately So. Sh. 5 for every dollar routed through the scheme, the staff representative continued. To offset the cost, the authorities had introduced a measure providing for an increase in the effective import duty on nonessential imports. However, they had felt the need for additional incentives, beyond the premium of the bonus scheme, to encourage the inflow of remittances and capital through the banking system. Accordingly, they had introduced a system under which a preference was granted to participants in the bonus scheme in obtaining import licenses. In addition, attractive and competitive interest rates were set on external accounts. The interest rate structure had been rationalized and set at a range of 9-11 per cent depending on the maturities of the deposits.

Regarding other questions on the external sector, the staff representative observed that most of the demand for Somalia's livestock came from Saudi Arabia, which required live animals. The meat factory and abattoir that had been built when the Soviet Union had been the main market for Somalia's meat had been virtually inoperative for some time.

A question on the appropriateness of the SDR as a peg for the shilling had been raised by Mr. Shaw, who had noted that bananas were exported to Italy and that the lira had depreciated relative to the SDR, the staff representative said. Bananas accounted for only about 5 per cent of total exports, so that the impact of the depreciation had been minimal. Livestock exports accounted for about 85 per cent of the total; however most livestock was exported to Saudi Arabia, which officially pegged its riyal to the SDR. The staff had run simulations with both an SDR basket and a currency import-weighted basket and had found the differences to be insignificant, except that it was technically easier to peg the shilling to the SDR.

The appropriateness of the exchange rate in Somalia had been discussed with the authorities during the latest mission in connection with the impact of the problem of capital outflows facing the country, the staff representative noted. Somalia had experienced two devaluations--one of 100 per cent in mid-1981 and another of about 50 per cent in domestic currency terms in mid-1982--with salutary effects on the economy. Export performance during the second half of 1981 and during 1982 had been strong, as the increased financial incentives had contributed significantly to export performance. The staff had also reviewed the cost-price structure of various export commodities, including livestock and bananas, and had decided that the exchange rate was more or less in line with the cost-price structure. Moreover, there were indications that the demand for imports had been somewhat dampened by the two large successive devaluations. Accordingly, it had been decided that a further exchange rate action had not been necessary at the time. Nonetheless, the authorities had indicated that they would continue to review the exchange rate and that they were willing to make changes if those were considered necessary in light of evolving circumstances.

The debt service ratio had been only about 9 per cent in 1982--mainly as a result of rescheduling--but it was expected to rise to 31 per cent in 1983 with further increases through 1987, the staff representative observed. The authorities shared the staff's concern about the rising debt service ratio and had indicated that they would be contacting creditor countries in 1983 to seek a rescheduling or even cancellation of external debt. Most of the debt incurred by Somalia was on highly concessional terms, and the authorities had been optimistic about reaching agreement on rescheduling or cancellation. No new commercial debt had been contracted during the previous two years and, while the program provided for a ceiling of $25 million in commercial debt contracted or guaranteed by the Government for 1983, it was not expected that any commercial debt would be incurred during the program period.

A number of Directors had inquired about the problem of underinvoicing of livestock exports, the staff representative recalled, and Mr. Prowse had asked whether the underinvoicing represented a kind of subsidy. The problem of underinvoicing of livestock was of concern to both the authorities and the staff, although it was difficult at present to determine precisely the amount of underinvoicing taking place. The authorities had explained that the importers of livestock, particularly in Saudi Arabia, wished to maintain a certain margin, estimated by the Saudi Arabian authorities at 10-15 per cent, as collateral against the full delivery of the quantity and quality of livestock agreed upon. During transit there were often losses, for which there was no insurance. Further, when the importer received the livestock, he examined the quality. The value of any difference in quality and of the losses incurred would be deducted from the margin, and the balance would be paid to the exporter. The authorities were as interested as the staff in determining the precise manner in which the marketing process operated and the exact degree of underinvoicing taking place; it was for that reason that they had agreed to undertake a comprehensive study of the pricing and marketing of livestock to determine what measures could be taken to reduce or eliminate the underinvoicing that existed at present without affecting in any significant way the financial incentives to livestock exporters. Because of the marketing process explained, there was no subsidy provided directly by the Government.

Regarding questions on fiscal policy, the staff representative commented that the emphasis was on the containment of expenditures. The authorities had improved expenditure control, introduced an austere fiscal policy, placed a freeze on employment, and limited to a great extent cost of living adjustments granted to government employees. Indeed, over the previous three years, the wages of government employees had been reduced by about 50 per cent in real terms. As they were concerned about the importance of maintaining a smooth functioning administrative infrastructure, the authorities had decided to grant a 10 per cent increase in wages to government employees in 1983; even so, however, the increase would not be automatic but would be dependent upon the evolution of the budgetary situation during 1983. Regarding the structural measures undertaken on the revenue front, he noted that the authorities had introduced nearly all the important medium-term and long-term structural adjustment measures proposed in the 1980 IMF Tax Survey. The taxation of imports was currently based on actual invoices rather than on valuation lists as in the past; there had been an effective increase in import duties; a 5 per cent sales tax was being introduced; a number of specific domestic excise taxes had been converted to an ad valorem basis; the taxation of public enterprises was undergoing reform; and the authorities had requested technical assistance from the Fund with a view to improving income tax assessment and collection. The objective of all the measures was to improve the elasticity of the tax system, to ensure an equitable distribution of the tax burden, and to restructure the tax system in a manner that would encourage economic growth in the country.

In response to those who had inquired about interest rate policy in Somalia, the staff representative noted that interest rates had been nearly doubled over the previous three years, since the authorities had recognized that an attractive interest rate structure could help to mobilize domestic savings. The authorities also felt that an appropriate structure was essential for the enhancement of the process of financial intermediation and the improvement of resource allocation, although they considered that the effects of an increase in interest rates should necessarily be gradual. A sharp increase could adversely affect the emerging private sector investment. A glance at the Mogadiscio consumer price index might lead one to believe that interest rates could remain negative in real terms, but the authorities had noted that that index tended to overestimate the rate of inflation in the country as a whole. For example, in 1982, the rent and energy components of the consumer price index had increased by 70 per cent, while the food component had increased by only 8 per cent. The authorities felt that the increases in rent and energy reflected the urbanization process and the high demand for housing by expatriates in the Mogadiscio area; accordingly, they tended to view the food component of the consumer price index as more indicative of the underlying rate of inflation in the economy.

With respect to questions on the external accounts, the staff representative remarked that, at the end of November 1982, the Mogadiscio branch had about 29 external accounts, most of which had been opened by livestock exporters. It was difficult to predict the role that such accounts would play; the authorities had gone to great lengths to set an attractive interest rate structure for them, but it was recognized that the inflow of deposits would be determined by factors other than simply the interest rate.

The Government remained committed to closing those public enterprises that were perceived not to be viable, the staff representative continued. For that purpose, they had set up an intragovernmental commission to analyze the position of various enterprises and to determine which ones should be slated for closing. The assessment had been deferred thus far, mainly because the authorities felt that the recent measures they had taken might significantly help the profitability and viability of public enterprises in general. They had noted, for example, that the new liberal pricing policies, the devaluation of the Somali shilling, the elimination of the franco valuta market, and the revision of the tax system could all contribute to the improvement of the profitability of public enterprises. One area of concern, however, was the deficiency in management and technical skills, which tended adversely to affect the profitability of the public enterprises. The authorities had thus requested the U.S. Agency for International Development to prepare a study that included an examination of public enterprises. That study had been completed, and the authorities would be examining it to see what changes might be made. The study had not recommended the closure of public enterprises so much as an infusion of management and technical skills, and had suggested that consideration be given to the adoption of joint ventures with foreign companies that could provide the management and technical skills necessary to ensure the viability of certain public enterprises.

With regard to development planning and the medium-term prospects for Somalia, a number of Directors had referred to the stated concerns of the World Bank with the Development Plan, the staff representative recalled. The authorities fully recognized the importance of their investment program for domestic and external financial stability, and had thus sought the assistance of the United Nations Development Program in the preparation of the Plan. The latest effort had focused seriously on developing the Plan in the context of a macroeconomic framework, and the authorities had indicated that all projects included in the Plan had been subject to thorough project evaluation analysis. The intention was to implement the Plan in a flexible manner, readjusting investment targets on a yearly basis in the context of the formulation of the government budget.

The World Bank had taken the view that there was a need for a three-year public investment program, including a rigorous project evaluation, the selection of investment priorities on the basis of well-defined economic criteria, and a realistic assessment of domestic and external resource availability, the staff representative continued. The authorities believed that most of those ingredients had been incorporated in the Five-Year Development Plan, and they were continuing to discuss the matter with the World Bank. A Somali team headed by the Minister of Finance would be arriving in Washington in March 1983 to meet the World Bank staff to discuss both the Development Plan and the preparations for the meeting of the Consultative Group, which had earlier been delayed.

Prospects for Somalia over the medium term should be viewed against the background of the current situation, the staff representative from the African Department considered. As a number of Directors had indicated, Somalia was a poor country, with estimates of per capita income at $125-200 a year. The authorities had adopted major adjustment measures and had already succeeded in considerably improving the external position and stimulating economic growth, but external financial aid would be necessary to increase investment over time so that growth in per capita income could be registered. The staff had produced balance of payments projections through 1987 and, while those projections were tentative, they indicated that, if Somalia were to sustain investment at its current level, the balance of payments position could become viable over the medium term. The underlying assumption that investment would be maintained at its current level, however, implied that Somalia might have to suffer a considerable reduction in per capita income. For that reason, the authorties were concerned about developing a coherent investment program and were seeking financial assistance in expanding the country's productive capacity.

The Executive Directors, agreeed to continue their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/83/32 (2/18/83) and EBM/83/33 (2/22/83).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/48 (2/17/83), EBAP/83/49 (2/17/83), EBAP/83/50 (2/18/83), and EBAP/83/51 (2/18/83) and by an Advisor to Executive Director as set forth in EBAP/83/46 (2/17/83) is approved.

APPROVED: July 22, 1983

JOSEPH W. LANG, JR.
Acting Secretary

Table 1: Sales of Foreign Exchange at the Second Window

Period	Number of Weeks	Sales in Millions of US$ Cumulative	Weekly average
Actual sales			
Aug. 27-Nov. 12, 1982	12	13.0	1.1
Nov. 15-Dec. 31, 1982	7	14.8	2.1
Jan. 3-Feb. 18, 1983	7	16.9	2.4
Future sales required to meet the ceilings			
Feb. 21-March 25, 1983	5	8.3	1.6
Feb. 21-June 24, 1983	18	43.3	2.4
Ceilings			
Aug. 27-Dec. 31, 1982	19	24.0	1.3
Aug. 27-March 30, 1983	31	53.0	1.7
Aug. 27-June 30, 1983	44	88.0	2.0

Table 2. Uganda: Indicators of Performance Under the Program

(End-December 1982)

	Program	Actual
	(In billions of U Sh)	
Ceiling on net domestic credit	62.6	55.5
Ceiling on net credit to Government	36.0)	
	)	34.6
Ceiling on net credit to Government (adjusted) 1/	38.0)	
	(In millions of SDRs)	
Net external borrowing		
1-12 years maturities	120.0	4.1
1-5 years maturities	50.0	4.1
	(In millions of US$)	
Net reduction in arrears	11.0	59.2
Of which: in cash payments	(5.5)	(16.9)
Sales at second window	24.0	27.4

1/ As specified in paragraph b of Section IV, page 28, of EBS/82/125 (July 13, 1982), the ceiling on net credit to Government for December 31, 1982, was to be raised by the shortfall of deposits lodged by the private sector under the IDA credit arrangement in the project account of the Treasury from the projected amount of U Sh 3.1 billion. As deposits amounted to only U Sh 1.1 billion, the ceiling on net credit to Government has to be raised by U Sh 2 billion at the end of December. No adjustment has to be made for the ceiling on net domestic credit.