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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/111

10:00 a.m., July 29, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
Dai Q.	
C. H. Dallara	M. K. Bush
	M. Lundsager, Temporary
	J. Prader
	E. Feldman
	M. Arif, Temporary
	S. K. Fayyad, Temporary
G. Grosche	
J. E. Ismael	K. N. Khong, Temporary
	J. E. Zeas, Temporary
	R. Comotto, Temporary
	D. McCormack
	G. D. Hodgson, Temporary
Mawakani Samba	
	I. A. Al-Assaf
	M. Fogelholm
	L. Filardo
H. Ploix	
G. A. Posthumus	
	C.-Y. Lim
	B. Tamami, Temporary
	L. E. N. Fernando
K. Yamazaki	
	R. Manfredi Selvaggi, Temporary

L. Van Houtven, Secretary and Counsellor
B. J. Owen, Assistant

Also Present

A. Mabika, Economic and Financial Advisor, Ministry of Economy, Finance, and Participations, Gabon. IBRD: R. Skillings, African Regional Office. African Department: A. D. Ouattara, Counsellor and Director; G. E. Gondwe, Deputy Director; L. M. Goreux, Deputy Director; P. J. Duran, C. Enweze, M. G. Gilman, J. E. Greene, S. M. Mshangama, S. N'guiamba, G. B. Taplin. Central Banking Department: L. E. Molho. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Kanesa-Thasan, R. P. Kronenberg, H. B. Junz, M. Nowak. Fiscal Affairs Department: H. R. De Zoysa, G. A. Mackenzie. Legal Department: L. Maktouf, J. M. Ogoola, J. K. Oh. Secretary's Department: C. Brachet, Deputy Secretary. Bureau of Statistics: C. Briançon. Advisors to Executive Directors: A. Bertuch-Samuels, L. P. Ebrill, G. Pineau, N. Toé, K. Yao. Assistants to Executive Directors: F. E. R. Alfiler, O. S.-M. Bethel, E. C. Demaestri, M. A. Hammoudi, Hon C.-W., L. Hubloue, A. Iljas, J. M. Jones, K.-H. Kleine, M. A. Kyhlberg, V. K. Malhotra, T. Morita, D. V. Nhien, L. M. Piantini, S. Rouai, D. Saha, H. van der Burg.

1. GUINEA - 1987 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT, AND STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1987 Article IV consultation with Guinea, together with a request for a 13-month stand-by arrangement in an amount equivalent to SDR 11.6 million and a request for an arrangement under the structural adjustment facility (EBS/87/143, 7/2/87; Cor. 1, 7/28/87). They also had before them a policy framework paper (EBS/87/141, 7/1/87), and a background paper on recent economic developments in Guinea (SM/87/175, 7/20/87).

The Acting Chairman made the following statement:

> There follows for the information of Executive Directors the text of a memorandum that the Managing Director has received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their July 21, 1987 discussion in Committee of the Whole of a paper entitled "Guinea: Policy Framework Paper."
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> 1. The Executive Directors of the Bank and IDA discussed, in a meeting of the Committee of the Whole, the paper entitled "Guinea: Policy Framework Paper."
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> 2. There was a general consensus that the policy framework paper represented a very impressive program to redress the structural distortions that had developed in the Guinean economy over the last several years. Several Directors called attention to the determination with which the Government had launched and carried out its program. They particularly commended the Government for its reliance on a market-oriented approach to determine the exchange rate and internal prices, and its emphasis on encouraging private sector development. The Directors cited the response that had been obtained, on the supply side and particularly in agriculture, as an evidence of the success of the Government's policies.
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> 3. The Directors noted that the positive response of the economy to the reform program was particularly important in light of the need to reduce the country's reliance on bauxite and alumina production and to diversify into nontraditional exports, thereby also broadening the base of fiscal revenues. They welcomed the progress made in reducing the size of the civil service and the efforts deployed to improve the efficiency of the economic ministries. The reorganization of the banking sector was also noted.
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> 4. The Directors noted that Guinea was likely to face some serious problems as it moved into the second phase of the structural adjustment program. In this context, they commented on

the projected further deterioration in the terms of trade and indicated that the difficult external environment in the years ahead made it all the more necessary for the Government to continue to pursue the policy reforms with determination. Some Directors indicated that reinforcing the policy environment was essential in order to capture fully the benefits of the adjustment program. In particular, they pointed to agriculture, transport, and infrastructure as areas which should continue to receive priority and where further work was needed to alleviate bottlenecks. Institutional reforms were also cited as an area in which the Government needed to sustain its efforts and continue to move ahead.

5. The Directors expressed the view that there should be strong support from the international community for Guinea during the second phase of its structural adjustment program. They also indicated that Guinea should be among the countries for which special efforts need to be made to obtain additional support for adjustment in the form of quick-disbursing assistance.

6. The Directors commended the actions that the Government had taken to alleviate some of the social costs of the adjustment measures and noted the favorable impact that such efforts would have on the sustainability of the reform program. Some Directors also indicated the need to proceed with caution in the area of civil service reform. The Directors noted that further benefits, in the form of increased growth and higher productivity, were necessary for the program to be successfully implemented and urged, in this context, the Government to continue its efforts.

Mr. Mawakani made the following statement:

On behalf of my Guinean authorities, I would like to thank the staff for the constructive discussions held in Conakry in the context of the Article IV consultation and the negotiations that led to the present requests for a stand-by arrangement and arrangements under the structural adjustment facility.

Today's Board discussions on Guinea will conclude the first Article IV consultation since the launching of the Guinean authorities' comprehensive and, indeed, ambitious adjustment program aimed at restoring the conditions for sustained growth and shifting the economy from nearly three decades of state control to one largely regulated by market forces. Thus, the economic and financial performance of Guinea in 1986 should be assessed against the background of a country in the learning process of establishing a free market mechanism.

Although the lack of reliable data makes the assessment of the performance of the Guinean economy and its comparison over time a very difficult task, 1986 can be considered a landmark in Guinea's economic history: a year when overall economic developments took a turn for the better. Indeed, there are indications that economic activity expanded in 1986, spurred mainly by a strong growth in agricultural output and a moderate increase in the output of the mining sector. Significant progress was also made on the inflation front. After an initial surge during the first seven months to reflect the pass-through effects of the exchange rate adjustment and the correction of relative prices, the consumer price index receded markedly, slowing down from 7.5 percent per month to less than 1 percent per month from July to December. There are also signs of increased confidence in the newly established banking system. Indeed, despite the limited spread of the commercial banks in the country, private sector deposits increased from a low of GF 1.4 billion in January 1986 to GF 12.4 billion in December 1986. Even in the fiscal and external sectors where performance was less than satisfactory, some positive developments have taken place. For example, transfers to public enterprises, which have been a cause for concern, were brought under control, with such transfers declining from GF 10 billion in 1985 to only GF 1.6 billion in 1986. With the exchange rate adjustment and the flexible exchange rate policy pursued thereafter, private sector transactions started flowing into the official market and, as a result, recorded exports increased in 1986 notwithstanding a 12 percent decline in export earnings from bauxite and alumina, Guinea's two major export products. And with the authorities' commitment to continue pursuing such policies, the prospects for channeling more private sector transactions into the official market appear favorable.

As to implementation of the 1986 program, it should be recognized that, although in some areas slippages occurred, most of the policy commitments contemplated under the stand-by arrangement were undertaken and its principal objectives were met. To mention a few, the overvaluation of the currency was corrected, a new and reliable banking system was established, all prices except those for rice and petroleum products, and the tariffs for urban transport were freed from state control, and internal and external trade was liberalized. The Guinean authorities are encouraged by the results achieved so far and are determined to pursue and intensify, where required, their adjustment efforts. To this end, they have developed, in close collaboration with the staffs of the Fund and the Bank, a policy framework covering the three-year period 1987/88-1989/90 within which they intend to address both the macroeconomic and structural problems facing their country. The three-year program and the 1987/88 economic and financial program for which a stand-by arrangement and arrangements under the structural adjustment facility are requested, are consonant with the general policy orientation presented in the policy framework paper.

Building on the progress made under the 1986 program, the three-year program aims at: achieving a real GDP growth of about 4 percent on average over the program period; narrowing the inflation differential with Guinea's trading partners; rebuilding the foreign exchange reserves of the Central Bank; and raising the level of domestic savings to 10 percent of GDP by 1990.

As to the 1987/88 economic and financial program, it aims at narrowing the external current account deficit to about 4.8 percent of GDP in 1987 and 1988, reducing the rate of inflation from 72 percent in 1986 to 28 percent and 13 percent in 1987 and 1988, respectively, and finally, achieving a real GDP growth rate of at least 6 percent in 1987 and at least 1 percent in 1988. Since the macroeconomic and structural policies to be implemented under the three-year program are extensively described in the policy framework paper (pages 5-13) and the policy measures contemplated under the 1987/88 economic and financial program are also spelled out in the letter of intent attached to EBS/87/143 and well summarized in table 8 of the staff report, I shall refrain from reiterating them. I shall rather focus my remarks on a few policy measures for emphasis.

Having taken stock of the difficulties encountered in the implementation of the 1986 economic and financial program, the Guinean authorities intend to put particular emphasis on policy areas where slippages occurred in order to prevent their recurrence. As pointed out by the staff in its report, the overshooting of the fiscal target stemmed primarily from large extrabudgetary expenditures that were financed by external borrowing not recorded at the inception of the program. The Guinean authorities are concerned about this development and are taking steps to strengthen budgetary control. In this respect, the drafting of a new government procurement code has been completed and will soon be put in place. It is also planned that by the end of 1987, the government budget will become the sole instrument for public sector financial management. Furthermore, during 1988 a new procedure for executing public expenditure will be adopted and post-audit procedures will be designed and implemented by 1989. In the same vein, the Guinean authorities intend to monitor closely public foreign borrowing by restoring the authority of the Economic and Financial Coordination Committee in charge of overseeing government borrowing decisions. In addition, a unit in the Ministry of Economy and Finance responsible for external debt management will be established by January 1988. All these measures are expected to strengthen the control over public expenditures.

Another area where the authorities intend to focus attention is exchange rate management. Given the adverse effects of a rigid exchange rate system on the performance of the external sector, the Guinean authorities are committed to pursuing a flexible exchange rate policy that could help expand the scope of private sector transactions going through the official channels, particularly transactions in artisanal gold and diamonds. The balance of payments test formulated in terms of changes in the foreign reserves position of the Central Bank, together with the evolution of gold sales to the banking system, would help detect at an early stage any inadequacy in the exchange rate of the Guinean franc.

In line with their objective of restructuring the public sector, the Guinean authorities intend to speed up the civil service and public enterprise reforms. As mentioned by the staff, the pace of the civil service reform accelerated during the second quarter of 1987 with as many as 4,000 public sector employees volunteering to depart from the Administration under the voluntary departure scheme as of end May 1987. The establishment of the reconversion bureau (Bureau d'aide a la reconversion des agents de la fonction publique, BARAF) which started processing its first applications is likely to elicit more voluntary departures in the period ahead. Moreover, the evaluation/selection tests of the personnel in the ministerial departments have been completed for the Ministry of Industry and they are at an advanced stage for the Ministry of Economy and Finance. With regard to the reform of the public enterprise sector, it is worth noting that since the conclusion of the second review under the last stand-by arrangement in February 1987, eight more enterprises have been transferred to the private sector. As the Guinean authorities have clearly stated their intention to divest, progress in this area will much depend on the ability to find investors willing to take over the enterprises to be privatized.

In sum, the resolution of the Guinean authorities to come to grips with the multifaceted macroeconomic and structural difficulties confronting their country has not faltered. They are encouraged by the progress made in 1986 toward the establishment of a free market mechanism throughout the economy and are determined to continue in this direction. This is the more so as the medium-term outlook of the Guinean economy indicates that success in attaining external viability by the mid-1990s will depend on the continued and vigorous implementation of policy reforms. It also indicates that the attainment of viability will hinge critically on the degree of concessionality of the external financial assistance to be provided to Guinea to fill the projected gaps during the period 1990-94. The Guinean authorities hope that this assistance would be forthcoming and provided timely on concessional terms.

Mrs. Ploix made the following statement:

I would first like to commend the Guinean authorities for the real progress achieved since the beginning of 1986, when the previous stand-by arrangement was concluded with the Fund. However, after the first phase, in which significant results were registered, slippages began to appear in mid-1986. Regrettably, some important performance criteria, such as the elimination of payment arrears, the slowing down of domestic credit expansion, and fiscal consolidation, have not been met. As a consequence, the overall economic situation is now less favorable than several positive developments might have suggested. I would just like to mention enhanced fiscal and export revenues stemming from a higher bauxite output and a lighter debt service burden resulting from a previous Paris Club rescheduling. The staff is therefore correct when it points to the pressing need for a stronger momentum in the implementation of economic reforms.

Three areas are of special interest in this respect: the overhaul of the state-owned industries, the administrative reform of the public sector, and the strengthening of the banking system and of monetary policy.

On the overhaul of the state-owned industries, it is rather disappointing to note that the ambitious program of privatization has seriously slowed down since mid-1986. Nevertheless, some recent indications are more encouraging, as the authorities seem prepared to step up the process. My authorities are still convinced that a determined move in this direction is critical in improving the overall efficiency of the economy. A better allocation of resources, resulting in part from less involvement by the state, can indeed allow the economy to move closer to its potential for growth.

Regarding the public sector itself, the willingness of the authorities to carry out the tax reform project designed with the joint technical assistance of the Fund and the Bank is most welcome. Another very important way of tightening the public finance administration will be to trim the civil service payroll. In this area also, despite the inherent difficulties of such an approach, the authorities are adopting a courageous stance. The objective is clearly a better motivated and more effective civil service. The same positive attitude must also prevail toward those who will become redundant, and the authorities should now proceed to develop special schemes aimed at facilitating the setting up of new activities in the private sector. The previous cases of Mali and the Central African Republic provide some evidence that this approach is workable and helpful.

In the banking and monetary areas further progress is clearly called for. The basic aim of the authorities should be to take all the necessary steps to muster and efficiently channel domestic savings. The investment program, as described in the policy framework paper, is an ambitious one and it does not seem desirable to finance it exclusively with external resources, in light of the already high level of external debt service. A significant contribution should thus come from inside the country, and the banking system must be geared up to be in a position to tap potential resources. Another instrument on which the monetary authorities should rely more heavily is the interest rate. In this respect, we were pleased to note from the staff report that interest rates are to be kept under close scrutiny, and that there is reasonable hope that real interest rates will become positive before the end of the program.

Before closing let me stress that, as pointed out in the staff report, Guinea's economic environment is likely to deteriorate from 1988 onward. Three factors look particularly worrisome: the decline in bauxite export receipts, the deterioration in the terms of trade, and an increasing debt burden. The authorities should therefore stand ready to show strong determination in following their intended policies.

As a conclusion, I would only recall that my authorities favor the type of package that combines an arrangement under the structural adjustment facility with a stand-by arrangement. Therefore, I support Guinea's requests.

Mr. Comotto said that his authorities welcomed the intention of Guinea to resume the ambitious economic reforms initiated in 1985 and endorsed the thrust of the measures put before the Board in the staff reports. However, his authorities wondered whether sufficient account had been taken of the difficulties manifest in the implementation of the previous stand-by arrangement. The unfortunate failure to successfully complete that program, which was interrupted in the middle of 1986 and again in January 1987, was not encouraging and suggested a serious lack of commitment at some levels. Even more serious in that respect, of course, was the decision of the Guinean authorities to contract a large nonconcessional loan in January 1986 in breach of the stand-by arrangement requested at that time. The failure to report the loan to the Fund represented unacceptable behavior by a Fund member, and he trusted that the staff was satisfied that such a lapse in cooperation would not recur.

But, even assuming the authorities' commitment was more widely based, the ambitious scale of the current proposals for public investment looked inconsistent with the obvious constraints on Guinean administrative capacity, Mr. Comotto continued. The staff stated that the public investment program "is likely to test the Government's investment planning and implementation capacity." Once again, the past record was not encouraging. The external difficulties which built up until 1985 were "chiefly the result of public investment outside the mining sector failing to generate returns adequate to service the associated external debt," and the staff noted that "much remains to be done, particularly in the area of project evaluation." He was also concerned that the burden of the proposed public investment program would divert Guinea's thin administrative resources from other vital areas, in particular from financial management and public sector reforms. Those areas were weak enough, as could be seen from the "serious problems (that arose in the) control of the civil service" and other public sector payrolls. And he had noted as well that technical assistance would be needed on a large scale to strengthen the budget process and expenditure controls.

Yet, despite weaknesses in Guinea's record of implementation, the Board had before it an even more ambitious set of proposals, Mr. Comotto observed. He had to confess to a concern that Guinea was overloading its adjustment effort with an oversized public investment program. However, his authorities were prepared to support the requests before the Board, given that the aim of the wide-ranging adjustment measures proposed was clearly in the right direction, and that there had been significant, if patchy, achievements to date.

Finally, his authorities did not generally regard use of the Fund's general resources under a stand-by arrangement as appropriate financing for a country in Guinea's circumstances, Mr. Comotto remarked, although they welcomed the use of the policy apparatus of a stand-by arrangement to reinforce adjustment efforts. It would seem appropriate in similar cases to consider making unexpected purchases under a precautionary stand-by arrangement subject to a review or consultation clause. Since such purchases were intended to be made only in the event of unanticipated adverse external developments, it would in any event seem entirely appropriate for the authorities to consult the Fund should such serious circumstances emerge.

Mr. Al-Assaf made the following statement:

> The Guinean economy is in the process of recovering from a prolonged period of economic and financial dislocation. This recovery involved the adoption in late 1985 of a comprehensive program of economic adjustment. Before considering the details of that program, it may be worth emphasizing that what was involved was nothing less than a complete reorientation of the Guinean economy, and I commend the authorities for the determination they displayed in initiating such adjustment efforts.
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> It is true that there recently have been significant slippages in the implementation of these efforts. However, these slippages should be seen in their proper context. Significant progress has been made in a number of areas including, notably, domestic pricing policies and, despite some reverses, exchange rate policy. Further, given the poor performance of the economy over recent decades, it is not surprising that the Guinean authorities would feel an urgent need for real per capita growth. What is important now, however, is to move forward from this point, and here, I believe that the request for arrangements under the structural adjustment facility is most appropriate. Not only will Guinea's future policy efforts be placed in a medium-term framework, but emphasis will be given to the type of balanced adjustment which will bring about much needed economic expansion.

As for the specifics of the policy measures, it seems that, in addition to maintaining a flexible exchange rate, fiscal policy will continue to have a crucial role to play. In this connection, the large unanticipated increase in extrabudgetary expenditure in 1986 was unfortunate. Countries in circumstances such as Guinea's cannot afford to relax their fiscal discipline in this manner. However, I am impressed by the scope of the measures being taken on both the revenue and expenditure sides. On the revenue side, I agree with the thrust of the authorities' strategy. In essence, this strategy is to increase tax revenues by broadening the tax base, while at the same time making the tax system more efficient by removing distortions. The goal of reducing expenditures, on the other hand, should benefit from the restoration of rigorous expenditure controls.

In this context, meeting the projected fiscal deficit targets will require careful monitoring. In particular, given Guinea's past difficulties with investment planning and implementation, the sharp increase in investments projected for the public investment program appears very ambitious. I am encouraged that the World Bank is providing extensive assistance in this area and I am optimistic that the authorities will be able to meet the objectives.

Guinea's economic and financial goals are ambitious and their successful attainment will depend, in the first place, on the authorities' determination to persist with their adjustment efforts, and in the second place, on a favorable external environment, which, in part, depends on the cooperation of the international community. Finally, I support the proposed decisions.

Mr. Dallara made the following statement:

Guinea's comprehensive program adopted last year was far ranging in its structural and macroeconomic aspects, and we very much welcomed the decisive steps to which the authorities were committed in their efforts to restore financial integrity and promote structural modernization of their economy. The policy framework paper and first-year arrangement under the structural adjustment facility, as well as the stand-by arrangement, carry through on these reform areas, and the phased implementation detailed in the policy framework paper appears broadly appropriate.

Referring to last year's performance, while the program was perhaps ambitious, we were nonetheless disappointed at the mixed performance recorded over the program period, including the inability to complete the program successfully after the second review, at which time the Board approved some modifications (and released a tranche). The large unprogrammed nonconcessional foreign loan was particularly worrisome in this connection.

In spite of some areas of weak financial performance, there were a number of positive developments. Real economic activity is recovering, as appropriate pricing incentives are being restored to the productive sectors. Pricing and marketing restrictions are being liberalized and sectors previously controlled by the Government are being opened to competition. While rice remains a sensitive issue, the authorities appear to be determined to maintain domestic producer incentives by appropriately pricing food aid. Also, the banking sector is undergoing a complete reorganization, with plans for expansion into the rural districts. This will help contribute to the monetization of the economy and may promote national savings.

But in other areas, we were discouraged by the slippages that occurred in the program and thus wish to emphasize the importance of better performance in the period ahead. The civil service reform was a particularly important aspect of the overall fiscal and structural adjustment effort, and now we learn that little was accomplished last year. Strong efforts must be made, since a much improved administrative capability and the necessary political will are high priorities if developmental goals are to be met. Specifically, wage increases are needed to retain skilled civil servants, but to provide the necessary resources, economies in the size of the civil service must be made immediately. We welcome the commitments in the policy framework paper and urge rapid progress this year.

A more effective civil service could help in improving control over government expenditures and revenue collection, another area of slippage last year. The revenue base is particularly vulnerable, given its dependence on the bauxite sector. With the projections for this sector being rather unfavorable, other revenue sources will be needed. Until the administrative capability improves, reliance will probably have to be placed on excise taxes, but as the situation improves, additional efforts to broaden the tax base should be made. Also, the programmed expenditure control is critically important, and will entail across-the-board limits on authorizations and expenditures.

On a related matter, the public enterprise reform effort, which centers on privatization and liquidation, is now being accelerated. We welcome this in light of the weaker than expected performance earlier. The complete divestment of commercial entities is expected next year and the plans to approach foreign investors could help to promote the success of this policy.

With respect to monetary policy, I agree with the staff appraisal and with the comments emphasizing the importance of achieving real interest rates made earlier by Mrs. Ploix.

After a somewhat uneven start, the authorities have widened access to the foreign exchange auction system and have restored flexibility in the rate, resulting in a much reduced spread from the rate in the parallel market. We hope that these efforts will prevent the re-emergence of external arrears. Also, plans to rationalize the tax and tariff system, so as to provide equitable treatment of domestic producers, will be useful. Of course, strict avoidance of external debt on commercial terms and additional debt relief from non-Paris Club creditors will be required as well. We noted with interest the medium-term scenario incorporating assumptions regarding borrowing on commercial terms. The projections clearly indicate that this would generate serious problems in the medium term.

Smooth implementation of the already initiated and additional measures planned under this program are the key to retaining the confidence of donors, who are providing the bulk of the financing. The World Bank in particular is providing loans and advice in critical areas, and we welcome its constructive involvement. Guinea's productive potential is substantial, but can only be drawn on through enhanced domestic incentives and persistent efforts. The support of the Fund through this structural adjustment arrangement and through the stand-by arrangement is, in our view, appropriate. We particularly welcome the authorities' clear recognition of their circumstances and outlook and their decision not to draw under the stand-by arrangement in the currently foreseeable circumstances. We would have had greater concerns about the stand-by arrangement had there been clear plans to draw upon it, in light of the difficult balance of payments environment that will exist for Guinea into the mid-1990s. And I would add that we found the staff's medium-term analysis to be particularly helpful in reaching judgments about the policy changes needed now and about the type of internal and external environment which they may help to produce over the medium term.

With the framework now in place, we join the staff and others in underscoring the need for strong, consistent implementation of the program in the coming period. The lack of consistency in recent efforts is, indeed, a source of concern. We hope that at our next review we will see a more consistent and steady effort on the part of the authorities. In that regard, we did wonder why the benchmarks for the structural adjustment arrangement did not include more specific measures related to the civil service or public enterprise reform efforts, both of which appear to us to be very important.

Finally, let me add our appreciation to the staff for the table produced on page 37, which we found helpful in evaluating program performance.

Mr. Grosche considered that in general the medium-term policy program described in the framework paper and the measures contemplated for 1987/88 were ambitious and, if implemented, would indeed go a long way toward correcting domestic and external imbalances. He thus shared the view of previous speakers that the program warranted the Fund's support under the structural adjustment facility. However, he had been disappointed to note that performance under the most recent stand-by arrangement had not been as good as expected and that a number of performance criteria had not been observed. Most regrettably, a sort of stop-and-go approach had resulted in major policy slippages in crucial areas, leaving the country in a significantly weaker position than would otherwise have prevailed. Like Mr. Comotto, he had been particularly disappointed by the extra budgetary expenditure in connection with the nonconcessional loan.

Clearly, the technical, administrative capability of the Government to implement and maintain policy measures remained weak and in need of major improvement, Mr. Grosche continued. Perhaps the main reason why he did not consider Guinea to be a good candidate for a stand-by arrangement was that the balance of payments position, even under very optimistic assumptions, would not become viable before the mid-1990s. Moreover, a highly indebted, low-income country like Guinea should not rely on short-term, relatively expensive resources. Nevertheless, he agreed that a stand-by arrangement could play a useful guiding role and thus help the Guinean authorities to maintain discipline in economic financial management. The acceptance of the discipline of a stand-by arrangement also boded well for the authorities' willingness to pursue economic reform.

Against that background, and with the indication--although it was certainly not legally binding--that Guinea did not intend to purchase under the stand-by arrangement, he could support the request for the stand-by arrangement as well, Mr. Grosche added. In that connection, he fully shared Mr. Comotto's preference for a narrow definition of the special circumstances that might warrant drawings under such a stand-by arrangement.

The potentially weakest part of Guinea's program was perhaps fiscal adjustment, Mr. Grosche remarked. It was not that he had great difficulties with the fiscal deficit targets or with the specific measures that were being contemplated. On the contrary, some of those measures appeared to be so ambitious that he wondered whether they were feasible at all. In the first place, progress in the ongoing effort to reduce the size of the civil service had been rather limited so far; it could even be argued that there had been almost no progress. In any event, the considerable uncertainties surrounding the attainability of the fiscal targets suggested that the authorities still had to undertake major efforts both on the revenue and expenditure side. Much remained to be done to strengthen the fiscal position while at the same time improving the structure of government expenditure and strengthening domestic savings.

If the adjustment effort to correct the deep-seated imbalances in the economy was to bear fruit over time, the development of a dynamic private sector was of crucial importance, Mr. Grosche stated. He therefore welcomed the programmed increase in credit to the private sector. However, the difficult external position gave added emphasis to the need for cautious overall monetary and credit policies, and, above all, for securing positive real interest rates without undue delay.

On external financing requirements, the staff was right to stress the critical importance of generous support from the international community, Mr. Grosche said. He therefore hoped that rescheduling agreements with bilateral official creditors and commercial banks could be reached promptly. At the same time, external financing would also depend critically on the authorities' own adjustment efforts, including first and foremost the continued pursuit of adequate exchange market and domestic pricing policies. An adequate organization of the exchange market by improving the auction system would make a large difference in the attempt to channel higher merchandise export receipts through the official market, so that the black market dried up.

Finally, Mr. Grosche said that with respect to Guinea's recent difficulties in remaining current with the Fund, he welcomed the indication of the Government's intention to continue to make arrangements to build up SDR holdings so as to cover obligations as they became due.

Mr. Hodgson said that he agreed with the thrust of the staff appraisal and could support the requested stand-by and structural adjustment arrangements. Guinea had made some important progress since late 1985 under its adjustment program, but not as much as demanded by the circumstances. The rigidities in exchange rate policy that emerged, and the inability to deal in a more positive fashion with the restructuring of public sector employment and public enterprises, were disappointments. Another disappointment had already been noted by Mr. Dallara and Mr. Comotto, namely, a loan that was not consistent with understandings under the stand-by arrangement and that had contributed to serious fiscal slippage. If Guinea was to restore sustainable growth and the external accounts over the medium term, careful demand management and correct price signals through the exchange rate, interest rates, and other prices, would be needed. The quality of economic management and project implementation must also be improved.

The authorities would need to follow a more stable and consistent adjustment path if their medium-term goals were to be reached, Mr. Hodgson added. It would be imperative to avoid the kind of slippages or delays in policy implementation--what Mr. Grosche had called a stop-and-go pattern--which had occurred during the past year. Guinea already faced numerous built-in constraints to development, and economic policy needed to be a source of stability, not one of instability. The commitments under the 1987/88 program under the structural adjustment arrangement, which included maintenance of the flexible exchange rate system without restrictions on current transactions, a flexible interest rate policy, better price liberalization, civil service reform, and tighter demand-management policies through an improved fiscal and monetary position, all needed to be followed in a consistent fashion.

Other Directors had already commented on the broad shape of the program, Mr. Hodgson observed. To add one point of emphasis, he noted the need to bring the size and function of the public sector firmly under control. Public administration would improve only if there was a smaller, better qualified, and better paid civil service, and the authorities should not waver in their commitment in this area. So too should the process of disengaging the Government from the industrial and commercial activities move ahead quickly. Without forceful reform of the public sector enterprises, it would be difficult for Guinea to realize its domestic savings targets and therefore its goal of increasing the growth potential of the economy.

Finally, Mr. Hodgson supported the authorities' intention not to use the resources available under the stand-by arrangement. In present circumstances, Guinea needed to seek additional concessional resources on better terms than could be provided under a Fund stand-by arrangement. Guinea was another illustration of the value of additional resources under the structural adjustment facility as a tool in strengthening the Fund's role, and an added reason why the Managing Director's initiative needed strong donor support and a speedy resolution.

Mr. Dai noted that after a long period of economic decline, the Guinean authorities had adopted an ambitious adjustment program in 1985, supported by a stand-by arrangement with the Fund. In the initial stage, the program had been carried out successfully, but after some policy slippages, especially a worsening in the terms of trade, the performance had more recently been mixed. It was probably to be expected, however, that the prolonged period of economic and financial dislocation could not be turned around in a relatively short period of time, especially when account was taken of existing uncertainties in the world economy and the dim prospects for Guinea's main export commodities. However, he had been pleased to note that real GDP had increased somewhat against that background, and that there had been a marked recovery in agricultural production.

He had also noted from the policy framework paper that the Guinean authorities were now following a prudent fiscal policy course accompanied by a cautious monetary and credit policy, and that they had rightly placed top priority on the achievement of real per capita income growth as their main goal in the medium term, Mr. Dai went on. Although the authorities might face temporary difficulties and frustrations as they followed those ambitious economic and financial goals, he believed that with determination and firm political resolve to carry out much needed reforms, they would gradually make the progress necessary to benefit the economy overall. He agreed fully with the staff that the program deserved Fund support under a stand-by arrangement and an arrangement under the structural adjustment facility, and he therefore supported the proposed decisions.

In view of the adverse external circumstances facing Guinea and the fact that it would continue to have a heavy demand for external resources over a prolonged period of time, Mr. Dai considered that it was essential for donor countries to increase their assistance.

Mrs. Filardo made the following statement:

> After 25 years of economic disequilibrium and maladjustment, the new Guinean Government had the tremendous courage in 1985 to undertake the most ambitious program to revamp the whole economy through the introduction of far-reaching reforms that included market-oriented policies, like more flexible exchange and interest rates, as well as an overhaul of the fiscal, financial, and trade sectors. This program was supported by a stand-by arrangement with the Fund, the first phase of which was successfully completed, but during the second part slippages occurred in the implementation of the foreign exchange auction and the restructuring of the public sector. The authorities are now requesting a new stand-by arrangement, a precautionary measure, and an arrangement under the structural adjustment facility. While we broadly support the Guinean Government in its effort to implement sound macroeconomic policies and structural reforms, in what follows this chair wishes to express some concern and make some comments related to the initial economic situation of Guinea and the characteristics of both programs.
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> The transformation of Guinea from a state-controlled toward a market-oriented economy is not an easy task since it implies structural reforms that take time and require an adequate institutional basis, qualified people to implement them, sufficient financial resources, and a favorable external environment. As Mr. Mawakani has stressed in his informative statement, "the economic and financial performance of Guinea in 1986 should be assessed against the background of a country in the learning process of establishing a free market mechanism." Furthermore, given the fragility of the economy, the debt burden, and the lack of financial assistance in significant amounts, it is necessary to design a longer-term economic strategy. Otherwise it appears as though we are supporting programs which are completely unrealistic. In this regard, great progress was achieved in the former stand-by arrangement. Nevertheless, one of the slippages occurred in the restructuring of the public sector with the aim of achieving the fiscal deficit target. Such a structural reform took time, which explained perhaps why the authorities were not able to comply with these performance criteria. As the reform remains one of the fundamental goals to be pursued in the new program, the question is how the Government intends to proceed, since in the letter of intent it is requesting technical assistance, either bilateral or multilateral, "as circumstances permit," to implement the tax reform, to strengthen the control of government expenditure, and to monitor external debt operations. Maybe the

staff or Mr. Mawakani could comment in this respect. In the meantime, slippages may occur in view of the underlying structural weakness of the fiscal sector.

The second point to be considered is that Guinea is confronted with protracted balance of payments problems simultaneously with a critical drop in export earnings as a result of the deterioration of international markets for bauxite and alumina. Thus, if the authorities' main goal is to sustain growth while implementing structural reforms, substantial financial resources will be required on a concessional basis and for a long period of time. The policy framework paper recognizes that even with the targeted increases in national savings, it is expected that by the end of the program period the country will require substantial balance of payments support in the form of debt relief, new concessional resources, or a combination of both. This in a certain way confirms the fragility of the program and the insufficiency of resources.

Referring to the new stand-by arrangement, which is included in the medium-term strategy, the authorities are contemplating three main objectives for 1987 and 1988 consistent with the economic policy goals that have been established. These objectives are: real GDP growth of at least 6 percent in 1987 and no lower than 0.5-1 percent in 1988; a moderation of inflation from 72 percent in 1986 to 13 percent in 1988; and the containment of the current account balance of payments deficit to a maximum of 4 2/3 percent of GDP.

My first question is related to the consistency of the growth target with the availability of financial resources, the pronounced differences in the growth objective from one year to the next, and the use of exchange and monetary policies for purposes of economic adjustment. Undoubtedly, growth is achieved with financial resources and sound economic measures, but in the case of Guinea, we are concerned that if the country does not receive the necessary financial support, growth will be curtailed. We also wonder whether it would not be better to pursue more even growth objectives in the different years of the program. The flexibility of exchange and interest rates will be verified by a balance of payments test, formulated in terms of changes in the net international reserve position of the Central Bank. While this is a good indicator, given the uncertainty in foreign exchange income and financial assistance to the country, we are concerned that as a result of the unavailability of resources, too much weight could be put on these two variables, hindering the achievement of the inflation objective.

My second question is related to the current account goal. Bauxite and alumina account for 85 percent of total merchandise exports. Exports of both are projected to decline substantially, in volume and price, during the next three years, and the possibility of mitigating these reductions in the medium term are limited. The staff or Mr. Mawakani may wish to mention how the authorities are going to proceed in the long run.

Finally, in light of the commendable commitment of the Guinean authorities to continue in their effort to implement macroeconomic policies and structural reforms, this chair supports their requests for stand-by and structural adjustment arrangements.

Mr. El-Kogali said that he supported Guinea's requests for a stand-by arrangement and for the use of resources of the structural adjustment facility. Two basic considerations made Guinea a prime candidate for assistance under that facility: first, the adjustment effort under way in Guinea had to be made in a medium term perspective if it was to be successful; second, Guinea was much in need of concessional financing if its growth prospects were not to be constrained by an unmanageable debt burden. Although the amount of money to be provided under the structural adjustment arrangement was small in relation to the country's need, such assistance had the potential of bringing in similar inflows from other international financial agencies and donor countries. He hoped that that would be the case, and that Guinea would benefit from the special efforts being made to obtain additional financing in support of the adjustment process in low-income countries.

Guinea's program was cast very much in the same mold as the one adopted some two years previously, Mr. El Kogali observed. Thus, on the one hand, its basic thrust was consistent with the objectives of establishing the basis for sustained economic growth and balance of payments viability. Yet the program was an ambitious undertaking, much as the one it succeeded. He made that observation for two reasons, one being to emphasize to the authorities the need to persevere in their efforts to ensure that the policies they implemented were mutually reinforcing; and the other reason being to stress that such an ambitious program required flexibility on the part of the Fund. As much as he would like to see adjustment take place in Guinea, it was important to keep in mind that there were limits to the speed with which adjustment could take place in a given country, and as such, expectations must be related to a country's capacity to adjust. The problem experienced by Guinea in implementing the previous program was in part due to the Government's inability to carry out certain reforms because of administrative and political constraints. It was a case of the capacity to adjust being overrun by the demands of the program. A program supported by a structural adjustment arrangement could be useful in such situations, especially if the authorities remained committed to the adjustment process because the medium-term orientation provided some room for maneuver in terms of the difficult decisions that might be required in a major adjustment program like that of Guinea. Having looked at the summary of the program for 1987/88, he was left wondering whether Guinea's capacity for adjustment was not once again being pushed to the limits. He hoped that he could be assured by the staff that that was not the case.

Mr. Tamami made the following statement:

Like other speakers, I wish to support the proposed decision on the 1987 Article IV consultation as well as the requests for a stand-by arrangement and for arrangements under the structural adjustment facility.

The implementation of the initial phase of the comprehensive adjustment program, which was aimed at restoring economic activity and at correcting financial imbalances that had been facing the economy for a long period of time, was largely satisfactory. The authorities should be commended for their vigorous efforts in implementing the far-reaching and ambitious policy reforms, including a substantial devaluation of the currency; unification of the exchange rates; trade liberalization; and considerable adjustment of administered prices.

The economic and financial performance of Guinea in 1986, however, was mixed and some financial slippages occurred. In this regard, while the reliance on market-oriented policies and the removal of price distortions brought about a marked recovery in output, particularly in agricultural production, the program's principal domestic and external financial objectives were not fully achieved. The deficits of the Central Government and in the external current account, which were each programmed to be contained to 4 percent of GDP in 1986, are estimated to have been 8 percent and 4 2/3 percent of GDP, respectively.

To revive the momentum of the adjustment and to put the Fund-supported program back on track, corrective measures as described by Mr. Mawakani in his statement were taken. Those measures--particularly the opening of the official market to all current account transactions, the removal of all remaining import restrictions to narrow the spread between the official and parallel market rates, and the accompanying adjustment in interest rates--were steps in the right direction. Despite the implementation of these measures, however, the authorities were unable to prevent some inevitable slippages from occurring. These developments resulted not only in a reduction of the country's access to the Fund's resources under the most recent stand-by arrangement, but also in the failure of the last drawing to materialize.

Regarding the medium-term program, I am in general agreement with the thrust of the staff appraisal and recommendations and can, therefore, afford to be brief. Taking into account the economic nature of Guinea, its stage of development and prospects, specific consideration should be directed toward three factors. First, the adjustment program is, in fact, a radical reconversion program aimed at rapidly changing the centrally planned economy to a market-oriented one. It requires, therefore, a large degree of flexibility in respect of the performance criteria and benchmarks. Second, the economy of Guinea is highly vulnerable to external factors and is expected to remain so in the medium term. Third, the economy is unable to mobilize all of its financial requirements from domestic resources in order to achieve adjustment with growth. In support of the program the country must rely heavily on external financing, yet it already bears a very high debt service burden.

The average 4 percent output growth rate envisaged under the three-year program requires an annual increase of 11 percent in investment. Guinea's external revenue is mainly dependent on bauxite and alumina exports. The outlook for foreign exchange earnings and related tax revenues for 1988 and beyond is unfavorable owing to the predicted decline in both the price and the volume of bauxite exports. While the expected increase in earnings from Guinea's other exports might offset the reduction in bauxite exports, it will not provide enough of a tax base to compensate the Government's revenue shortfall in order to generate a rapid increase in domestic savings. Therefore, as the staff has rightly pointed out, "these constraints on domestic resources mobilization mean that the substantial increase in investment that is programmed over the next three years must be financed externally."

To conclude, the Government's undertakings under the proposed stand-by and structural adjustment arrangement, the radical nature of the reforms on pricing and sectoral policies, the restructuring of the public sector, privatization, removal of the existing trade restrictions, and the pursuit of cautious fiscal and monetary policies all call for full participation on the part of the international financial community in providing the resources needed to finance the program on highly concessional terms. The authorities should also make their best efforts to create an environment conducive to the mobilization of national savings to help reduce the economy's heavy reliance on foreign assistance. In this respect, I urge the authorities to abstain from recourse to nonconcessional external loans and short-term credits.

Mr. Fayyad observed that the slowdown in the pace of reform in the second half of 1986, particularly in the policies on the exchange rate, interest rates, public finances, as well as public sector reorganization, had considerably weakened Guinea's fiscal and external positions. What was perhaps more important, that slowdown had threatened to undermine the comprehensive adjustment program undertaken by the authorities in late 1985 in a serious effort aimed at ridding the Guinean economy of the major financial disequilibria and structural deficiencies that had characterized it for over a quarter of a century.

In the circumstances, the authorities had done well to recognize the need for the strong and urgent adjustment measures outlined in the medium-term policy framework paper. The view of his chair was that those measures, in support of which the authorities were requesting use of Fund resources under stand-by and structural adjustment arrangements, should permit an orderly resumption of the adjustment effort undertaken in the context of the previous program. Indeed, an immediate restoration of the momentum toward adjustment was of paramount importance, especially in view of the anticipated deterioration in the external environment, and Guinea's need for heavy inflows of concessional assistance to finance investment and balance of payments deficits throughout the medium term.

The program for 1987/88 consisted of a wide range of financial and structural measures necessary for the attainment of the policy goals outlined in Table 8 of the staff report, Mr. Fayyad added. As he was broadly in agreement with the staff's assessment, he wished simply to underscore the importance to Guinea's overall adjustment effort of alleviating the present scarcity of human resources, not only in order to improve the capacity to implement the envisaged reforms but also to exploit efficiently and competitively the country's wealth of largely untapped natural resources. It was therefore essential that the contemplated measures in the areas of training, retraining, and basic education broadly identified in the policy framework paper be pursued vigorously.

In conclusion, Mr. Fayyad considered that the comprehensive reform measures to be enacted over the program period reflected the authorities' determination to move Guinea onto a path of recovery and sustained economic growth. The proposed program was well thought out and consistent with the attainment of the objectives set out in the policy framework paper. Accordingly, he supported the proposed decisions.

Mr. Fogelholm said that by and large, he shared the analysis of the staff and of previous speakers with respect to Guinea's past performance under the program supported by a stand-by arrangement. Despite the positive measures already undertaken, he wished to join other Directors in their view that Guinea was not at the current juncture a particularly suitable candidate for a stand-by arrangement. Therefore, he welcomed the authorities' request for a structural adjustment arrangement, which was a most appropriate way of supporting Guinea's program. Should the Guinean authorities wish to draw under the stand-by arrangement, despite their announcement to the contrary, he would tend to be of the same opinion as those speakers who had requested prior notification of such drawings.

The Deputy Secretary, head of mission, remarked that Guinea's set of policies was unquestionably ambitious. It was probably a misnomer to refer to the measures introduced at the start of 1986 as adjustment measures, preceded as they had been by 25 years of central control over economic management and eventually virtual dislocation of the economy. Nonetheless, the staff believed that the program had been quite well conceived by the authorities and that in those areas where policies had been implemented as planned, the results had been as good, if not better, than had been anticipated in early 1986. In particular, even though there were very few data on the rebound in output, the exchange rate change and the attendant modification in relative prices had produced a noticeable surge in output and income in the countryside, where more than 80 percent of the population lived. In addition, as the staff of the World Bank and other aid agencies had observed, there was a boom in certain sectors, including residential and commercial construction, especially in the interior. Therefore, the strength of the rebound in 1986 had probably been stronger than had been hoped. On the other hand, as soon as there had been a relaxation of flexibility in exchange rate management, both activity and balance of payments developments had tended to weaken. He would therefore be inclined to take issue with the view that the shock to the system had been too great and the program too ambitious; even though the authorities still expected the implementation of their policies to be difficult, there was probably no alternative to the current strategy if the economy was to be moved onto a different course and to grow again.

In response to a question by Mrs. Filardo about whether there was not too much variability in the growth objectives and whether the program was consistent, the Deputy Secretary said that the staff had done its best to ensure internal consistency with the scant information at hand. The variability of the growth targets had much to do with the fact that the volume of bauxite/alumina exports was going to be higher in 1987 than for the preceding six or seven years, and certainly much higher than was in prospect for 1988 and beyond. Such a large share of mining in total value added had a strong bearing on the overall level of GDP. In addition, certain activities were expanding very fast, such as coffee and fish production, as certain projects matured.

On more technical issues, the authorities were firmly committed to maintaining the de facto link between the speed of reduction in public sector employment and--if necessary--wage adjustments in the civil service, the Deputy Secretary continued. There was some evidence that the process of trimming unemployment levels had been speeded up quite substantially since May. The determination of the President of the Republic to move ahead in that respect was encouraging. At the present stage, the staff saw little risk of slippage on that count.

The greatest risks to the program nonetheless lay in the overall fiscal position for the current year, the Deputy Secretary added. In 1986, there had been no established expenditure control mechanism to speak of, and tax revenues were still heavily dependent on bauxite. The authorities were fully aware that a major effort had to be launched to expand the tax base away from the mining sector, and were seeking technical assistance from the Fund and the Bank in that area. But even more important than the tax effort, in the view of the staff, would be the initiation of a program to organize and strengthen public sector financial management. The Fund was constrained in terms of the technical assistance that it could provide--in addition to the four central bank experts in

Guinea--but discussions had taken place recently between the World Bank, the Fund, and the authorities, with a view to providing additional technical assistance financed by the World Bank.

As for the external sector, it had been an unwelcome surprise to the staff--and it had to be said in fairness, also to some of its counterparts in Guinea--to discover that a nonconcessional loan had been contracted in early January 1986, the Deputy Secretary remarked. He was confident that the authorities were taking appropriate measures to prevent the recurrence of such incidents, they had been able to prevent a similar loan from being contracted late in 1986. One important undertaking of the program was the establishment of a technical cell to monitor the authorization of, and movements in, operations relating to Guinea's external debt.

With respect to medium-term balance of payments prospects, the staff had been convinced of the need to be as candid as possible in indicating that, even based on the ambitious assumptions and objectives of the program, balance of payments viability would not be reached until the early 1990s, the Deputy Secretary said. At the same time, it had to be noted that, since the margin for error was quite large in Guinea's case, the staff had erred deliberately on the downside, especially in estimating the volume of bauxite exports. Indeed, it had been encouraging to learn recently that the off-take of bauxite eventually might be higher in 1988 and 1989 than the 7 million tons assumed in the program; as a result, balance of payments prospects might be somewhat better than they were painted in the report. Nonetheless, it had seemed important, from the point of view of the Fund and of the other creditors that Guinea was approaching, to minimize the downside risk in the medium-term projections.

As for exchange rate policy, there was no question that the stickiness of the rate had been detrimental to the balance of payments in the second half of 1986 and early 1987, the Deputy Secretary commented. However, the authorities had shown more flexibility in exchange rate management since May 1987. The rate currently stood at GF 435, and the spread between the official and parallel market rates as well as between the U.S. dollar and the CFA franc in the parallel market had disappeared. The staff was more concerned with the need for exchange rate flexibility than with the mechanism to achieve such flexibility. In any event Guinea had only three banks and probably was not yet in a position to operate a true auction market. The important consideration was for the de facto crawling rate to remain flexible enough and the balance of payments would be the means of testing that flexibility.

On structural policies, as of mid-July, 14 enterprises had been privatized and 6 of them had started operations, the Deputy Secretary observed. Thus, there had been some recovery of momentum in the privatization process, although the benchmark in the program in that respect for 1986 probably had been too ambitious. Serious legal difficulties had had to be overcome before the policies could be put in place. The authorities apparently had seen a danger of adding to unemployment by proceeding too fast with closing down public enterprises and reducing the civil service, and they believed that there was a trade-off with the pace at which they proceeded with the resumption of activities in new industries.

It was doubtful whether the reduction in the size of the civil service could be the objective of a benchmark, the Deputy Secretary remarked in response to a question by Mr. Dallara. In addition, the World Bank and the Guinean authorities had reached important understandings about the reduction in the number of civil servants, and the Fund staff had been cautious to avoid any suggestion of cross-conditionality.

The investment program was ambitious although the staff had accepted the numbers that the authorities had had in mind guardedly, the Deputy Secretary noted. There had been a certain scaling down of the initial objectives. Much would depend on the review that the World Bank was to carry out in the last quarter of 1987. The availability of funds was of less concern. If anything, more funds had been available in 1986 than had originally been anticipated, as the balance of payments outcome had shown. The staff of the World Bank was aware of the existence of implementation problems, and Guinea was receiving substantial technical assistance from the World Bank to overcome those problems.

Initially, the staff had not itself proposed a precautionary stand-by arrangement, the Deputy Secretary noted. Instead, the authorities had come to the view that, given the interest costs of using the Fund's ordinary resources, drawings should be avoided under the requested stand-by arrangement. The stand-by arrangement, however, would provide a more detailed and quantified framework for the conduct of economic policy than the structural adjustment arrangement alone, and also demonstrate determination to carry out policies, the Deputy Secretary observed. Under the guidelines on conditionality, drawings under a stand-by arrangement could not be made conditional on a review, if also governed by performance criteria. In practice, there would be periodic reviews with management, if only because of the need to monitor performance by sending missions to Conakry.

The Deputy Director of the Exchange and Trade Relations Department pointed out that paragraph 1 of the stand-by arrangement for Guinea, in accordance with the normal procedure, stated that Guinea would have the right to make purchases without further review. That right was of course qualified in other clauses of stand-by arrangements, for instance, those relating to phasing and mandatory reviews. But those clauses did not affect the right to make a purchase so long as performance criteria were being observed. Nevertheless, stand-by arrangements did contain references to the member remaining in close consultation with the Fund. In the stand-by arrangement for Guinea, as in others, the Managing Director would have the specific power to request a consultation if he considered that desirable. Because the authorities had indicated that they would not draw under the stand-by arrangement, barring unanticipated adverse external circumstances, careful thought would have to be given by the management to going beyond its normal practice of remaining in close contact with the member. However, if the external situation were to deteriorate to the point at which the member might wish to make a purchase, the Managing Director would have the basis to request a consultation of the authorities with the management, but not with the Board. There would be no prior notification to the Board in a legal sense.

The staff representative from the World Bank, referring to comments that had been made about the pace of implementation of the program, acknowledged that throughout much of 1986, ther had been rather slow or very little progress at all in carrying out various measures that had originally been contemplated under the Bank's first structural adjustment loan. The second tranche of the structural adjustment credit, which the Bank had hoped to release in 1986, had still not been released. However, having consolidated public support for the program, the Government had been able since early 1987 to accelerate the steps that had been agreed under the structural adjustment program and the Bank was close to releasing that second tranche. To be more specific, the targets for reducing the numbers of public servants had been met somewhat later than expected, an estimated 12,000 employees having been released from the public sector out of 85,000 originally employed in the public sector. Likewise, with respect to the divestment of public enterprises, 16 formerly public industrial enterprises had been passed over to the private sector under various kinds of financial and management arrangements. The only two conditions for release of the second tranche of the structural adjustment credit that had not been met were the promulgation of a new commercial code and presidential approval of a set of guidelines for the dissolution of those public enterprises that would no longer be retained by the state. The Bank staff had been assured that the relevant decisions had been taken and that it would be only a matter of weeks before the legal formalities had been completed. The hope was that the second tranche could be released in the month of August.

The investment program was indeed ambitious in size and composition, the staff representative from the World Bank continued. The adequacy of the Government's executive capacity to carry out the proposed investments in certain sectors did indeed have to be questioned. The program was concentrated on the restoration of major infrastructure, which was in a deplorable state when the new government took office in 1984. The highway system was in ruins; the telecommunication system was very poor; and the supply of electricity was unreliable. The Government had been concentrating its attention in those areas since that time; it had been very successful in the transportation sector in improving the capacity of the port of Conakry and beginning the reconstruction of the road system, supported by a World Bank credit, to be followed up shortly with another credit. Where the capacity to improve the infrastructure was less satisfactory, for instance, in the electric power and the telecommunications sectors, the Bank was seeking to work with the Government to improve the management and operations of the agencies concerned so that the financing of new investments in those sectors would be justified. It was the staff's conviction that the current state of the infrastructure was one of the principal brakes on the development of productive capacity and output, and that the Government was absolutely correct to place emphasis on the objectives in its programs.

On the financeability of the program, the staff representative from the World Bank recalled that at the request of the Government, the Bank had organized a consultative group for Guinea in March 1987. The Government had presented its investment program, and its economic program in general, to the donors. Both countries and institutions represented at that meeting had expressed great confidence in Guinea's ability to carry out the reform program and to implement an investment program. The indications of support given at the consultative group meeting had led the World Bank to believe that no serious difficulty would be experienced in providing financing on the order of magnitude foreseen in the medium-term scenario. The Government was about to begin the preparation of a second structural adjustment program, under which a great deal of emphasis would be placed on reinforcing the country's capacity for financial management. In connection with the structural adjustment credit, the Bank intended to propose another technical assistance credit which, in cooperation with the Fund and with the French authorities, would provide support and assistance to the Ministry of Finance in order to improve its operations. The Bank was conscious of the difficulties that Guinea was facing but it was also conscious of the Government's determination to pursue its program, which the Bank intended to continue to support.

Mr. Mawakani noted that in evaluating the adequacy of Guinea's current account objectives, in light of the projected fall in bauxite and alumina export earnings, account had to be taken of the large potential for additional, nontraditional exports, including agricultural products, artisanal gold, and diamonds, which were normally exported through parallel channels. The flexible exchange rate policy being pursued was expected to bring those exports into official channels. In addition, as he had indicated in his opening statement, private sector transactions were increasingly taking place in the official market as well.

While he understood the concern that had been expressed about the implications of the precautionary nature of the stand-by arrangement, which had led some Directors to seek some type of prior notification of a drawing by Guinea, Mr. Mawakani considered that the normal provisions of stand-by arrangements should be observed in Guinea's case as in any other case. He was of the view that it would not be wise to depart from that and overload the conditionality for Guinea. He wished to emphasize that, despite some slippages that had occurred in implementing the stand-by arrangement in 1986 and early 1987, and bearing in mind the adverse external environment in which the adjustment program had had to be implemented since 1985, the Guinean authorities were committed to pursuing the adjustment effort in the context of the three-year adjustment program, supported by the stand-by and structural adjustment arrangements that the Board had just considered. As in the past, the Guinean authorities were determined to maintain their close collaboration with the Fund during the implementaiton of that adjustment program.

The Acting Chairman made the following summing up:

Directors were in broad agreement with the appraisal in the staff report for the 1987 Article IV consultation with Guinea. It was noted that the initial phase of Guinea's reform program that was adopted in 1985 had in general been carried out successfully, although there had been at the start of the program a large excess in foreign borrowing on nonconcessional terms. Subsequently, however, there had been slippages in policy implementation, particularly in the areas of exchange and interest rate policy and public sector reform. As a result, economic and financial performance in 1986 and early 1987 had been mixed. Activities in the agricultural sector had expanded significantly and inflation moderated, but the budget and external current account deficits in 1986 had been larger than programmed and new external payments arrears had emerged temporarily.

These slippages, Directors remarked, had left Guinea in a weaker position for 1987 than had been envisaged earlier, which was a cause for concern, particularly at a time when medium-term prospects were clouded by the deterioration in the terms of trade and the likely decline in bauxite earnings starting in 1988, as a result of new contractual arrangements, as well as the increases in external debt service obligations. Directors therefore welcomed the close collaboration between the authorities and the Fund and the World Bank staff in developing a comprehensive economic and financial program for the three-year period 1987/88-1989/90 that would be supported by an arrangement under the structural adjustment facility and a stand-by arrangement. Directors viewed as appropriate the authorities' medium-term goals of achieving real per capita income growth, a progressive decline in inflation, and progress toward a sustainable external position. They observed, however, that Guinea's track record in the implementation of wide-ranging policy measures needed to improve significantly and that owing to the slow process of mobilizing national savings, Guinea would continue to depend heavily on external resources for a number of years.

Directors noted that the program correctly focused on those policy areas where there had been shortcomings in implementation since mid-1986. For example, they remarked that there was an urgent need for strengthening fiscal management and, in particular, for the introduction of rigorous budget and expenditure control procedures, including a halt to extrabudgetary spending; for reforms of tax legislation and administration, and for broadening the tax base, with the related enactment of new revenue measures, including an increase in the excise tax on petroleum products. Given stepped-up investment spending and outlays related to the reform of the civil service, strong efforts would be required also to contain the wage bill and expenditure on goods and services if the Central Government's deficit targets were to be met in 1987 and 1988. Directors also stressed that a much quickened pace of government disengagement from industrial and commercial activities, along with a more forceful and prompt application of measures to reduce public sector employment, were required to buttress efforts aimed at sustained fiscal improvements.

Several Directors expressed serious concern with regard to Guinea's ambitious public investment program which would test and perhaps overload Guinea's planning, evaluation, and implementation capacity and divert scarce human and financial resources from other priority areas and risk adding to an already heavy external debt burden.

The monetary and credit policy stance adopted by the authorities was viewed by Directors as consistent with the restoration of an orderly financial intermediation process. Emphasis on avoiding government recourse to monetary financing in order to accommodate the recovery in private sector activity was considered appropriate. The mechanisms that had been developed to guide flexible exchange rate and interest rate policies were welcomed.

In Guinea's external circumstances, Directors stressed the importance of strengthening institutional control mechanisms over new authorizations of external borrowing and also of pursuing a prudent external debt policy, including abstention from recourse to nonconcessional loans and short-term credits. They also expressed the hope that, consistent with Guinea's undertakings vis-à-vis Paris Club participants, rescheduling agreements would be reached quickly with Guinea's other official bilateral creditors as well as with bank and nonbank nonguaranteed creditors.

Directors noted that despite programmed elimination of all external payments arrears and buildup of international reserves, Guinea's external financing needs for 1987/88 were expected to be covered. They observed, however, that even with the current strong adjustment policies, Guinea could not be expected to resume adequate growth and attain a viable balance of payments position until the early mid-1990s. Extensive assistance on concessional terms therefore would remain necessary for a number of years to come. Several Directors recommended that the Fund give favorable consideration to Guinea's needs for technical assistance in various areas.

There was agreement that the next Article IV consultation with Guinea will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding 1987 Article XIV Consultation

1. The Fund takes this decision relating to Guinea's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1987 Article XIV consultation with Guinea, in the light of the 1987 Article IV consultation with Guinea conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Guinea maintains the restrictive exchange measures described in SM/87/175, in accordance with Article XIV, Section 2, except that the restriction on payments and transfers for current international transactions arising from the foreign exchange auction system is subject to approval by the Fund under Article VIII, Sections 2(a) and 3. The Fund grants approval for the retention of this restriction until completion of the review of the stand-by arrangement for Guinea set forth in EBS/87/143, Supplement 2, or February 15, 1988, whichever is earlier.

Decision No. 8657-(87/111), adopted
July 29, 1987

Stand-By Arrangement

1. The Government of Guinea has requested a stand-by arrangement for a period of 13 months from July 29, 1987 through August 28, 1988, in an amount equivalent to SDR 11.6 million.

2. The Fund approves the stand-by arrangement set forth in EBS/87/143, Supplement 2.

Decision No. 8658-(87/111), adopted
July 29, 1987

Structural Adjustment Arrangement

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

2. The Fund approves the arrangements set forth in EBS/87/143, Supplement 3.

Decision No. 8659-(87/111), adopted
July 29, 1987

2. GABON - 1987 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1987 Article IV consultation with Gabon and the review under the stand-by arrangement which was approved on December 22, 1986 (EBS/87/142, 6/30/87; Cor. 1, 7/22/87). They also had before them a background paper on recent economic developments in Gabon (SM/87/176, 7/22/87).

Mr. A. Mabika, Advisor to the Minister of Finance of Gabon, was also present.

The staff representative from the African Department stated that a critical element for the completion of the present review of the stand-by arrangement with Gabon was the financing of a residual budgetary gap of CFAF 20.5 billion, after taking into account debt relief from the rescheduling of debt service by the Paris Club and commercial banks (details of the debt renegotiation with Paris Club creditors and with commercial bank creditors and were contained in EBS/87/62 (3/3/87) and EBS/87/142 (6/30/87), respectively. As noted in paragraph 21 of the Finance Minister's letter of June 29, 1987 (EBS/87/142, Appendix I), further information on the sources of financing the budgetary gap was to be provided before the Executive Board reviewed the program. The staff had just been informed by the Gabonese authorities that the requisite financing had been assured. The main element of the financing package was a loan by a group of commercial banks for about CFAF 12.0 billion (US$39 million) in new money, to be disbursed in 1987. The signing of the loan was imminent. In addition, the Gabonese authorities had identified CFAF 8.5 billion from domestic nonbank sources, the main element of which was CFAF 6.6 billion to be paid by parastatal entities to the Central Government with respect to debt relief on rescheduled external liabilities that had been assumed by the Central Government.

Mr. Mawakani made the following statement:

> The staff papers give a comprehensive description of the recent developments in the Gabonese economy as well as the policies and measures being implemented under the program in order to come to grips with the serious economic and financial difficulties confronting the country. Given my authorities' broad agreement with the thrust of the staff appraisal, I shall limit myself to a few remarks on the overall economic and financial developments in 1986 and prospects before highlighting certain features of the adjustment process and the measures that the authorities are implementing to keep the 1987 program on track.
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> There is no doubt that the sharp drop in the price of oil in 1986, together with the depreciation of the U.S. dollar against the CFA franc, has led to serious disruptions in the Gabonese economy. As a result, real GDP declined by almost 5 percent in 1986, and budgetary revenue and export earnings fell by

20.3 percent and 51.3 percent, respectively. Owing to the sharp decline in government revenue, the overall budgetary deficit, on a commitment basis, increased from 5 percent in 1985 to 14.5 percent in 1986. The decline in oil prices also led to a widening of the current account deficit (excluding official transfers) from 5.1 percent of GDP in 1985 to 29 percent of GDP in 1986 and to an overall balance of payments deficit of about 4 percent of GDP in the same period.

My authorities recognize that this difficult economic situation is likely to continue and might worsen in 1987 and 1988. A further decline of real GDP by about 17 percent and 4 percent, respectively, is expected. Furthermore, the financial position of the Central Government will remain tight with budgetary revenues projected at only half of those collected in 1986. However, on the positive side, the rate of inflation, as measured by the CPI, is expected to fall from about 6 percent in 1986 to an average of 2 percent in 1987-88. In the meantime, a slight improvement in the external accounts is also expected as a result of a fall in imports and an increase in the value of exports, particularly of petroleum products.

The medium-term economic outlook in Gabon will remain dependent on the evolution of the oil sector. The economy's vulnerability to exogenous factors has underscored the need for economic diversification and for improving the competitiveness of the non-oil sector.

It is against this background that the Gabonese Government introduced in late 1986 an adjustment program supported by the Fund.

Regarding the adjustment process in the fiscal sector, which my authorities consider as the cornerstone of the 1987 program, it should be emphasized that most of the measures envisaged have been implemented. However, as underlined in the letter of intent, the implementation of a few measures had to be delayed because of their adverse social impact. The financial effects of this delay, together with insufficient budgetary revenue, in particular the drop in customs receipts, aggravated the budgetary deficit and led to an accumulation of internal and external arrears at the end of 1986. While my authorities are requesting a waiver for the nonobservance of the performance criterion for the accumulation of arrears, they reaffirm their intention to achieve the program's financial targets. In that connection, the Government has adopted promptly additional expenditure-containing and revenue-raising measures that were not contemplated under the program. On the expenditure side, current outlays have been further reduced in order to achieve an expected saving of CFAF 10 billion in the 1987 budget. Cuts have also been made in the investment budget. On the revenue side, efforts are being made to improve the collection of tax arrears through a recently established inter-agency enforcement unit. Regarding the financing gap, the authorities have worked closely with a group of commercial banks and have been able to secure the financing.

As to the parastatal sector, the Gabonese authorities are of the view that the rehabilitation and restructuring of public enterprises is an integral part of their efforts to reduce the internal imbalances. As indicated in the letter of intent, a diagnostic audit program in this sector is under way and a number of measures have already been implemented. Four public enterprises--Société Nationale de Commerce et Développement (CODEV), Société Gabons-Coréene de Commerce (SOSACO), Société-Nationale de Développement des Cultures Industrielles (SONADECI), and Société de Transports en Ville (SOTRAVIL)--have ceased operations as proposed in the program and two others--Société Nationale Gaboniase d'Assurances et de Réassurances (SONASAR) and Société Nationale de Distribution d'Hydrocarbures (DIZO)--have recently been turned over to the private sector. The Government is determined to pursue its ongoing policy of privatization, restructuring, and liquidation, as warranted.

As far as monetary and credit policies are concerned, efforts are being made to adjust liquidity to the depressed level of economic activity, particularly in the non-oil sector. Furthermore, the banking system's credit to the Central Government, to the parastatals, and to the private sector, is being closely monitored. However, it should be noted that the end-March 1987 criterion for the net credit of the banking system on the Government was not observed. Consequently, my authorities are requesting a waiver and also a modification for the end-June performance criterion. They do hope that the Executive Board will approve their request given that, as mentioned by the staff, the excesses involved are relatively small and that the 1987 budgetary objectives remain unchanged and are likely to be achieved.

Concerning the external sector, policies that are being followed under the program aim at restoring external equilibrium over the medium term. To that end, imports will continue to be reduced in order to narrow the current account deficits projected for 1987 and 1988. As indicated in the letter of intent, most of the financing of these deficits has been secured through debt rescheduling already obtained from the Paris Club and commercial banks.

The Gabonese authorities remain very concerned about the deterioration of the economic and financial situation of their country. They believe that the adjustment program that they are implementing with the assistance of the Fund is well designed to cope with this situation and, therefore, they are committed to pursuing firmly, as indicated in the letter of intent, the objectives of the program. They would like also to reaffirm their commitment to the economic diversification process which is an essential feature for achieving a sustained economic growth over the medium term. To that end, they do hope that Gabon's eligibility for World Bank resources will be shortly re-established as this institution could play an important role in resolving the structural problems confronting the Gabonese economy.

Mrs. Ploix made the following statement:

When the stand-by arrangement with Gabon was approved at the end of last year, many Directors acknowledged the authorities' courageous stance and rated the proposed program as ambitious. Today we are asked to grant a waiver of two performance criteria and to consider a revised program for this year and 1988.

I have no difficulty supporting the staff's proposal on the waiver. The major slippage that resulted in the lack of compliance with performance criteria was due to a problem in the fiscal area. The staff paper makes it clear that the main reason for this unfavorable development was a lack of control over investment outlays. Considering the "inertial component" of many investment projects, the rather poor implementation of the first part of the program must not be seen as undermining the whole adjustment process. The authorities are still committed to a stabilization policy, as evidenced by the apparently even greater stringency of the revised program in some areas.

The staff report indicates that in the fiscal field, the objectives of the revised program are broadly consistent with the original ones. Some significant measures, such as the compulsory domestic loans, are already beginning to produce results. Similarly, setting up closer monitoring procedures over capital expenses should ensure more predictability in fiscal outturns. Moreover, introducing new compensation regulations in the public service at the beginning of next year should also contribute significantly to narrowing the overall fiscal deficit.

In some other areas, the prospects are even better than initially envisaged. The inflation rate, which was already low compared with the rates in some partner countries, seems likely to come down further. This decrease in inflation should be achieved in part through tighter monetary controls, in which a more flexible interest rate policy should play a larger role. On a related issue, the staff rightly emphasizes that interest rates must be kept at an appropriate level if domestic savings are to be mustered and efficiently used.

On the external side, the new projections presented in the staff paper are better than the initial forecast. However, the current account deficit should still be substantial until the end of the program. External financing from various sources is thus needed. I was glad to learn that the financial gap is definitely on its way to being narrowed.

Before closing, I would like to stress that the ongoing negotiations with the banking sector are a clear indication of the international community's support for Gabon. As noted in the staff report, on the basis of present trends, Gabon will not return to a viable external position before 1992, on the basis of present trends. Prolonged and significant support is thus clearly needed. On their part, the Gabonese authorities know that the adjustment period will be long; they seem to be prepared to steer a steady course in the years ahead and they have this chair's best wishes for success in their endeavors.

Mr. Al-Assaf made the following statement:

I support the proposed decision and, since I am in agreement with the thrust of the staff report, I will limit myself to a few brief observations. First, while there were some slippages in the implementation of Gabon's adjustment program, it must also be recognized that many important and courageous measures have been fully implemented. Clear evidence of the magnitude of the commendable adjustment efforts that are taking place is the fact that nominal central government expenditure in 1987 will be only 49 percent of what it was two years earlier.

Second, the two-pronged adjustment strategy of the Gabonese authorities, with its focus on reducing short-run macroeconomic imbalances and on implementing long-run structural policies to encourage export diversification, remains appropriate. These two different components are mutually reinforcing. To elaborate, a major impediment to sustained diversification of the Gabonese economy is the persistence of relatively high wage costs. An intensification of efforts to restrain these costs will not only go a long way to restoring competitiveness but will also reduce the fiscal deficit, alleviating short-run imbalances in the process. What I have especially in mind here is the need to control and reduce the civil service wage bill.

Third, a word of caution. I believe it is important for the authorities to resist any temptation to relax their adjustment efforts just because there has been an increase in the price of oil. The overriding objective is for Gabon to achieve a more balanced economic structure. This will require major adjustment efforts irrespective of the movement in the price of oil.

Fourth, I note that the staff report does not present a detailed analysis of what the appropriate supply-side policies should be. I suspect that this is in part due to the fact that in the past Gabon's per capita income rendered it ineligible for World Bank lending. As a result, World Bank technical involvement in Gabon may have necessarily been somewhat limited. I therefore welcome the fact that the Bank is in the process of reconsidering Gabon's eligibility, and I hope that this will lead to greater Bank involvement in the country.

Fifth, it is important to remember that Gabon has been hit by two shocks. Not only did the price of oil decline sharply in 1986, but the CFA franc has appreciated sharply. In view of the fact that the CFA franc zone itself will shortly be in deficit in the aggregate, I wonder whether any changes are planned to mitigate the impact of this appreciation.

Ms. Lundsager made the following statement:

When the program was approved last December, it was clear that Gabon was confronted with an abrupt change in economic circumstances and that strong measures were required to contain the financial deterioration and to bring about economic diversification so as to lessen dependence on oil. Facing that challenge, after many years of comfortable growth and development, it might have been expected that Gabon would encounter difficulties in implementing the program. But even with realism in mind, we were disappointed at the weak performance in 1986 and early 1987. The problem with control over fiscal expenditures was particularly discouraging, given the limited number of policy tools available and the large imbalances that must be addressed by them.

Implementation of the fiscal consolidation program has been complicated by the historically lax approach to investment budgeting, both by the Central Government and by the entities. While slippages emerged in 1986, as shown in the tables in the staff report, the authorities are making stronger efforts this year to rein in unsustainable investment. Nonetheless, extrabudgetary expenditure and net lending will not be eliminated as originally programmed, although exceptional financing arrangements--compulsory loans--have been made to cover these expenditures.

With Gabon's historically high ratio of revenues to GDP, most of which were oil-related receipts, measures to broaden the tax base, with account being taken of the incentive effects of various taxes, would be appropriate. But, in any event, the greater burden of adjustment should fall on expenditure control, particularly the wage bill and transfers and subsidies, both of which, we recognize, are programmed to decline in nominal terms during the program period. Nonetheless, even stronger measures are needed, especially with regard to wages, an extremely important point. The authorities' commitment to lower nominal wages in the future demonstrates their awareness of the priority need for fiscal consolidation and, equally important, the need for improved international competitiveness in order to stimulate economic diversification. This will be a painful process, given the fixed exchange rate, and it will be even more difficult now that the CFA franc has appreciated in real effective terms.

The latter point leads naturally into the supply-side issues facing Gabon and ways to stimulate economic diversification. Clearly, the budgetary constraints cannot permit any producer subsidies or large-scale investment in new sectors. Thus, the emphasis must be on sending appropriate pricing signals to those sectors most likely to be able to grow in the near term. The priority placed on cost control through wage control is welcome, but we wonder whether the authorities should not be considering, in the context of the monetary union, some adjustment in the exchange rate. We noted that the authorities are raising the issue of higher interest rates with the Board of the Bank of Central African States (BEAC), and believe that they should be analyzing the possibility of exchange rate actions as well. The expectation that Gabon's overall position in the operations account with the French Treasury may be turning negative is a clear sign of emerging problems, now that Gabon, previously one of the members of the BEAC with a strong external position, is facing balance of payments difficulties.

One final point that bears consideration by the authorities is the need for additional structural reform, for instance, in the domestic marketing arrangement. According to Appendix B to the background paper, a complex system of regulations governs domestic pricing and marketing. Enhanced competition could help bring down prices while improving efficiency and facilitating resource reallocation. Perhaps the Gabonese authorities might consider inviting the World Bank to analyze these critical issues. Even without long-term studies, the authorities should take market liberalization steps on their own. Assistance from the World Bank in the public enterprise sector, which has also performed poorly, would be helpful as well, building on the steps already taken to liquidate some entities.

Finally, the suggested approach to completing the review can be considered acceptable, despite the poorer than expected performance early in the program period. The authorities appear to be making strong efforts now, and are prepared to take contingency measures if required. They must not relax their efforts, even though oil prices have recently firmed, given the longer-term need for broader economic growth and development.

Mr. Comotto remarked that the measures outlined by the Gabonese authorities were a welcome attempt to resume the process of adjustment to the dramatic deterioration in their economy. It must be said, however, that such action was somewhat overdue. He recognized the formidable difficulties facing the authorities, not only in terms of the scale of the problems that had emerged and the speed with which they had done so, but of the constraints on the freedom of action of policymakers, particularly in monetary and exchange rate policy. The current measures were just about enough--if fully and faithfully implemented--to contain the situation in 1987, but they were essentially a demonstration of the dexterity of the Gabonese authorities in the art of short-term crisis management. The following year, 1988, remained to be tackled, and Gabon remained vulnerable to a relatively modest further worsening in external circumstances. Some fundamental questions had been ignored that were vital to longer-term stability and a resumption of orderly, sustainable development.

Broadly speaking, the Gabonese economy required a far-reaching transformation to move away from dependence on oil, which had led it up something of a developmental blind alley, Mr. Comotto observed. The process must begin by dealing with some of the excesses encouraged by the oil boom, of which the most important were inflated wage/cost pressures; an oversized civil service; and the large and poorly controlled public investment program. The World Bank missions to look at wage costs and the railway were none too soon. His authorities remained skeptical of just how much could be achieved by way of improving competitiveness, given the current constraints on policy options. In addition, the Gabonese authorities needed urgently to implement the long overdue measures on civil service wages; the various compulsory loans were no substitute other than as a temporary budget device.

Finally, Mr. Comotto said that he could support the request for waivers and modification of performance criteria, albeit with some reluctance, on the grounds that the Gabonese authorities had made strong efforts to shift their stand-by arrangement back on track and given that there would be a further review later in the year before the bulk of Fund resources started to become available.

Mr. Arif stated at the outset that Gabon's request for waivers of some performance criteria deserved positive consideration. His view was based on the fact that the slippage had occurred despite a concerted official policy response in many areas, and was due to adverse developments largely beyond the authorities' control as well as the severity of the structural and other weaknesses of the economy that constrained the adjustment effort and economic viability in the medium term.

As the staff had observed, with the initiation of the program in November 1986, most of the measures had been implemented as foreseen. However, the overall impact of the fall in oil prices and the larger than anticipated depreciation of the U.S. dollar had had a major negative impact which was expected to be stronger and to last longer than originally expected.

Those economic difficulties had had their mirror reflection, among other things, in the fiscal performance, with a consequent decline in revenue in 1986, Mr. Arif continued. However, the authorities had been able to keep current expenditures in line with the program targets. Furthermore, the ministerial reorganization in January with the objective of improving the management of the public sector's investment expenditure and various other significant steps that were listed on pages 10-11 of the staff report--including elimination of subsidies on many consumer goods, the closing down of some public sector enterprises, and continuing progress toward privatization of some others--reflected the authorities' seriousness in implementing the program. The projected deficit on the external current account for 1987 was lower than originally envisaged, and monetary targets had also been strengthened to permit a lower rate of inflation. The revised program for 1987 involving waivers and modifications also envisaged the elimination of all domestic and external arrears of the Government through cash payments or their consolidation into public debt.

The policy slippages that partly accounted for the revision of the program stemmed from the inherent characteristics of the economy as well as the imbalances built up over the years, Mr. Arif concluded, the rectification of which was difficult in a short period and would inevitably have ramifications. The pace of the adjustment effort would, therefore, have to strike a balance between the need to strengthen policies in order to achieve a sustainable external position over the medium term, and the adverse social impact of certain policies, which was rightly of concern to the authorities. Against that backdrop, Gabon's current policy stance was appropriate. The staff had rightly observed that the authorities had set themselves an ambitious task. It was in light of the policy action already taken and being contemplated that he could support the proposed decision.

Mr. El-Kogali made the following statement:

> The sharp fall in the price of oil in 1986 has not only led to a severe deterioration in the overall economic performance of the economy but has also brought into sharper focus some serious weaknesses and complications in economic management. For example, investment initiatives which hitherto could be undertaken by individual ministries without unduly burdening the Government's financial position are now a cause of serious concern. The authorities realize that these initiatives will need to be brought into the normal budget process if they are to exercise full control over expenditure. Under the current stand-by arrangement, some of these expenditures were not fully taken into account and were partly responsible for the slippages in fiscal performance.
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> Experience since the Executive Board approved the stand-by arrangement in December 1986 has confirmed some of the reservations that had been expressed regarding the overall design of the

program which, it was feared, was heavily predicated upon expenditure cuts. It has become clear that the authorities found it difficult to fully implement such measures as, for instance, those relating to wages and staff benefits. In consequence, the program went off track, although by a narrow margin, and the authorities seek waivers and modifications of the quantitative performance criteria related to domestic credit of the Central Government and external borrowing.

As indicated by Mr. Mawakani in his statement, the authorities feel comfortable with the current arrangement and the implied path of adjustment, given the modifications. I, therefore, have no objection to the proposed waivers and modifications. Nevertheless, I feel that a redesign of the time profile of the adjustment path could have been helpful in order to take account of the new economic and, if I may say, political realities. Mr. Mawakani has referred to the social impact of some of the measures that had to be delayed. My view may also be justifiable on the grounds that the external current account is turning out not to be as bad as had been originally predicted in the program. The problem with the current arrangement arises principally from the budget where revenues are falling far short of projections while expenditure remains sticky at a high level. For example, the Government wage bill, which is admittedly very high under present circumstances, may not be easily reduced. Moreover, reductions in investment expenditure have to be made with great caution in order to avoid jeopardizing future growth prospects, particularly in the non-oil sector. While there is need to reduce overall government expenditure, the pace at which this is done should be as realistic as possible. It would be very unfortuante if the authorities were soon to discover that further tightening of fiscal adjustment was not practicable and thereafter abandon the adjustment process altogether.

For the time being, I would like to give the authorities the benefit of the doubt since adequate measures have been adopted to bring the program back on track. It is also encouraging to note that the authorities have considered undertaking contingency measures if it becomes necessary to do so. This serves to demonstrate their commitment to the program. I will, therefore, support the proposed decision and wish the authorities every success in the difficult task that lies ahead.

The staff representative from the African Department said that the negotiations between Gabon and the commercial banks were nearing the final stages. In fact, while the meeting was in process, he had been handed a telex from the Minister of Finance, Budget and Participations, stating that the package with the commercial banks had been completed, although it did not indicate whether a formal signing had taken place.

On the appropriateness of supply-side policies and the need for involvement by the World Bank, the staff representative went on, although Gabon was not currently eligible for World Bank loans, its status was being re-examined. It would be recalled that a joint Fund/Bank mission had been in Gabon during the initial stages of formulating the program supported by the stand-by arrangement. A World Bank team had made a subsequent visit to explore in greater detail a number of areas, including state enterprises and marketing arrangements. The liberalization of the latter arrangements had in fact been a matter on which the World Bank staff had focused its attention. A detailed aide memoire had been prepared by the authorities, together with the World Bank staff, setting out the kind of policy stance and details of the policy adjustments that would be appropriate within the context of a World Bank supported structural adjustment arrangement. As he understood it, active consideration was being given to putting Gabon back on the list of countries eligible to use the Bank's resources.

As for the impact of the appreciation of the CFA franc, the staff representative noted that the program's fiscal stance, in particular, which was tighter than it would otherwise have been, had been set in the light of the movement in the CFA franc. The assumptions with respect to exchange rate developments were clearly indicated on page 48 of the staff report (EBS/87/142).

There had been no relaxation on the part of the authorities' effort to avoid extrabudgetary expenditure of the nature that had emerged in previous years, the staff representative from the African Department explained. In Table II of Appendix IV to the staff report, extrabudgetary expenditures and net lending for 1987 had been grouped together; the number for 1987 reflected the impact on the budget of the rescheduling of medium-term debt of state enterprises whose debt was guaranteed by the Central Government. In earlier years, the figures on such expenditures had been for extrabudgetary spending.

Mr. Mawakani said that he wished to underline the efforts undertaken by the Gabonese authorities to implement the current program under adverse external circumstances characterized by a fall in budgetary revenue and in export earnings. Despite all the additional measures that the authorities had taken to bring the budget deficit down to a sustainable level, a residual financing gap of about CFAF 20.5 billion remained, as mentioned by the staff representative in his opening remarks. As also mentioned by the staff, the Gabonese authorities had come to an agreement with a group of commercial banks on a loan for about CFAF 12 billion, with about CFAF 8.5 billion being mobilized from domestic nonbank sources. Therefore, the Executive Board should be assured that all possible measures had been taken by the authorities to enable them to continue to implement their program as envisaged. Finally, he wished to reaffirm the commitment of the Gabonese authorities to the pursuit of their adjustment efforts.

The Acting Chairman made the following summing up:

Directors generally agreed with the views expressed in the appraisal in the staff report for the 1987 Article IV consultation. They noted the critical importance of the policies pursued by the authorities since the latter part of 1986 in response to the abrupt decline in oil prices and also the appreciation of the CFA franc. They therefore regretted the inability of the authorities to implement fully the measures foreseen in the program in late 1986, in particular civil service wage cuts. It was also noted that there had been serious problems in monitoring investment expenditure. As a result, there had been slippages in program performance, and the Central Government and the external current account deficits in 1986 had exceeded the program targets.

Against this background, Directors welcomed the additional measures identified and implemented by the authorities in early 1987 in order to maintain the original fiscal stance for that year. Additional measures would still be needed to broaden the tax base, to cut the public sector wage bill, to reduce budgetary subsidies, and to improve the financial position of the public sector enterprises. Directors noted that monetary objectives have been tightened and that the external current account deficit is now projected to be less in 1987 than foreseen in the original program, and that a lower rate of inflation is expected.

Directors stressed that the authorities have set themselves an ambitious task under the program for 1987 which will require determination and constant vigilance. While oil market prices have firmed in recent months, the medium-term outlook remains very difficult. Moreover, given the institutional constraints on the use of exchange rate policies and monetary policy instruments, there was a clear need to tighten control of financial developments, domestic costs, and, in that context in particular, wages. Directors also stressed the need for caution in regard to investment selection and external borrowing.

Although the financial adjustment undertaken by the authorities is commendable, Directors were of the view that the solution to Gabon's problems would require more far-reaching structural measures. They noted that a diversification of the non-oil economy to make it less vulnerable to external shocks is an important program objective. In particular, it was urgent to act on the high level of unit labor costs that encourage consumption and discourage productive activity.

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

The Executive Board then took the following decision:

1. Gabon has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Gabon (EBS/86/269, Sup. 1), and as contemplated in the fourth paragraph of the letter of the Minister of Economy, Finance, Budget and Participations dated November 26, 1986 attached to the stand-by arrangement, in order to review policies, establish performance criteria for the second half of 1987, and reach understandings with the Fund subject to which purchases may be resumed by Gabon under the stand-by arrangement.

2. The letter from the Minister of Finance, Budget, and Participations dated June 29, 1987 shall be attached to the stand-by arrangement for Gabon, and the letter of November 26, 1986 shall be read as modified and supplemented by the letter dated June 29, 1987.

3. Accordingly, the reference in paragraph 4(a) of the stand-by arrangement to paragraphs 26 and 30 and Table 1 of the memorandum annexed to the letter dated November 26, 1986 (relating to the performance criteria on net domestic assets, net credit to the Central Government, and nonconcessional external loans contracted or guaranteed by the Government) shall comprehend references to paragraphs 26 and 33 and the table attached to the letter dated June 29, 1987.

4. The Fund decides, pursuant to paragraph 4 of the stand-by arrangement, that the first review contemplated in paragraph 4 of the letter dated November 26, 1986 is completed; and that, notwithstanding the nonobservance of the performance criteria relating to the accumulation of internal and external arrears, and to the end-March 1987 limit on net bank credit to the Central Government, Gabon may resume to make purchases under the stand-by arrangement.

Decision No. 8660-(87/111), adopted
July 29, 1987

3. MALAYSIA - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Malaysia (SM/87/154, 7/7/87; and Cor. 1, 7/23/87). They also had before them a background paper on recent economic developments in Malaysia (SM/87/163, 7/15/87; and Cor. 1, 7/23/87).

Mr. Khong made the following statement:

I would like to convey the appreciation of my authorities for the excellent staff work done in connection with the 1987 Article IV consultation with Malaysia. As always, they have found the staff views and recommendations very useful as inputs for policy formulation. My authorities agree broadly with the thrust of the appraisal contained in the staff report, although they may not share all the staff views on the analysis of developments in 1985-86. While they are more cautiously optimistic about the medium-term outlook, they also agree with the staff on the desirable direction of policies.

Growth and adjustment in Malaysia in the 1980s

My authorities welcome the significant change in the staff's views on the medium-term outlook for Malaysia's balance of payments and external debt situation between the 1986 and 1987 consultations, a subject of some controversy at the Board discussion last year. Directors may recall that the staff's medium-term outlook in these two areas at the time of the Board discussion in 1986 was rather gloomy, a view which my authorities disputed based on information available after the consultation, although the authorities had agreed earlier with the broad direction of the staff projections. In contrast, the medium-term outlook this year envisages a current payments and external debt position that has improved significantly. My authorities agree with this new scenario, although they are now a little more optimistic based on later information. For comparison, the different outlooks painted by the staff in 1986 and 1987 are summarized in Table 1. 1/

To be fair to the staff, some of the differences are due to changed assumptions, for instance, about export prices (commodity prices, especially oil prices, have recovered faster than expected), growth rates, and international interest rates. However, given the uncertainties, the critical difference may lie in the judgment about the authorities' commitment and their ability to pursue adjustment, and the response of the economy to the different policy environment, especially the strong volume growth of exports in recent years and the reduced import intensity of growth. With regard to the last point, Directors will recall that my authorities held the view that a fundamental adjustment had occurred in the relationship between stocks, economic growth, and imports, reflecting a reordering of priorities in public sector projects, the winding down of turnkey projects, the drive to intensify use of domestic material and services, a break in the inflationary psychology and in expectations about a continuing favorable external environment, and a more active use of the

1/ Reproduced in Annex.

exchange rate. In addition, measures were in train (although not accepted yet at the political level) for further fiscal adjustment, especially to restrain expenditure of public enterprises and to increase efficiency in the public sector. Such further adjustment was reflected in the cutback in current expenditure allocations for 1986 around midyear, the revision of public investment targets under the Fifth Malaysia Plan (1986-90), and the 1987 budget presented in October 1986.

To better understand developments in 1985 and 1986, it is worthwhile to recapitulate Malaysia's record in adjusting its fiscal and external imbalances, as summarized in tabular form. 1/ The principal features include:

(i) A reduction in the Federal Government overall deficit by 11 percentage points of GNP from 1982 to 1985, while the public sector deficit was reduced by 9.3 percentage points of GNP;

(ii) A reduction in the external current account deficit by 11.6 percentage points of GNP--from 14.1 percent of GNP in 1982 to 2.5 percent of GNP in 1985; and

(iii) The adjustment took place with strong growth and relative price stability, and in an environment of progressively liberalized trade and exchange control policies.

Developments in 1985-86: The Malaysian Perspective

The adjustment efforts were undermined in the second half of 1985 and in 1986 by the collapse in commodity and oil prices. Despite the continuing strong increases in volume (1985: 4.7 percent and 1986: 14.5 percent), merchandise exports declined by 7.7 percent (-$1.3 billion) 2/ in 1985, and by 9 percent (-$1.4 billion) in 1986. My authorities estimated that the nation lost a total of $4 billion in export earnings from the decline in commodity prices in 1985 and 1986--the equivalent of 3.1 percent and 10.9 percent of GNP, respectively, in these years. Given the widespread deflationary impact of such a loss on income and liquidity in the economy (exports were equivalent to 60 percent of GNP in 1985-86), and the consequent dampening of business and consumer confidence, domestic demand declined in 1985 and in 1986 to the detriment of growth in both years.

In these circumstances, I feel the staff has over played the importance of an "inefficient capital structure" by making it appear to be of equal importance to the erosion of business

1/ Reproduced in Annex.
2/ U.S. dollars converted from Malaysian ringgits at M$ 2.5 = US$1.

confidence in the slowdown of growth (SM/87/154, pages 1 and 15). 1/ The authorities believe weak business confidence was by far the more dominating factor, reflecting the sharp downturn in commodity prices. Although some of the increments to capital in the early 1980s might be less efficient in generating growth and exports, the entire capital stock cannot be termed as such. Otherwise, exports could not have increased in volume by 14.5 percent in 1986, and by an average of 12.3 percent a year in 1982-86, compared with a growth of 3.7 percent in world trade volume in the same period. The terms of trade loss was the overwhelming factor in the slowdown, my authorities believe. In addition to its direct impact on income and demand, the loss of exports contributed much to the loss of business confidence, business failures, depressed stock and property markets, and weakened loan portfolios of financial institutions.

Another major factor in the slowdown was the continuing consolidation of public sector expenditure (Table 2 in Annex) to reduce the fiscal imbalance and to promote external adjustment. This was not mentioned in the staff report, although a more balanced picture is presented in the background paper. Consolidated public sector expenditure (especially after adjusting for rising interest payments) continued to decline even in nominal terms in 1985 and 1986. This also implies that the re-emergence of larger fiscal deficits in 1986-87 was due entirely to the decline in revenue (equivalent to 10 percentage points of GNP between 1985 and 1987) rather than an increase in expenditure. My authorities feel that the staff may have underrated the strong efforts to curtail public expenditure in recent years, an adjustment which has been masked by the rise in public debt servicing and the decline in revenue due to low commodity and oil prices. However, they agree with the staff that further fiscal consolidation would be necessary given the reduced resources available. As a matter of policy, the authorities aim to eliminate the deficit in the current account of the Federal Government by 1989, as well as to reduce the overall deficit to a more sustainable ratio of GNP. My authorities feel that there should not be undue difficulties in this task with the external current account returning to a surplus by 1987 and stronger growth in the rest of the 1980s.

Stance of policies

Viewed in retrospect, perhaps the most significant decision adopted in the two years of recession was the policy of persisting

1/ Similarly, caution should be used in interpreting the ex post calculations of ICOR. In an environment where domestic demand is depressed due to external deflationary forces, output growth tends to slacken with a consequent rise in ICOR. In at least two of the four years in the period 1982-85 chosen by the staff, external influences contracted output.

with fiscal and external adjustment despite the very difficult circumstances. Indeed, the rationale for adjustment was made even more cogent in the circumstances. By not resorting to increased public expenditure (as in the early 1980s) to counter the effects of the decline in commodity prices, the authorities sought to promote a widespread and fundamental adjustment in the economy, with the aim of channeling resources to exports and increasing efficiency. Producers were forced to look to external markets to make up for the slack in domestic demand. Many became "first-time" exporters--one factor behind the strong volume growth in exports. Manufactured goods exports turned around strongly to rise by almost 20 percent in 1986 (-5.6 percent in 1985) to account for 42 percent of total export receipts, compared with a share of 26 percent in 1982.

Although dampening short-term growth, the decline in investment in 1985-86 would rationalize the ratio of gross domestic investment to a more reasonable level at 28 percent of GNP, compared with 39 percent of GNP in 1982. To the extent that such an adjustment reduces past overinvestment in real estate development projects and reflects closer scrutiny of large public sector project proposals, future productive capacity need not be undermined. Indeed, as pointed out by the staff, this adjustment may well improve growth prospects over the medium term.

The authorities were certainly not accepting passively the deflationary influences from external sources. They did all they could to ease some of the most adverse effects without undermining the balance of payments--by maintaining adequate liquidity; reducing interest rates; strengthening the financial system; using more actively the exchange rate; increasing judiciously domestic demand that has minimal import leakages (mainly through a special low-cost housing program, land development for tree and cash crops, and construction of highways and feeder roads using domestic production of cement and steel--all implemented by the private sector); widespread liberalization of rules and regulations; and active promotion of private sector investment, especially foreign investment. The wide-ranging changes in fiscal, monetary, industrial, and external policies are adequately described in the staff report, and the details need not be repeated here. The authorities recognize the remaining impediments to business investment highlighted by the staff, and intend to address them effectively.

In the adjustment strategy, the authorities believe that the key to sustained long-term growth rests mainly on the private sector to actively invest in productive projects that are geared toward the export of both manufactured goods and primary commodities, as well as services. The policy framework has put the economy in a better position for a revival of growth, private investment, and employment creation without renewed pressure on the balance of payments.

Latest developments in 1987 and medium-term policies

In the first quarter of 1987, economic activity picked up to rise at an annual rate of 1.8 percent (1.3 percent and 0.7 percent in the third and fourth quarters of 1986, respectively). The stronger growth was mainly due to the favorable performance of the manufacturing (real annual growth of 7.4 percent), agricultural (2 percent) and services (1.6 percent) sectors. The upward trend in manufacturing activity continued to be bolstered by buoyant exports sales (+30 percent), while sustained growth in agricultural output reflected the increased production of saw logs (+22 percent) and rubber (+10 percent). The total value of checks cleared at the Central Bank clearing houses, a good indicator of economic activity, turned around to rise at an annual rate of 1 percent, after four conservative quarters of negative growth. However, private consumption and investment indicators continued to show that private sector demand was not buoyant, although applications for incentives for new industrial projects increased markedly.

On the external front, the trade account registered a surplus of $1.6 billion in the first four months of 1987 because of higher growth in gross exports (+13.2 percent) relative to imports (+6.5 percent). Export earnings from manufactures, rubber, saw logs, and saw timber increased substantially, while receipts from palm oil, petroleum, and tin continued to decline. The terms of trade turned positive after the decline in 1985-86. In addition, stock market capitalization (an indicator of perception of wealth) rose by $12 billion (58 percent) in the first half year. The ringgit has also reversed much of its strengthening in early 1987 mentioned by the staff. On July 22, for example, the interbank middle rate was M$ 2.5490, about 3 percent weaker than at the end of April.

Based on those trends and higher commodity prices than foreseen at the time of the Article IV consultation, preliminary estimates indicate that real GDP growth could strengthen to 2-2.5 percent in 1987 (1.5 percent in staff report) and 3.5-4 percent in 1988-90. Export earnings would rise by about 10-11 percent, while imports increase by about 6 percent, so that the merchandise account would strengthen further. The current account is expected to be in surplus by about $0.6 billion (2.2 percent of GNP), following a revised deficit of $0.3 billion in 1986 (0.8 percent of GNP), compared with the staff estimates of -$0.3 billion and -$0.5 billion respectively. A moderate, but lower, surplus could be sustained in the medium term, if commodity prices do not weaken from current levels. On the fiscal side, the latest 1987 outlook is not much different from that of the staff, but the authorities anticipate that the Federal Government deficit would decline to 9 percent of GNP in 1988. In the case of demand, a cautious turnaround in private investment is now seen as likely by the authorities (-1.8 percent in staff report), as reflected in the rise of 9 percent in imports of capital goods in the first quarter of 1987 (-20 percent in 1986). With the continuing consolidation of public investment, the main impetus to growth would emanate from private sector demand and a stronger real trade balance.

With a relaxation of the external constraints, the authorities will be able now to focus on implementing a growth-oriented strategy to create employment in an environment of price and external stability, as well as equity in sharing the benefits of national development. The authorities feel there may be some room for a cautious, moderate reflation if oil prices strengthen further, especially in public investment that complements private investment and increases private sector efficiency. Nevertheless, the key medium-term priorities remain the further rationalization of the role of the public sector in the economy, and a rising level of domestic and foreign investment in export-oriented activity. The authorities do not differ very much from the staff views with regard to the desirable direction of policy.

Mr. Khong extended his remarks as follows:

I would like to emphasize that the figures for 1987 cited in my statement are somewhat tentative at this stage, and could be revised by the authorities as the macroeconomic outlook is subjected to a more vigorous process of review before the 1988 budget is presented in October.

Directors may be interested in the following additional information:

(i) Business confidence--an important factor in the 1985-86 slowdown--has begun to revive with the recovery of commodity prices, an improving economy, the increase in liquidity and decline in interest rates, greater foreign interest in Malaysian equity (especially the successful launch of the Malaysia Fund in May on the New York Stock Exchange), markedly higher stock prices, and announcement of a rescue plan for the deposit-taking cooperatives (DTCs);

(ii) With regard to the cooperative problem, 11 DTCs had agreed earlier, under a rescue package proposed by the Central Bank of Malaysia, to their assets being taken over by other financial institutions in return for a staggered refund of their depositors' money over a maximum period of three years. Recently, the Central Bank has approved another rescue package for the remaining 13 DTCs, which has proved to be widely acceptable. With the latest package, the DTC issue could be regarded as having been resolved satisfactorily;

(iii) Outstanding foreign exchange swaps had declined further to only M$73 million by July 23, from M$600 million at the end of April reported in the background paper on recent economic developments (peak of M$2.6 billion in August 1986); and

(iv) The Government has recently approved additional measures to accelerate growth with higher employment, and to improve further competitiveness in the economy. These measures aim to do more to improve the environment for private investment, promote small and medium-sized businesses, reduce business costs, reform the tariff and incentive system, and maintain public infrastructure investment.

The point I would like to emphasize is that there is great concern to consolidate the gains being obtained from the better export earnings to improve economic performance and business confidence, especially to generate employment opportunities.

Mr. Lim made the following statement:

We continue to support the Malaysian authorities' adjustment efforts. We note that notwithstanding the substantial worsening of the terms of trade, the continued weak demand for Malaysia's petroleum exports, and even the low productivity of earlier investments in heavy industries, the authorities managed to reverse the decline in real GDP in 1985, stabilize consumer prices, and continue to generate trade and overall balance of payments surpluses and increase reserves in 1986.

There appear to be signs, however, to remind the authorities that more effort is needed. For example, the ratio to GNP of the federal government deficit seems to be drifting back to high levels in spite of efforts to cut back on expenditures in response to revenue shortfalls. The rate of unemployment also continues to rise, which may indicate that business confidence is not being restored as rapidly as desirable. Indeed, the staff pointed to several impediments to more vigorous private sector investments on pages 10 and 11 of SM/87/154 that need not be mentioned here. We need only say that we are encouraged by the fact that Mr. Khong indicated in his statement that the authorities recognize that private investments remain a key element in their adjustment strategy for long-run growth.

We fully agree with Mr. Khong on the significance of the authorities' decision to persist with their fiscal and external adjustment policies in the face of great temptation to stimulate the economy through fiscal means to restore the economy to its high growth path before 1985. We can even venture to say that the much more favorable medium-term outlook at this stage owes much to this persistence. Should the terms of trade in the medium term turn out more favorably than assumed in the medium-term scenario, and as the previous adjustment efforts allow a shift in the composition of trade to manufactures, the achievement of higher growth may come earlier than expected. Indeed, Mr. Khong made a point in his statement of the staff's tendency to be less optimistic in its projections.

On exchange rate policy, we note that in 1986 the policy stance of the Central Bank was to allow the exchange rate to reflect the economic fundamentals of the market, intervening primarily to maintain market orderliness. We would only like to point out that the debt service burden has already risen considerably owing to the appreciation of other major currencies vis-à-vis the U.S. dollar. In fact, the staff has stated that 72 percent of the increase in Malaysia's external debt in 1986 was due to this development. There is thus concern that further depreciation against the U.S. dollar to maintain export competitiveness in the medium term might worsen the already weakened financial position of public enterprises with high foreign debt burdens and further undermine business confidence. This dilemma, which is faced by many middle-income developing countries with high external debt positions, highlights the unequal impact of currency realignments on industrial and developing economies. We would appreciate the staff's views with respect to Malaysia's experience.

Mr. Foot remarked that the authorities were to be commended for their continuing adjustment efforts in a number of key areas. Together with some improvement in the external environment, those efforts had very considerably improved the external position and its outlook. For the future, it was common ground that further retrenchment in the consolidated public sector deficit was called for, particularly should there be any sign of a reduction in the willingness of the nonbank domestic sector to finance that deficit as readily as in the past.

While useful progress had been made in liberalizing the financial sector, Mr. Foot added, it seemed clear that the underlying condition of many banks remained fragile, and that monetary policy will have to be continued with one eye on further remedying that problem.

Although it was true that the authorities had opened the way for additional foreign investment, it seemed unwise to expect too much too quickly from the changes that had been made, Mr. Foot considered. Anything that the Government could do to demonstrate that it was throwing the doors open wider for foreign investment on a long-term basis would be helpful.

Finally, while it was possible to hope that the trend of the debt service ratio and of the ratio of external debt to GNP would be downward in future, it could also be generally agreed that the current figures were as high as was comfortable and that the authorities should therefore remain conservative in their attitude to taking on new external debt.

Mr. Yamazaki made the following statement:

> The clear-cut exposition of his authorities' view by Mr. Khong, stating agreements with and distinctions from the staff appraisal, is helpful.
>
> Although the economic development of Malaysia continued to stagnate somewhat, the medium-term outlook has turned out to be more favorable, especially in the external area. This favorable outlook must be, in large part, the result of the authorities' comprehensive and continuous adjustment effort since 1982, for which they should be highly commended.
>
> Having said that, however, despite the progress achieved thus far, much remains to be done, particularly on the domestic front, despite the progress achieved thus far. The public sector deficit has more than doubled to 16.6 percent of GNP in 1986, and private sector activity has remained stagnant owing to the weak business confidence. In this respect, I was encouraged to hear Mr. Khong's opening remarks. In the circumstances, the authorities' strategy is now rightly directed toward the recovery of activities in the private sector through further close scrutiny of the size and the role of the public sector. Since I am also of the view that the fiscal imbalance is the main problem to be tackled first, I can generally support the thrust of the authorities' strategy. Specifically, it is encouraging to know that efforts will continue to be made to review closely and further rationalize the public enterprises. Furthermore, public investment will be scaled back to avoid further inefficiency as well as the crowding-out of private investment. The efforts to consolidate the budget deficit will be continued through both expenditure restraint and revenue-raising measures, including the tax reforms.
>
> As regards the financial liberalization, some welcome progress has been achieved in 1986 in removing certain rules and regulations, together with the stronger monitoring scheme by the central bank, which was introduced to stabilize the financial system. Further measures are to be carried out in 1987.
>
> Even with only limited experience in conversations with some of the foreign business communities in Malaysia, I could not but perceive their appreciation of some encouraging signs of favorable

change in the foreign investment environment under the cautious, well thought-out guidance of the Government. Since I am a strong believer in the utmost importance of foreign direct investment in the economic development of any developing country, I very much wish that such commendable efforts should be further advanced. In short, all the intended measures I have mentioned are consistent with the authorities' basic strategy and should be firmly pursued.

Let me comment briefly on the specific issues, and referring first to fiscal policy, the revenue structure should be more elastic; the present structure is not elastic enough, as it relies largely on oil revenue and import-export duties. These sources are the major causes of revenue volatility. I, therefore, very much hope that the value-added tax will be introduced in the near future.

With respect to expenditures, I understand Mr. Khong's view to the effect that the authorities' efforts to curtail public expenditure have been masked in part by the rise in public debt service. Nonetheless, I wonder whether stronger efforts to cut current expenditure would not be justified, since current expenditure is on an increasing trend in terms of GNP while development expenditure is declining sharply. In order to ease the undue pressure on the monetary market from the large public sector borrowing need, the authorities' target of achieving fiscal balance by 1989 needs to be realized.

Second, measures to remove rigidities in the labor market must be seriously considered now that the production structure is changing its direction toward the market-oriented manufacturing.

Third, on external policy, the close monitoring of external debt should be continued. External debt outstanding has jumped upward in 1986 mainly owing to the valuation loss from the exchange rate changes. The result requires greater attention. In this context, the recent early repayment of debt is welcome.

Exchange rate policy should be conducted in a flexible manner so as not to undermine competitiveness, especially in the recently growing export-oriented manufacturing sector. I join the staff in emphasizing such a policy as one of the key conditions for the future soundness of the balance of payments.

Finally, the monetary policy stance is considered to be accommodative of the private sector need for credit. Although past experience shows that high rates of credit expansion did not necessarily lead to the high inflationary pressure in Malaysia, I wonder whether greater caution should not be exercised, especially when there is a large public borrowing need.

Mr. Al-Assaf made the following statement:

Continued adverse external developments, including a steep decline in commodity and oil prices in 1986, have undermined the Malaysian authorities' adjustment efforts and have dampened business and consumer confidence.

The challenge now facing the authorities is how to reactivate the economy and restore growth in an environment of continued fiscal consolidation, without compromising the external adjustment. Given the magnitude of the loss in the growth impulse, which is estimated to have been equivalent to close to 11 percent of GNP in 1986 alone, the task of reactivating the economy will be a difficult one indeed. The authorities ought to be commended for not countering the deflationary impact from external sources by fiscal means. Instead they have wisely sought to promote a fundamental adjustment in the economy aimed at stimulating private sector growth and investment and channeling resources to the export sector. Such a strategy appears to be working, as just reported by Mr. Khong. Manufactured exports turned around strongly to rise by almost 20 percent in 1986, to a large extent resulting from the private sector's aggressive penetration of external markets.

Looking ahead, I am pleased to note the improvement in the medium-term prospects of the Malaysian economy. Preliminary estimates indicate an acceleration in economic growth and the emergence in 1987 of a current account surplus. The improvement in the current account is welcome as it will facilitate the task of the authorities in stimulating domestic demand, and in implementing the growth-oriented strategy needed in order to reverse recent trends in unemployment. It is important, however, that the authorities persist in their efforts in the fiscal area and rationalize the role of the public sector. Significant progress in this respect will further strengthen business confidence and provide a better environment for private sector growth. I was especially impressed by the authorities' efforts and comprehensive approach in encouraging private sector investments, both domestic and foreign. The recent liberalization of the Industrial Coordination Act, the relaxation of the guidelines for foreign equity ownership, and the streamlining of the Promotion of Investment Act are welcome, and should provide the needed incentives to enhance private investment, including foreign direct investment.

To conclude, the Malaysian authorities have been moving their economic policies in the right direction. I commend them for their determination to persist with the adjustment process in the face of a harsh external environment.

Mr. Dai noted that the Malaysian economy continued to be affected by the 1985 recession. Although output had started to rise, unemployment remained high. Large imbalances in the public sector had resulted in a sizable and continuous fiscal deficit. The difficulties facing the Malaysian economy were mainly due to the adverse external environment, marked by a sharp decline in commodity prices. Thanks to timely adjustments, however, the balance of payments kept improving, and inflation was under control. It was particularly heartening to note that the authorities were reacting promptly by adopting a package of measures which included reducing government spending, restructuring the public sector, promoting exports, and encouraging private investment. In his view, the authorities' adjustment efforts were moving in the right direction, and the effective implementation of the adjustment measures had already brought about an upturn in the economy.

In addition to those general observations, Mr. Dai made three specific comments. First, the measures being taken in 1987 to reform the public sector appeared to focus mostly on restraining expenditures, although it seemed that greater attention may need to be paid to dealing with the large loss-making heavy industries in the public sector.

Second, while a sharp cutback in public sector investment had been under way, private investment had not yet increased significantly, Mr. Dai noted, resulting in weak gross investment. That was a matter calling for attention, not only because of its adverse effects on short-term growth and employment, but also for the long-term impact on Malaysia's economic development. Consequently, the forceful implementation of the comprehensive industrial policy ought to be given priority.

Third, in the base scenario for the medium-term outlook, manufactured exports were projected to grow at 7 percent annually, Mr. Dai observed. In view of the uncertainties in the world economy, particularly with respect to commodity prices, it might be advisable for the authorities to be prepared for less favorable eventualities, even though the performance of the manufacturing sector might well continue on its current buoyan course.

Mr. McCormack made the following statement:

> Malaysia's recent economic difficulties have served to highlight pre-existing structural weaknesses in the economy. These include lack of a broadly based industrial structure, excessive dependence on government investment initiatives, and the uneconomic nature of elements of past private and public sector investment, the weakness of the financial sector, and inadequate financial regulation.
>
> The Malaysian authorities have responded vigorously by developing an adjustment strategy which emphasizes the need to reduce the role of the state in economic activity and to promote an efficient private sector, geared primarily to export-oriented

activity. In order to achieve this objective, a critical element will be the reduction in the number of nonfinancial public enterprises, ensuring at the same time that those that remain in the public sector operate efficiently and subject to the discipline of the market. It is notable that there has been a proliferation of enterprises with varying degrees of state equity involvement in Malaysia; the background paper refers to some 900 such entities as being monitored by the Central Information Collection Unit. The staff report points out, in a telling footnote, that between 1973-75 and 1982-85, the incremental capital output ratio--with all its defects as an indicator of aggregate investment productivity--doubled from three to six. The association between this increase and the proliferation of state entities is surely not coincidental. As the staff concludes, and as is recognized by the Malaysian authorities, there is a compelling need for the development of a systematic strategy for privatization. Decisions on an ad hoc basis, enterprise by enterprise, would not be an efficient way to proceed over the medium term.

Regarding fiscal policy, the authorities recognize the need to generate increased levels of public savings. To this end, they have undertaken a number of welcome measures to restrain expenditure. These include what is described as a "voluntary moratorium" on wage increases. I understand that this may be somewhat of a misnomer, insofar as in Malaysia moral suasion may be a more effective instrument than it is in other countries. We would also emphasize the importance of the Malaysian authorities persevering in their efforts to reduce dependence on petroleum receipts as a source of revenue and to increase the overall buoyancy of the tax system. The estimates of tax buoyancies reported in Table 9 of the background paper are encouraging. However, still greater efforts seem to be called for. Table 25 of the same paper shows that between 1983 and 1986, the share of nonpetroleum revenue in total federal government revenue actually declined from 72 percent in 1983 to 64 percent. Happily, an increase is budgeted for 1987. Similarly, non-oil revenue as a percentage of GNP, as shown in Table 2 of the staff report, has shown no tendency to increase in recent years. We also note that substantial use of tax concessions to promote investment and exports, often in the most dynamic areas of the economy, tends to erode the tax base and may have negative consequences for achieving fiscal balance. Further extensions of these concessions should receive close scrutiny.

The operation of monetary policy last year was complicated by exchange rate considerations. While the authorities' aim was to be broadly accommodating, in the event monetary policy was somewhat more restrictive than had been intended. Given the need to encourage private sector investment, an accommodating stance this year would also seem to be appropriate. However, it is important that the demands of the private sector should be accommodated, but no more, and it is essential to avoid any tendency for credit expansion to rekindle the speculative activities of recent years. The measures to liberalize the financial system are to be welcomed, as are the steps taken to improve the framework of financial supervision in Malaysia. These were clearly essential in order to restore the damage to confidence in the financial sector. We welcome in this regard the fact that the Fund was able to provide technical assistance to help the Bank Negara in its efforts.

On exchange rate policy, we are inclined to agree with the staff that an active use of exchange rate policy would tend to promote a more competitive industrial sector. I sympathize, however, with the Malaysian authorities in their belief that it was essential to remain sensitive to the state of market confidence. By this, I take it to mean that it is important to avoid disorderly, precipitate movements in the exchange rate, which could have damaging effects on confidence in the Malaysian financial and economic system. One other point concerning the exchange rate is that fact that, in effective exchange rate terms, the ringgit has depreciated markedly over the last two years. At the same time, prices in Malaysia have been quite stable and import prices in domestic currency have actually appeared to fall, contrary to expectations. I wonder whether the staff could give some explanation of this behavior, and comment on what it implies for the use of the exchange rate as an instrument of balance of payments adjustment in an economy such as Malaysia's.

Finally, we would encourage the authorities to persevere in their adjustment efforts. There are clearly important gains to be achieved by the resolute pursuit of the policies which are already in place or in prospect. Admittedly, there is a worrying increase in the rate of unemployment in Malaysia, but it would be unfortunate if this were to lead to any weakening of the adjustment effort at this time. There is abundant evidence of how quickly hard-won gains can be lost through premature relaxation of policies. I found Mr. Khong's statement very encouraging in this respect.

Mr. Fernando made the following statement:

The structural transformation of the Malaysian economy since the early 1970s is striking. Considerable diversification of traditional agriculture has occurred. With the impetus of domestic output of petroleum and gas, the mining sector has strengthened. Most welcome is the steady growth of the manufacturing industry, which increased its share of GDP from 12 percent in 1971 to 21 percent last year. These developments have provided the basis for a strong growth of exports and, equally important, a variety and a resiliency to the product composition of exports.

The strong export bias of manufactured products--44 percent of total exports--is commendable. Mr. Khong has commented on the setback to growth in the last two years. But over the broader span of time Malaysia has successfully combined structural changes with a strong growth record. Judgments about the year-to-year performance of economic policies and economic management must attach sufficient weight to Malaysia's good record, which is sufficiently satisfactory to allow the Malaysian authorities to be the best judge of the timetable for action.

On the subject of the volume of exports of manufactures, the sensitivity analysis for the medium term points to a more adverse effect on the current account of the balance of payments of a reduction in export volume than of a stockbuilding exercise. The staff report quite rightly attaches importance, for reaching the medium-term targets, of competitive strength and the strengthening of business confidence. Policies in this area lie within the control of the Malaysian authorities, and given the recent trends and proposed policies, we are confident that progress toward the objectives will be achieved. At the same time, an equally important role can be played by the commitment of industrial countries to keep their markets open to Malaysian exports, a factor which is beyond Malaysia's control but which presumably has not been an issue. Nevertheless, the increased relocation of production facilities financed by foreign capital, on the basis of Malaysia being a low-cost country, raises the possibility of such a risk for long-range planning.

With a view to maintaining and improving the incentive structure to keep up the momentum for exports, the authorities, while giving an important place to a flexible exchange rate policy, also point to the need for other incentives, especially of a fiscal nature. The staff has correctly pointed to the distortions that such incentives can cause, in particular by weakening the tax structure. However, we have much sympathy with the authorities' viewpoint. New exports, product development, and entry into new markets are fraught with uncertainties and risks that may not be adequately taken care of by the exchange rate instrument. The authorities should also have the flexibility to judge the appropriateness of exchange rate movements. In an open economy like Malaysia's, the advantages attaching to a stable exchange rate should be carefully weighed. A fast depreciating rate will also feed back into costs, and the authorities are mindful of the import content of the manufactures. The exchange rate incentive for exports should also be placed in the perspective of the total incentive structure for all production, including production for the domestic market. Higher incentives for domestic market production should not act as an impediment for export manufacture. In the context of the increasing importance of foreign capital investment in Malaysian exports, we wonder about the relative merits for investment decisions of fiscal incentives versus a realistic exchange rate policy.

We have viewed with some concern the decline of investment, in particular private investment, which is unfortunate not merely because it is a constraint to future growth, but because it would also reduce the early possibilities of improving the incremental capital output ratio. We welcome the steps already taken and those contemplated to facilitate procedures for investment, the specific incentives being developed, and the progress made in removing the remaining impediments. In the context of the focus on expanding foreign investment we have noted the case-by-case approach under which the determination of ownership is influenced by such factors as export orientation, and the number of workers employed. It would be helpful if the staff or Mr. Khong would indicate whether broader parameters for foreign investment approvals exist. In particular, are there specific subsectors in the economy or specific product lines that are not open for foreign investment? Another question is whether foreign investments are permitted in competition with the nonfinancial public enterprises? Perhaps the staff could also give some indication of any special feature of foreign investment in manufacturing industry, for instance, the possible concentration of investment in certain product lines. These are questions that would help us to gauge the importance of foreign enterprise in total manufacturing exports.

It has been observed that prices were remarkably stable during 1986, with the consumer price index showing only a 0.7 percent increase, despite the expansionary stimulus of the fiscal deficit, the acommodative monetary policy, which resulted in the infusion of liquidity into the financial system, and the exchange rate depreciation in nominal as well as real terms. In such a situation, it is most interesting to encounter price stability. There is a reference to a decline in import prices and it would be helpful to know how this occurred, given the downward movement of the exchange rate. We have noticed a reference to a price supervision scheme under which the prices of a number of items were lowered. What was the rationale underlying this action? Was there any adverse effect on the operations of nonfinancial public enterprises as a result of decisions on pricing being taken by another authority?

Finally, we welcome the important steps taken to reform the financial structure. It would appear that in comparison to the rapid and substantial changes in other areas of structural adjustment, the financial sector has lagged behind. The required improvement in business confidence to achieve a sustained level of productive investment would be greatly facilitated by improvements to the financial system. We urge the authorities to press ahead with their program.

Mrs. Filardo made the following statement:

The Malaysian authorities merit commendation for their impressive effort and dynamism in designing and implementing a sound economic medium-term strategy initiated in 1986 that envisages a significant improvement in the current account of the balance of payments and external debt position, notwithstanding the weakening of prices in the country's key primary export commodities, which was reflected in a US$4 billion drop in export earnings. Especially remarkable have been the measures undertaken in cutting government expenditures and in privatizing the state-owned companies, aimed at reducing the fiscal deficit.

As Mr. Khong stressed in his statement, the authorities have made a great effort to consolidate the public sector since 1982, and the renewed large deficit in 1986-1987 was mainly due to the decline in revenues, since consolidated government expenditures have fallen in real terms since 1984. We also welcome the authorities' intention to keep external debt under control, and their firm commitment to persevere with the improvement of financial imbalances as well as the implementation of monetary, exchange, and trade policies with a view to stimulating business confidence and increasing private investment. Notwithstanding the fact that the 1987 budget and the medium-term strategy appear to include economic measures in the right direction, in what follows we would like to stress some points related to public finance and monetary reforms.

Given the importance of the public sector in the economy and the extension of entrepreneural activity by the Government at all levels, the thrust of the problem remains the deficit of the nonfinancial public enterprises that will continue to deteriorate as a result of the expected revenue decline and operating expenditure increase. Thus, even though the authorities' budget strategy envisages a reduction of the public sector, the improvement of the country's efficiency and the promotion of private investment, there seems to be a need for structural reform in this area, with a clear-cut definition of the role of the Government in the economy. In this regard, it is useful to learn that "the authorities believe that the key to sustained long-term growth rests mainly on the private sector" and that they are committed to implementing the required measures.

With respect to monetary policy, the move by the authorities to dynamic and flexible interest rate management, to reduce the segmentation of the financial market, and to strengthen the standing of the financial system have been useful changes in the right direction. Nevertheless, we have noted that even though deposit rates were at a sufficient level to promote the mobilization of financial savings and discourage capital outflow, the interest lending rate has been maintained at about 12.3 percent since 1982, while the deposit rate declined from 10 percent in 1982 to 4.5 percent in 1987. This significant spread between those rates for such a long time is an indication of structural weaknesses or the lack of competitiveness of the banking system, in which case there exist rigidities in the management of monetary policy. Although the Bank Negara has implemented several measures to tackle the problem, the lending rate remains at 11.2 percent; maybe the staff or Mr. Khong would like to elaborate on this point.

Finally, we agree with the staff and with Mr. Khong that the medium-term prospects for the Malaysian economy appear to be more favorable and that the set of macroeconomic policies and structural reforms that the authorities have been implementing are steps in the right direction. We encourage them to continue on the same path.

Mr. Feldman made the following statement:

Since 1983, the Malaysian economy has experienced a relatively successful adjustment. During 1983-85, adjustments in the public and external sectors were favored by the positive evolution of both external demand and the terms of trade. Under those circumstances, it was possible to reduce the public sector and current account deficits, and simultaneously to keep the economy growing while domestic inflation remained moderate.

Since 1985, however, the external environment, mainly the terms of trade, has shown a remarkable deterioration, increasing Malaysia's economic vulnerability. Consequently, the Malaysian economy is suffering the effects of a recession--GDP stagnated and national income declined almost 12 percent during 1985-86 in line with the deterioration in the terms of trade. Lower economic activity and weak private demand, particularly in public and private investment, resulted in a narrowing of the external current account deficit and in a poorer public financial situation, as the overall deficit climbed up again to values almost similar to those prevailing before the adjustment effort.

Public finances have deteriorated, in particular because revenues decreased owing to the lower level of activity, and the larger deficit was financed by increasing the public debt, both external and domestic. On the other hand, the current account and the overall balance of payments have improved, mainly because import and service payments have decreased, and there was a positive short-term capital inflow.

The need to restrain imports, high real interest rates, and, according to the staff report, the "general environment" have had a negative impact on investment decisions. Domestic investment, particularly private investment, has fallen dramatically, and the unemployment rate has increased substantially, reaching a critically high level.

We basically agree with the analysis provided by the staff and we have found Mr. Khong's statement quite helpful in providing an explanation of what has been going on in Malaysia.

On Malaysian economic performance, I have three remarks to make--on the role of public and private investment in economic strategy, the functioning of the labor market, and, finally, the fiscal policy outlook for 1987.

To begin with the role of public and private investment, despite the alleged inefficiencies of the public sector in Malaysia, it is apparent that public investment has played a central role in the industrial development strategy initiated in the 1970s. This strategy was in turn crucial to the achievement of a successful record of fiscal adjustment combined with growth during the period 1983-85. We agree with the objective of enhancing the role of private investment but we have some doubts about the economic factors that will generate the resumption of that investment. It seems clear that the adjustment achieved during 1983-84 in the fiscal sector was not offset by an expansion in private investment. In fact, owing to the slackening in external demand and to the overexpansion of some labor-intensive sectors related to domestic demand--notably in construction--private investment is expected to decline around 36 percent during the triennium 1985-1987.

On wage policy and productivity, the staff considers that the structure of labor costs has become rigid, resulting in increasingly high costs that are difficult to reduce without recourse to cuts in employment in recessionary periods. In this respect, we would emphasize that unemployment has grown systematically in Malaysia since 1982, during years both of recession and of expansion, to a current dramatically high level. This feature is particularly critical when account is taken of the definition of unemployment adopted, namely, working for less than one hour a week.

According to figures included in the staff report, labor productivity in the Malaysian industrial sector grew 11 percent from 1983 to 1986, but real wages seem to have risen by less than that. Thus, it is difficult to see how wage policy is affecting inflation or private investment decisions. The staff might like to comment on this aspect of the functioning of labor markets in Malaysia.

Concerning the fiscal policy outlook for 1987, our third and last point, as we know, after the successful adjustment in fiscal accounts achieved during 1984 and 1985, the overall balance of public sector worsened markedly again during 1986 and is expected to remain during 1987 at levels similar to the ones observed before the adjustment took place. It is clear from the data presented in Table 2 of the staff report that prior to 1984-85 the largest proportion--around two thirds--of the gap between expenditures and revenues was externally financed and that this policy contributed significantly to the increase of Malaysian foreign indebtedness. In contrast, once the fiscal adjustment policy was put in place, the Malaysian authorities took the opportunity to lower their reliance on foreign financing; during 1985 and 1986 domestic financing accounted for approximately 80 percent of the overall fiscal imbalance. According to the staff report, domestic sources of financing have been of a nonmonetary nature related to the Employees' Provident Fund and to Petronas, and to the depletion of the public sector's financial assets held at the Bank Negara. In commenting on the fiscal outlook and policy for 1987, the staff report states that, as in previous years, external financing will be kept to a minimum with a further large increase in financing by the domestic banking system and by recourse to traditional nonbank sources. We wonder, and perhaps the staff or Mr. Khong would like to comment on this, how the domestic banking system will contribute to that financing and whether this financing might not aggravate the high level of interest rates that already exists. Moreover, we wonder whether the financing through nonbank sources, which in a way are sources that can be exhausted, is sustainable over time.

Finally, we share the Malaysian authorities' declared objectives, as pointed out by Mr. Khong, of implementing a growth-oriented strategy to create employment in an environment of price and external stability and an equitable sharing of the benefits of national development.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/110 (7/27/87) and EBM/87/111 (7/29/87).

4. THEORETICAL ASPECTS OF DESIGN OF FUND-SUPPORTED ADJUSTMENT PROGRAMS - PUBLICATION

The Executive Board approves the proposal for publication, in the Occasional Paper series, of the staff paper entitled "Theoretical Aspects of the Design of Fund-Supported Adjustment Programs," as set forth in SM/87/151 (7/6/87).

Adopted July 27, 1987

5. AUDIT REPORT, 1987 - TRANSMITTAL TO BOARD OF GOVERNORS

The Executive Board approves the proposed letter set forth in EBAP/87/156 (7/15/87) and Correction 1 (7/17/87) transmitting, for consideration by the Board of Governors, the Report of the External Audit Committee for the financial year ended April 30, 1987.

Adopted July 27, 1987

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/148, Supplement 1 (7/24/87), EBAP/87/163 (7/27/87), and EBAP/87/167 (7/27/87) and by Advisors to Executive Directors as set forth in EBAP/87/163 (7/27/87) and EBAP/87/167 (7/27/87) is approved.

APPROVED: February 23, 1988

LEO VAN HOUTVEN
Secretary

Table 1: Malaysia: Current Payments and External Debt Outlook

	1986	1987	1988	1989	1990	1991
			(In percent)			
A. 1986 Staff Report						
Current account/GNP	-8.5	-8.7	-8.4	-8.1	-7.3	-6.1
External debt/GNP	76.4	80.8	83.6	84.8	84.5	84.5
External debt/current receipts	138.8	148.5	149.7	149.7	147.0	144.6
Debt service ratio	19.4	18.4	21.4	20.8	20.4	19.6
B. 1987 Staff Report						
Current account/GNP	-1.8	-1.0	-0.8	-0.6	-0.2	0.2
External debt/GNP	85.3	84.8	82.4	79.9	76.9	73.2
External debt/current receipts	134.4	129.3	121.9	116.6	111.3	105.5
Debt service ratio	18.8	18.9	17.7	17.0	16.5	15.9

Source: SM/86/164 dated July 7, 1986 and SM/87/154 dated July 7, 1987.

Table 2: Malaysia's Adjustment Program

	1982	1983	1984	1985	1986	1987
			(As percent of GNP)			
Federal government overall deficit	-16.9	-10.6	-6.6	-5.9	-10.9	-12.0
Public sector deficit	-17.1	-13.0	-10.3	-7.8	-16.6	-14.8
Current account deficit	-14.1	-12.5	-5.3	-2.5	-1.8	-1.0
Memorandum items:						
1. Real GDP (percent change)	5.9	6.3	7.8	-1.0	1.0	1.5
2. Consolidated public expenditure: 1/						
(M$ billion)	33.5	34.6	36.8	36.0	35.9	32.8
(percent GNP)	56.1	53.1	49.6	50.1	53.8	47.3
2a. Public expenditure, excluding interest payments: 2/						
(M$ billion)	30.8	31.1	32.4	30.9	30.6	26.8
(percent GNP)	51.6	47.8	43.7	43.1	46.0	38.7
3. Public sector revenue: 3/						
(M$ billion)	23.3	26.1	29.2	30.3	24.8	22.6
(percent GNP)	39.0	40.1	39.3	42.3	37.2	32.5
4. Export volume (percent change)	9.2	21.3	11.6	4.7	14.5	2.6
4a. Export price (percent change)	-6.3	-3.3	4.7	-11.4	-20.9	7.6
5. Import volume (percent change)	8.9	9.5	9.0	-6.9	-1.6	2.1
5a. Import price (percent change)	-1.1	-2.5	-2.8	-6.3	-10.1	6.3
6. Terms of trade (percent change)	-5.2	-0.7	7.7	-5.5	-12.0	1.2

1/ General government expenditure plus development expenditure of NPEs.
2/ Total above less interest payments of Federal Government.
3/ General government revenue plus current surplus of NPEs.

Source: Computed from SM/87/154 and SM/87/165.