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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/135

10:00 a.m., September 30, 1991

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	L. E. N. Fernando
	Chen M., Temporary
	D. Powell, Temporary
	C. M. Towe, Temporary
	Q. M. Krosby
	M. E. Hansen, Temporary
	V. Kural, Temporary
	Y.-H. Lee, Temporary
	A. Giustiniani, Temporary
M. Finaish	A. F. Mohammed
	I. Fridriksson
	K. Ishikura, Temporary
	B. Esdar
J. E. Ismael	
	J. R. N. Almeida, Temporary
	P. Bonzom, Temporary
	H. Dognin, Temporary
A. Mirakhor	
	L. J. Mwananshiku
	P. Wright
G. A. Posthumus	A. M. Tanase, Temporary
C. V. Santos	A. R. Ismael, Temporary
	M. Galán, Temporary
	L. J. Morelli, Temporary

C. Brachet, Acting Secretary
B. J. Owen, Assistant

Also Present

IBRD: H. Fazel, Africa Regional Office. African Department: E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; C. V. Callender, K. B. Dillon, J. P. Gordon, R. P. Hicks, P. Wade, J. Wang, R. C. Williams. Exchange and Trade Relations Department: T. Leddy, Deputy Director; A. Basu, S. Kanesa-Thasan, C. Puckahtikom. External Relations Department: S. J. Anjaria, Director. Legal Department: H. Elizalde, J. L. Hagan, J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; S. H. Hitti, Z. Iqbal, E. W. Saunders. Treasurer's Department: C. A. Hatch. Advisors to Executive Directors: M. B. Chatah, L. Dicks-Mireaux, B. R. Fuleihan, A. Gronn, S. von Stenglin. Assistants to Executive Directors: B. Bossone, Deng H., T. P. Enger, H. Golriz, M. A. Hammoudi, O. A. Himani, P. K. Kafle, J. A. K. Munthali, P. L. Rubianes, D. Sparkes.

1. MANAGING DIRECTOR

The Executive Directors met first in executive session, under the chairmanship of Mr. Kafka, to consider certain matters relating to the position of Managing Director.

The Executive Board then took the following decisions:

Managing Director - Offer of Appointment to Mr. Camdessus

The Executive Board agrees to offer Mr. Michel Camdessus a second five-year term as Managing Director to begin January 16, 1992.

Adopted September 30, 1991

Managing Director - Committee to Negotiate Terms of Service

The Executive Board agrees to the appointment of a Committee to be comprised of Mr. Kafka, as Chairman, and Messrs. Dawson, de Groote, Finaish, Fukui, and Monyake to negotiate terms of service with Mr. Camdessus and to report to the Executive Board.

Adopted September 30, 1991

Managing Director - Pension Review

The Executive Board notes that it shall review the pension of the Managing Director for the period following January 15, 1992.

Adopted September 30, 1991

The Managing Director then entered and assumed the chair to express his thanks to Mr. Kafka and the members of the Executive Board for the confidence that they had shown in him by unanimously electing him to a second term as Managing Director and Chairman. His work with the Executive Board for almost five years had been a source of many satisfactions for him, but much remained to be done. It was with pleasure and anticipation that he agreed to continue that work--anticipation, not because he had a specific agenda, but because the few years ahead would be full of opportunities for the world, and exceptional years for serving the purposes of the Fund.

The task was beyond the strength and talents of an average human being, the Managing Director added, but he knew that with the help and guidance of the Executive Board, it was feasible to carry it out. He would be proud to undertake it, and to lead the outstanding staff of the institution.

The Managing Director asked the Deputy Managing Director to assume the chair for the remainder of the meeting, which would begin with the 1991 Article IV consultation with the Syrian Arab Republic.

2. SYRIAN ARAB REPUBLIC - 1991 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1991 Article IV consultation with the Syrian Arab Republic (SM/91/185, 9/4/91). They also had before them a paper providing statistical background information (SM/91/189, 9/10/89).

Mr. Finaish made the following statement:

> Since the mid-1980s, economic policy in Syria has aimed at two main objectives: first, to create a noninflationary domestic macroeconomic environment conducive to medium-term external viability; and second, to enhance economic efficiency and resource allocation in order to improve growth performance. The need to move on both fronts was necessitated by the domestic and external imbalances which emerged in the first half of the decade following the sharp economic slowdown in the region, as well as the authorities' recognition that structural changes were required in order to unlock the country's economic potential.
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> Significant progress has been achieved over the past five years. Substantial fiscal adjustment, coupled with a wide range of measures in the areas of pricing, the exchange system, and regulations governing private sector activity, have led to a significant improvement in economic performance. The sharp decline in government expenditure relative to GDP and the rapid increase in non-oil exports (even excluding those associated with the bilateral agreement with the U.S.S.R.) are indicative of that improvement.
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> The authorities recognize that while progress was achieved in most policy areas, it has been more rapid in some than in others, partly reflecting the authorities' approach to structural reform, which aims at balancing economic and social considerations. Given the financing constraints, shock treatment could prove extremely disruptive if sufficient external flows to mitigate its short-term impact are not available.
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> What is important, however, is that the authorities have followed a steady course in their efforts toward adjustment and reform. This course has been maintained in the period since last

year's Article IV consultation. The authorities' prudent policies, together with the external support provided mainly by the Gulf countries, have helped Syria absorb the major economic shock associated with the crisis in the Middle East.

Following the significant fiscal strengthening which occurred in 1985-89, preliminary estimates point to a further improvement in the budgetary position in 1990. The increase in tax revenue reflected a sharp rise in oil, as well as non-oil, exports in addition to improved collection of tax arrears. On the other hand, total expenditures declined in real terms and also relative to GDP, which is in line with trends since the mid-1980s. This reflected, among other things, the fact that no wage increases were granted in 1990.

The 1991 budget has not yet been officially approved. This is due, in part, to uncertainties about how much of the increased aid flows will be incorporated in the budget, given the authorities' intention to include such flows only to the extent they are actually drawn upon to finance projects. In any event, however, the authorities are maintaining their tight control over current expenditures.

In the area of tax reform, an important step was taken recently when a revised company tax law, to be effective at the beginning of 1992, was approved. Under the new law, marginal tax rates have been reduced substantially.

Pricing policies during the past year have continued to move gradually toward a market-based system. By limiting rations of subsidized food items and permitting the private distribution and retailing of these items at higher prices, the effective subsidy on foodstuffs was reduced substantially in 1990. This explains, in large measure, the relatively large increase in the retail price index which was registered last year. Procurement prices were also raised significantly for the 1990/91 crop season. Moreover, in order to enhance export incentives, the exchange rates applied to surrender requirements were made more market related. At the same time, subsidies on major agricultural inputs were either eliminated or greatly reduced.

In line with the policy of promoting private sector investment activity, a new investment law was adopted in May 1991 which applies uniformly to foreigners and residents. The law includes streamlined procedures for approving investment applications, as well as tax and other incentives.

This new investment law is part of a broader effort to liberalize the external sector. Indeed, the substantial increase in private sector imports and exports in 1990 reflects, at least partially, the further easing of controls on international trade. This easing included, among other things, abolishing the advance deposits for certain imports and shifting certain exports from the official exchange rate to the "rate in neighboring countries," in addition to changing the rate applied to surrender requirements mentioned earlier.

Although further simplification of the exchange system is clearly still required, the authorities have continued to take steps aimed at effecting a gradual shift toward market-related exchange rates. Among these is the substantial depreciation of the official exchange rate in 1989, the gradual shifting of transactions to the "rate in neighboring countries," and the recent abolition of the promotional rate.

Syria's underlying external position continues to be difficult, although the balance of payments improved substantially as a result of the increase in external support in 1991 in connection with the Middle East crisis. Another major factor behind the recent improvement in the external position is the substantial increase in exports to the U.S.S.R. The authorities recognize the need to strengthen the underlying balance of payments position in a more durable way. It is toward that end that they are adopting measures to enhance private sector exports and to increase oil receipts by expanding production capacity and discouraging domestic consumption. The authorities are hopeful that their adjustment and reform policies will lead to sustained improvement in the balance of payments position. In the meantime, they are using any margin that becomes available to contain the problem of arrears. Indeed, as in 1989, the commercial bank has remained current on interest payments and has reduced its stock of external arrears. As far as Syria's arrears to the World Bank are concerned, the matter has been under discussion between the Syrian authorities and the Bank staff. It is also expected that during the forthcoming Annual Meetings, further discussions will take place on possible avenues for clearing the arrears.

Mr. Al-Jasser made the following statement;

During the 1980s, the Syrian economy was confronted by adverse external developments, which, coupled with long-standing structural rigidities, led to serious economic and financial difficulties. While the authorities' initial response was to tighten administrative controls, they have recently introduced commendable liberalization measures that should lead to an improvement in economic efficiency and growth.

As noted by Mr. Finaish in his helpful statement, the Syrian authorities have exhibited determined efforts to stabilize the economy. Indeed, the transformation of a fiscal deficit (excluding grants) of 14 percent of GDP in 1986 into a projected fiscal surplus of 0.9 percent of GDP in 1990 represents substantial fiscal consolidation. This was achieved through commendable price adjustments aimed at reducing subsidies, coupled with greater expenditure control and improved tax receipts. Nevertheless, further efforts are needed if the economy is to embark on a sustainable growth path. In particular, public sector enterprises should be subjected to hard budget constraints, while recourse to bank credit should be contained. Here, I would reiterate that public ownership is not necessarily incompatible with sound commercial management. In addition, there is a need to improve fiscal management as well as to reform the tax system. With respect to the latter, I welcome the revision of the company income tax law, and I encourage the authorities to adjust the customs valuation rate.

Regarding exchange rate policy, I welcome the authorities' efforts to price foreign exchange more realistically and their relaxation of foreign exchange restrictions. As Mr. Finaish notes in his statement, the authorities have significantly depreciated the exchange rate in 1989, gradually shifted transactions to the "rate in neighboring countries," and abolished the promotional rate. However, I share the staff view on the desirability of bringing the official rates closer together and unifying them in the near future.

The main challenge facing the Syrian authorities is to strike an appropriate balance between the public and private sectors. In this context, I welcome the authorities' recent efforts to reduce public sector control of the economy. Such measures will clearly help invigorate Syria's reasonably well-diversified agricultural and industrial base as well as help unleash the entrepreneurial skills of its highly capable work force.

Furthermore, I am encouraged by the recent increase in procurement prices and the introduction of more favorable exchange rates for exports, as well as the reduction and, in some cases elimination, of input subsidies. Nevertheless, price distortion and administrative regulations remain pervasive in the agricultural sector. Hence, I urge the authorities to accelerate movement to a more market-based and competitive system. This is particularly crucial, given the impressive response of output to the measures already undertaken.

Moreover, I welcome the adoption of a new investment law, which represents a significant liberalization of investment regulations and places foreign and domestic investors on an equal footing. However, if private sector activity is to be accelerated, comprehensive price decontrol and liberalization of the exchange and trade system are essential.

In conclusion, the Syrian authorities have initiated a process of economic liberalization that should be encouraged. These efforts represent an important step forward that needs to be consolidated in the context of a more comprehensive approach. Clearly, the emergence of a significant hydrocarbon sector should provide a necessary cushion to the adjustment measures.

With these remarks, I wish the authorities success in their endeavors.

Mr. Mirakhor made the following statement:

As both the staff report and Mr. Finaish's helpful statement indicate, the authorities' efforts have helped Syria absorb major economic shocks associated with the recent Middle East crisis. These policies, along with external support and contributions from the industrial, oil, and--most important--the agricultural sectors allowed the Syrian economy to experience improvements in real GDP growth in 1990. The increase in value added in both the agricultural and oil sectors was substantial. While the contributions of those two sectors in terms of value added were helped by exogenous factors, the staff report indicates that there was also a positive response in the agricultural and the industrial sectors to policy reforms. The authorities are aware of the responsiveness of the agricultural and manufacturing sectors to pricing, production, regulatory, and exchange rate reforms, and they intend to press on gradually and steadily with these reforms. The agricultural sector in Syria has a great potential, particularly in terms of contributing to export growth, and it is hoped that the months ahead will produce policy responses to remove regulatory fetters and price distortions that exist not only vis-à-vis the agricultural sector itself, but also in the agribusiness and manufacturing sectors that have linkages with the agricultural sector. Policy reforms are urgently needed in the agricultural and closely associated sectors to permit the Government's objective of self-sufficiency in cereals to be achieved and to allow the potentially significant contribution of this sector to economic growth to be actualized. Particularly important are policy reforms that would encourage increased private sector investment in the agricultural and manufacturing sectors with substantial export growth potential.

It is encouraging to note that the ratio of real savings to GDP has increased by 2 percent in 1990, and that the authorities are providing inducements for the reinvestment in the economy of these savings, which have accumulated in the private sector. Also encouraging is the relaxation of import controls, which permitted an increase in private sector imports of 73 percent in 1990 with additional large increases projected for 1991-92. This should help the economy to reverse the serious impact of the massive import compression of the second half of the 1980s, which along with distortionary policies led to very low levels of capital accumulation, resulting in constraints on the efficiency and productivity of the agricultural, manufacturing, and industrial sectors. Although limited reductions in controls and increased incentives have already increased real private sector investment, broader and more intensive policies to decontrol economic activity and further restoration of incentives for the private sector are needed if a meaningful supply response is to result. Policy reforms are particularly needed in the area of manufacturing where two thirds of activity is accounted for by public manufacturing enterprises.

Although the staff's medium-term projections show improvements for the balance of payments in the next two to three years, the economy remains vulnerable to external shocks. We share the staff's view that the expected improvements are not sustainable over the medium term in the absence of fundamental policy reforms. The authorities should seize the opportunity which the current respite is providing to initiate more intensive policy reforms toward the elimination of economic and financial imbalances facing the economy.

We firmly believe that given the existing resource base and the availability of skilled human resources, the Syrian economy has enormous potentials which need to be realized through the intensification of the welcome policy initiatives referred to in Mr. Finaish's statement and the staff report. The elimination of price controls and liberalization of the exchange and trade system, plus the reform of the financial sector, should permit the Syrian economy to reduce its vulnerability to the external shocks which so severely constrained economic growth in the second half of the 1980s.

It was encouraging to learn from Mr. Finaish that the authorities have already undertaken negotiations with the World Bank with the aim of finding a possible avenue for clearing the arrears with the Bank.

The authorities should be commended for their steady steering of the economy under very difficult circumstances in the past few years, and we wish them every success as they accelerate the pace of reform and adjustment.

Mr. Bonzom made the following statement:

This chair is in broad agreement with the thrust of the staff appraisal on the Syrian economy. We welcome the positive developments of 1990, and specifically the return of growth due in part to a rebound in agricultural production, the strengthening of the current account, which reached a surplus of almost $2 billion, or approximately 8 percent of GDP, and the improvement in the budget performance, with a surplus of 1 percent of GDP.

As the staff mentioned, those results were accompanied and partly caused by the welcome change in the authorities' attitude toward economic management. The aim, which was also proposed during previous Article IV consultations with Syria, should be to strike a more adequate balance between public controls and private initiatives. Indeed, the authorities have recently reduced the high level of subsidization, reformed the company income tax with a view to lowering marginal rates, and implemented a new law facilitating private investment. However, the scope of Mr. Finaish's remark on persisting difficulties in the underlying external position can be broadened to encompass different aspects of the economy.

First, the sharp reduction in the savings and investment gap since 1986 was mainly due to a fall in investment. Indeed, savings are not encouraged by increasingly negative real interest rates. We share the staff's disappointment on this subject. Second, and as mentioned by the staff, the unexpected return to a budgetary surplus does not tell the whole story about the pressures imposed by the public sector at large on the economy. In particular, the claims of the domestic banking system on the public sector increased by more than 12 percent in 1990, which certainly contributed to the rise in inflation to 19 percent.

In this context, broadening the tax base could strengthen the fiscal position. We thus welcome the authorities' willingness to consider the introduction of a sales tax, which could provide the opportunity for a comprehensive review of the tax system. But the fiscal performance would also certainly be improved by the restructuring of public enterprises, which account for two thirds of manufacturing activity. The report elaborates on one aspect of the restructuring, namely, pricing policy. Could the staff give more details on the progress made, if any, in other areas of management of public firms?

My third point deals with the exceptional character of the strengthening of external accounts. Indeed, had it not been for the huge increase in official transfers, projections for the overall balance in 1991 would have been much lower. Besides, the accumulation of arrears of more than $1 billion substantially and artificially reduced the pressures on reserves. As a consequence, it is not surprising that the projections for 1992 and 1993 point to a tight external position.

Fourth, as far as exchange restrictions are concerned, we welcome the authorities' intention to move transactions to the most market-oriented rate and, like Mr. Al-Jasser, we hope that this could represent a first step toward the adoption of a unified exchange rate.

Last but not least, it is disappointing to see economic analysis and policy making complicated by the lack of comprehensive data on several key indicators, such as wages or external debt. We fully concur with the staff on the need to improve the statistical framework.

In conclusion, I would like to stress that the first measures taken in favor of adjustment and reform, as well as the exceptional international context of 1990, have created a window of opportunity which the authorities could use efficiently by devising and implementing a comprehensive strategy aimed at achieving balanced and sustainable growth. In this context, appropriate support for the efforts of productive agents, as well as the restoration of normal relations with creditors, in particular with the World Bank, would prove crucial. We wish the authorities success in their endeavors.

The staff representative from the Middle Eastern Department observed that the World Bank mission that had been in the field at the same time as the Fund consultation mission had targeted the reform of public sector enterprises as one of the main areas that the Bank staff would like to examine further, with a view possibly to coming forward with support, once the problem of the financial relations between the World Bank and Syria had been resolved. It went without saying that the Fund staff coordinated closely with the World Bank in its work in such areas.

Mrs. Krosby made the following statement:

I would like to thank the staff for a very useful assessment of the Syrian economy. This is a case where we are particularly indebted to the analytical efforts of the staff, since pervasive economic distortions and poor statistics make it very difficult for the untutored to piece together a coherent picture of developments in Syria.

We fully support all the staff's comments and suggestions about the need for improving the quality, comprehensiveness, and timeliness of data.

The poor economic performance of the Syrian economy over an extended period strongly suggests that the Syrian authorities would be well advised to study the lessons of economic liberalization that are in the ascendancy in most of the world and begin to dismantle their home-made barriers to economic advancement. Casual evidence provided in the staff analysis points to a potentially dynamic private sector when private economic incentives are given freer rein.

As Mr. Al-Jasser noted, recent steps to begin to reduce punitively high marginal income tax rates are in the right direction, as is recent legislation to improve opportunities for foreign investors. However, these measures only scratch the surface of a pervasive system of price controls, subsidies, quantitative restrictions, regulatory distortions, and governmental production that defeats the efficient functioning of the economy. A very good place to start on economic reforms would be to deal with the multiple currency practices and exchange restrictions referred to in the proposed decision.

The staff report indicates that a major resource transfer to the U.S.S.R. has been accomplished in a very short time on the basis of bilateral payments arrangements and distorted foreign exchange incentives. Paying down unrecorded debts in this fashion may be beneficial to the two parties involved but it discriminates against the unsettled claims of other parties. The long-standing Syrian arrears to the World Bank are a matter of concern to my authorities. We believe Syria should give priority to making these payments current and to regularizing its external debt arrangements.

Syria's economy benefitted significantly as a result of the crisis in the Middle East, from higher oil revenues, an infusion of aid, and increased economic ties with the industrial countries. The aid windfall more than offset the war-related costs. The project aid pledged to Syria should provide a good start on needed recovery of investment. Government cutbacks on investment since 1988 as part of an austerity program have caused a deterioration in the transportation network, industrial projects, and power generation. Imports of essential manufacturing inputs, equipment, and parts were also curtailed.

Recent changes in investment regulations to permit joint public/private ventures in some sectors may help mobilize private resources for domestic investment. Indeed, the staff notes that recorded defense expenditures in the budget amounted to about 45 percent of current expenditures. Redirection of some state expenditures from military to industrial or transportation sector investment would also promote additional growth. Further restraint of credit expansion is needed and could best be achieved by reducing public sector enterprise claims on available credit.

Mr. Powell said that he supported the proposed decision. Naturally, he welcomed the improvement in the external performance of the Syrian economy in the past couple of years. However, as the staff had pointed out, many of the developments which had led to that improvement had been both temporary and largely due to factors outside the control of the authorities. In the absence of fundamental and sustained policy reforms, much of the benefit from those developments would be lost.

The recent dialogue that had taken place between the authorities and the Bank staff, with a view to clearing Syria's arrears to the World Bank Group, was indeed an encouraging sign, Mr. Powell remarked. He urged the authorities to use the recent improvement in their financial position to clear arrears, both to the World Bank group and to other external creditors. Because a program of arrears clearance would need to be backed by a wide-ranging package of economic reforms along the lines indicated in the staff paper, he asked whether the staff saw a role for the Fund in developing a suitable program, if the authorities chose to go down that path.

Mr. Al-Jasser noted that he had intentionally avoided any mention of military expenditures, to which the staff had devoted a paragraph in its report, in order not to conjure up the Board's nightmarish discussion on such expenditures at its previous meeting. It was unfortunate that the staff found itself in the position of having to make such subjective judgments on military expenditures in Syria being high or low, and that Mrs. Krosby had stated that those resources should be channeled to more productive investment. While that might be desirable in itself, neither he, nor the staff, nor Mrs. Krosby were in a position to evaluate the situation in Syria and to know whether 45 percent, or 10 percent, or 70 percent was the right amount for any country to spend on the military. It was basically because of the difficulty of making those judgments that he believed the staff would be well advised to refrain from trying to evaluate such situations and from making such statements in any paper.

Mrs. Krosby noted that she had deliberately avoided referring to "productive uses"--the staff's words--in light of the discussion at the previous meeting (EBM/91/134, 9/27/91). She had simply said that the redirection of those expenditures would promote additional growth, which was hardly a value judgment.

Mr. Al-Jasser remarked that it was not a matter of whether the expenditure was productive or unproductive, but of the indication that the Fund felt that it was in a position to advise a country that it should transfer resources, if it wanted higher growth. Military expenditure was such a problematic subject that it was difficult to make such judgments. However they were worded, the statements by the staff and Mrs. Krosby were advice to switch expenditures from the military--it was to be hoped, to more productive investments--but the difficulty of making such judgments suggested that the staff in particular would be well advised to refrain from them. Executive Directors, of course, were free to raise any issue, even if it had political connotations, but the staff had to be much more careful to avoid topics or areas that were not within its mandate.

Mr. Mirakhor inquired whether the staff was instructed to seek information on military expenditures, ahead of any decision by the Executive Board to permit it to do so.

The Acting Chairman responded that there had never been anything in the Fund's policies or rules to prevent the staff from discussing or obtaining information on military expenditures, as shown by the fact that so many countries reported it. The issue raised at the Board's previous meeting, in part, was how far the staff should go in assessing, for example, the impact of military expenditures on an economy. As he read the paragraph at the bottom of page 12 and the top of page 13 of SM/91/185, first, the staff was using the word productive in the technical, economic sense, to refer to an expenditure that would increase the potential growth of an economy. Second, he did not get the sense from that paragraph that the Syrian authorities disagreed with the staff view. In fact, the last sentence in that paragraph said that "Syria would welcome the circumstances that would allow devoting increased resources to development of the economy and raising the standard of living of the people." That again was in keeping with the technical concept of productivity as the Fund used it.

At the previous meeting, that term had taken on a broader characteristic, the Acting Chairman noted, and of course, if productivity was defined from the point of view of national security, who was to say that an expenditure was or was not productive? But it was clear from the context that the staff had discussed the matter in the more narrow, technical sense, in the way that had certainly been open to it in the past to focus on any kind of expenditure category that stood out as being significant in the economy, whether it was public sector enterprises or the number of civil servants, for instance. The comments on the paragraph in the staff report, coming as they did on the heels of the Board's discussion of military expenditure, were perhaps reading more into the matter than perhaps had been intended by the staff.

Mr. Finaish said that he had chosen not to raise the point in his opening statement, although of course, Syria, as usual, had cooperated with the staff. The authorities had been asked specific questions, on which they had commented; their attitude as reported by the staff was that "Syria had repeatedly said that it wanted peace to prevail in the region and that it had accepted all of the relevant United Nations security resolutions concerning the Middle East," and that "Syria would welcome the circumstances that would allow devoting increased resources to the development of the economy and raising the standard of living of the people."

However, in addition to making their views clear, Mr. Finaish continued, the authorities had asked him in particular whether the staff was making similar comments in its reports for Article IV consultations with other countries, including certain countries in the region. They had also noted that the staff paper on military expenditure had been circulated after the return of the staff mission; in fact, the question had been raised by the mission even before the G-7 meeting in London at which military expenditure had been an issue.

Mr. Al-Jasser noted that the Syrian authorities themselves had provided the answer to the question--namely, political, geostrategic, security considerations. His problem was whether such answers had a place in staff reports for Article IV consultations. In his view, it was unfortunate that questions and answers on those considerations found a place in staff reports.

The Acting Chairman noted that even prior to the Board's discussion of military expenditures, the staff had been under general guidance--for instance, in the surveillance discussion--to focus on any area in the structure of an economy that had a significant, overall, material impact on the economy. To be sure, in the past, the staff had been more reticent to probe into military expenditures, although he believed that the record would show that many Article IV consultation reports had referred to the level of military expenditures, if not in quite such a specific way as in the report under discussion. At the same time, he did not recall any individual directive to staff to focus on military expenditures. However, in discussing the matter, the feeling had been that if military expenditure had a significant impact on an economy, it was not completely outside the bounds of what could be discussed, or in other words, that the staff was not prohibited from discussing it. It was more in that spirit that the staff was focusing on the issue of military expenditure in the case under discussion.

The staff representative from the Middle Eastern Department added that on many previous occasions, even before the consultation discussions had taken place, the Syrian authorities had investigated in general terms the possibilities of working out a program with the Fund and Bank, and had referred to the issue of the burden of military expenditures as a component which had to be taken into account in evaluating their economic and financial situation. In conducting the 1991 Article IV consultation discussions, the staff had been frank with the authorities, who had been willing to talk about the burden of military expenditures in current expenditures, and had made the statements mentioned in the staff report in explaining under what circumstances they would be able to reduce military expenditures. On the other hand, it was clear from the staff report that the Syrian authorities did not wish to discuss questions of military financing, or provide information on the external military debt and its servicing, questions that were in some sense vital for balance of payments analysis, as the staff had pointed out. But the question was closed, because the authorities had not wished to open it up for discussion.

Mr. Mirakhor said that he would appreciate receiving an indication of other cases of Article IV consultations in which the question of military expenditures had been raised. In addition, if the staff had been reticent to raise such questions in the past, he wondered whether at some point it had received instructions to do so, and, if so, whether any guidelines had been issued on exactly what questions could be asked. If such guidelines were being prepared, he would request that they be brought to the Board for possible discussion.

The Acting Chairman responded that he believed that explicit mention had been made of military expenditures that were taking place at the time of consultation discussions, for instance, in cases such as that of Sri Lanka, which had had to make expenditures on defense. A more systematic survey of such cases could be made. To his knowledge, the staff had never been prohibited from asking about or discussing military expenditures. Of course, the staff was very much aware of the sensitivity of the subject, which, to the extent that it entered into the discussion, sometimes came up when the authori ies themselves referred to the burden arising from unavoidable military expenditures.

In referring to the staff's reticence, the Acting Chairman noted, he had in mind that neither in the case under discussion, nor in any other case, would the staff attempt to second guess or even to express a view that such expenditures were not necessary, given the country's security situation. But where the expenditures did have a material impact on the economy, it was sometimes very hard to keep the issue out of the discussion, in part because the authorities sometimes raised it as a problem they had to deal with.

Some thought would have to be given to the possible need, particularly in light of the discussion at the Board's previous meeting of military expenditure, which had yet to be completed, the Acting Chairman said, to giving the staff some general guidance on what it could and could not take up.

Mr. Posthumus remarked that it would be improper if, as he was being given to understand, the staff mission had taken the initiative to refer to the subject in its report. Without commenting on the specific text and specific situation of the Syrian Arab Republic, he felt that the Board should not be bypassed in that way. Obviously, the staff report had been written long before the paper on military expenditures had been issued, and long before the Board's discussion of that paper, which would continue on the basis of the draft summing up.

Mrs. Krosby said that she did not recall, during the Board's discussion of the staff report for the 1991 Article IV consultation with the United States, any support for her authorities in respect of staff comments on their own military expenditures--in the purely economic sense that if those expenditures were cut back, the United States would have more money to finance its deficit. That clear economic equation had been mentioned by the Japanese chair, once during the Board's discussion of the Article IV consultation, and again during its consideration of the world economic outlook, but without eliciting any response to the effect that the Board was not the place to comment on such matters. Like Mr. Posthumus, however, she looked forward to the draft summing up of the Board's debate on military expenditure as a way to resolve the issue.

The Acting Chairman commented that, indeed, no Article IV consultation with the United States went by without the subject being raised in the staff report. But as he had mentioned, part of the problem with the current discussion was that it was taking place in the light of the Board's preceding discussion of military expenditure. He reiterated that the staff had never been told that it could not discuss defense expenditures, particularly if they had had a significant economic impact or accounted for a large part of government expenditure. There was nothing new in that approach, and it might well be useful to go back over time and look at the cases in which defense expenditures had been discussed.

Mr. Mirakhor said that if the staff had always been under the impression that it could discuss, and report on, military expenditures, including in the context of Article IV consultations, he wondered what purpose the staff paper on military expenditure, and its discussion by the Board, had served. After all, one of the major questions raised in that paper was whether or not the Executive Board thought it proper for those issues to be raised in Article IV consultations and be brought, in staff reports, to the Board for consideration.

In the case of the United States, he had understood that the subject had been raised voluntarily as a point of discussion between the authorities and the staff, Mr. Mirakhor added. He had never thought that the staff had been under instructions to ask questions, during the Article IV consultation with the United States, and to bring the matter to the Board. Nor was he under the impression that the Executive Board could raise a question about the level of military expenditures in a country. The question raised in the Board at EBM/91/134 was whether or not, in fact, it was within the purview of the Board to suggest to the staff that it could discuss the subject in Article IV consultations, and in its report, for discussion in the Board. Had he known that the United States had engaged involuntarily in that kind of discussion, he would have raised the issue at the time.

The Acting Chairman remarked that as he had interpreted it, one of the objectives of the staff paper on military expenditure was to give greater impetus to the possibility of the staff exploring the area in cases of large military expenditures even if the authorities were not volunteering the information or the discussion. Certainly, Directors had disagreed on whether the staff could be required explicitly to focus on military expenditures across the entire membership. In the current environment, the staff would have more authority, in a sense, if the proposals in the staff paper on military expenditure were approved, to address the issue of military expenditures, which was the purpose of those proposals.

Military expenditures had not been excluded from discussions in the past, the Acting Chairman reiterated. Obviously, the area was recognized as a very sensitive one; whether it remained so had been part of the Board's discussion at its previous meeting, a whole host of developments, having suggested in current world circumstances that more attention should be focused on the economic impact of military expenditures. Another motive underlying the staff paper had been to put that concept forward.

Mr. Posthumus considered that it would be better to continue the discussion on the basis of the draft summing up of the Board's preceding meeting. At the same time, the report in the Washington Post that day, referring to an announcement by a senior IMF official of a new Fund strategy proposing mutually agreed global defense spending reductions--and press reports of course were not all true, but usually they had some truth to them--left him with a feeling that the Board was not being made aware of what exactly was happening. That situation should be discussed, and Mr. Mirakhor's pertinent questions should be taken up, but not, he believed, in the context of the Article IV consultation with the Syrian Arab Republic.

The Acting Chairman noted that the summing up of the Board's discussion at EBM/91/134 should be available in time for Directors to take it up at their next meeting, when the general topic could also be considered.

Mr. Mirakhor commented that he had not raised the question in his statement, and had had no intention of detracting from the Board's consideration of the staff report for the Article IV consultation with the Syrian Arab Republic.

Mr. Al-Jasser said that before the issue was closed, he wished to note that there were many topics that the staff was not precluded explicitly from discussing but that it stayed clear of in the knowledge that they did not fall under the Fund's main responsibilities. Military expenditure was one of those topics. His second point was that from his own recollection, it was only in exceptional cases that military expenditures had been discussed, basically because the authorities of certain countries wanted to use them as an explanation for some of their problems. Thus, it was not for the staff to volunteer to countries that they should explain their military expenditures; it was for those authorities that wanted to do so to raise the issue. Presumably, that had been the case for the United States, which was why he had not raised the general issue of the discussion of military expenditure at that time. Exceptions proved the rule, which in his view was that the staff should stay clear of the subject, unless the authorities chose to discuss it, when the staff would decide what was proper for inclusion in the report and what was improper. But for the staff to volunteer, or to take up the subject, was a different matter.

The staff representative from the Middle Eastern Department, in response to Mr. Powell's inquiry about whether there had been any discussions with the authorities of a possible role for the Fund and the Bank in formulating economic reforms, said that the Syrian authorities had on several occasions, over a number of years, inquired as to what would be the main outline of a package of economic reforms. Both Fund and Bank staff had supplied the authorities with an indication of an outline and had discussed the matter during consultation discussions or on other occasions. No further steps had been taken, beyond those initial probing questions.

Mr. Finaish said that he was grateful to Directors for their views and advice, which he would convey to the authorities. He had sensed from the comments that had been made that further and faster structural reform was desirable in Syria. He agreed, as no doubt would the authorities, that more should be done. At the same time, what had already been done should not be underestimated, as some Directors had indicated. The authorities had shown great determination in reducing expenditures and mobilizing domestic revenues, including through substantial price adjustments in the past few years. It was correct that a number of prices were still determined administratively, but the adjustments in input prices and output prices as well as the exchange rate had led to a significant reduction in distortions.

Mention had been made of a more dramatic approach by the authorities to reform, Mr. Finaish continued, but that was a question of judgment on which views could differ. It was clear that the authorities had taken the approach that they had because they felt that it was more feasible and less disruptive than shock treatment, particularly if the financing was not assured. But what was important, and not only in the case of Syria, was the evidence of steady and sustained movement in the area of reform. The speed, of course, was not only a purely economic question, but also one of social considerations.

As a number of speakers had noted, Syria had great potential, Mr. Finaish observed. It had a well diversified resource base, a large agricultural sector, a number of industries, oil, great potential for tourism, a large skilled labor force, an entrepreneurial class, and a recognition, particularly in the recent period, that foreign investment was important. The new investment law was an indication that the authorities were paying a lot of attention to the latter.

Steps also needed to be taken to improve data, Mr. Finaish agreed. That was perhaps one of the areas for greater cooperation between the Syrian authorities and the staff.

Enough had been said on the question of defense spending, a subject to which the Board would return, Mr. Finaish commented. But the Board's discussion at EBM/91/134, and during its consideration of the staff report for the Article IV consultation with the Syrian Arab Republic, showed that the matter was a complex one that would have to be looked into with great care. The Syrian authorities had already asked whether other countries were treated in the same way. For example, they had noted that another staff report--which had been issued on September 13, after the issuance of the report under discussion on September 4--on a country in the region that was represented by Mr. Posthumus, had not included the same advice or judgment even though military spending in the country in question was very high.

In the future, even if the Executive Board was to agree that the subject could be raised, its complexity and sensitivity would have to be foremost in mind when it came to the implementation of any such new policy, Mr. Finaish concluded. He recognized that the staff had touched on the question in other reports in the past, although not in every case. His only point was to stress the need for care in how the problem should be handled.

The Acting Chairman made the following summing up:

> Directors were in general agreement with the staff appraisal. They noted that the authorities had taken a number of measures to improve private sector confidence, to contain demand pressures through changes in administered prices and restraint in government expenditures, and to move the exchange rate a step in the direction of a more realistic level. These efforts, coupled more recently with some exogenous factors, including higher oil prices and substantial aid receipts in the wake of the Middle East crisis, had led to an apparent easing of Syria's severe financial constraints.
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> However, Directors viewed the recent developments as essentially temporary, and pointed to the long-standing structural weaknesses and financial imbalances that have characterized the economy. In the opinion of Directors, these weaknesses and imbalances called for fundamental reforms aimed at the decontrol of economic activity, including further steps toward a broad liberalization of the exchange and trade system, in order to foster a climate of confidence in the economy.
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> Directors noted the recorded improvement in the budgetary position of the Central Government, turning gradually from large recourse to domestic bank financing in 1986 to small surpluses in

1989-90. At the same time, however, they observed that only a small fraction of the total cost of subsidies was included in the budget. In addition, the financial position of the public sector as a whole continued to be weak, as evidenced by the large amount of borrowing from the banking system. In these circumstances, it was urgent that the authorities take additional action to increase public sector saving, particularly through additional steps to strengthen revenues and through measures to impart greater efficiency to the management, and thus improve the financial position, of the public enterprises. The authorities were also encouraged to seize on every opportunity to reduce the weight of the public sector and shift the emphasis to private sector entrepreneurship and development.

In the area of financial intermediation, Directors recommended more active and market-oriented monetary and credit policies, stressing the importance, in particular, of an early move to positive real rates of return on financial assets.

Directors observed that medium-term analysis indicated that the balance of payments remained fragile. The recent improvements, in part, were dependent upon near-term factors, such as the surge in exports to the Soviet Union. As this development was basically the counterpart of debt repayments effected through the bilateral account, it did not help the country's foreign exchange position in a fundamental way. In these circumstances, Directors were of the opinion that it was essential for Syria to press ahead not only with a program of domestic economic liberalization, but also with the opening up of the economy through the unification of exchange rates at a level reflecting underlying market conditions and the elimination of the fundamental economic and financial imbalances facing the economy. Directors saw the recent relative improvement in Syria's financial position as providing an excellent opportunity for the authorities to build on the liberalization measures that had already been taken to proceed with such broad-based adjustment effort.

Directors expressed concern with the continued existence of external payments arrears. Stressing the importance of Syria maintaining access to international financing, they urged the authorities to work toward early settlement of external payments arrears, with particular emphasis placed on clearing those to the World Bank. In that context, the recent discussions between the authorities and the World Bank were welcomed.

To facilitate the process of economic analysis and policy formulation, the authorities were encouraged to work actively toward improving the quality, coverage and timeliness of data.

The next Article IV consultation with the Syrian Arab Republic will be held on the standard 12-month cycle.

The Executive Board took the following decision:

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

2. Syria continues to maintain restrictions, as described in SM/91/185, on payments and transfers for current international transactions in accordance with Article XIV, Section 2, except that the multiple currency practices and exchange restrictions, described in SM/91/189, including those evidenced by external payments arrears, are subject to Fund approval under Article VIII, Sections 2(a) and 3. The Fund encourages the authorities to take the necessary steps for the elimination of arrears on current payments and transfers, to unify the exchange rates, and to liberalize other exchange restrictions on current payments and transfers. The Fund urges that the restrictive features of a bilateral payments agreement with a Fund member be eliminated as soon as possible.

Decision No. 9830-(91/135), adopted
September 30, 1991

2. MALAWI - ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REQUEST FOR FOURTH ANNUAL ARRANGEMENT

The Executive Directors considered the staff report on the request by Malawi for a fourth annual arrangement under the enhanced structural adjustment facility (EBS/91/153, 9/10/91; and Cor. 1, 9/11/91), together with a policy framework paper (ED/91/258, 9/4/91). They also had before them a statement by the Managing Director.

The Managing Director's statement read as follows:

There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Committee of the Whole of the Executive Directors of the Bank and IDA in their meeting on September 17, 1991:

Executive Directors encouraged the Government of Malawi to continue its effective implementation of comprehensive structural adjustment measures. Given Malawi's vulnerability to exogenous shocks, in particular, uncertainty associated with opening of the external transport bottlenecks, they recognized that the development strategy was optimistic but deserving of continued BOP support and debt relief. Directors emphasized the need to improve the environment for private investment and initiative so as to achieve the objectives laid out in the policy framework paper. They stressed the importance of implementing prudent fiscal policies for assuring adequate resources for the private sector and the need to improve civil service morale and interministerial communication.

Directors encouraged the Government to increase the momentum of the implementation of its poverty reduction strategy. In this regard, several speakers underscored the critical importance of increased budgetary allocation to the social sectors. They expressed concerns about the rapid population growth in Malawi and recommended further determined action to contain population growth.

Support to smallholders needs to remain at the center of Malawi's agricultural strategy including the proposed pace of expanded access to high value cash crops though some Directors questioned the appropriateness of the timetable for elimination of the fertilizer subsidy. Directors noted the serious environmental problem facing Malawi and underlined the importance for rapidly developing energy conservation measures.

While noting progress made in restructuring key elements of the parastatal sector, Directors noted the importance of enhanced efficiency and performance of the rest of the sector such as transport.

Mr. Mwananshiku made the following statement:

Following the completion of three successful annual arrangements, Malawi would be the first country to avail itself of a fourth-year arrangement under the enhanced structural adjustment facility (ESAF). Owing to the importance of the reforms being implemented, the country would benefit greatly from continued Fund assistance. It would provide the opportunity to deepen structural reforms, while consolidating the substantial gains already made in sustaining a high rate of economic growth under relatively stable conditions.

Malawi's request broadly meets the conditions stipulated in the guidelines adopted during the last review of operations under the structural adjustment and enhanced structural adjustment facilities (SAF/ESAF). In the first instance, the amount of assistance being sought is at a sharply reduced annual level of access when compared with the resources made available under the three-year arrangement. The use of Fund resources will help to catalyze external donors' assistance in support of Malawi's adjustment efforts and add to a cushion of reserves that should give protection against adverse exogenous shocks.

Second, the use of resources under the ESAF is compatible with the objective of reducing the country's debt-service burden, which remains high. Although much has been achieved in the last three ye -s toward meeting this objective, I would strongly endorse the view of the World Bank Board, as outlined in the Managing Director's statement, that Malawi also deserves debt relief. Undoubtedly, this view was in response to the staff's cogent comments in the policy framework paper to the effect that Malawi could benefit from any future debt relief initiatives even though the country has been able to meet its debt payments on time and is on the path to external viability. Malawi was not, however, seeking debt relief at the present time.

When the ESAF-supported program was adopted in 1988, the basic objective was to reduce internal and external imbalances and lay the basis for sustained economic growth. The macroeconomic targets set out under the program have been largely met even though the external reserve objective has not been attained. Growth performance has been better than originally predicted, and inflation has decelerated markedly, while the fiscal deficit has been reduced by slightly more than anticipated.

Despite these significant achievements, much remains to be done. As the Board has often acknowledged, Malawi's economy remains basically weak and vulnerable to exogenous shocks, especially in view of the increasing openness of the economy as a result of the import liberalization measures. More recently, the closure of the Tete route in Mozambique has resulted in the intensification of transportation problems and an increase in costs, substantially raising the c.i.f. component. In consequence, the external current account outcome remains uncertain.

The authorities have also recognized the need to make further progress in structural reforms in order to enhance economic efficiency and flexibility so that the economy may be better able to respond to external shocks in the future. Thus far, much has been achieved in import liberalization, the reform of the parastatals, the financial sector, and the tax system. The basic intention in the 1991/92 program is to raise productivity in agriculture and manufacturing, to further reduce the rate of inflation, strengthen fiscal performance, expand parastatal reform, focusing on Malawi Railways in particular, and ensure a viable balance of payments position. In view of Malawi's excellent track record and the comprehensiveness and strength of the measures already being implemented, I am confident that the macroeconomic targets set out in the program will be attained. The policies to achieve those objectives have been correctly formulated in a medium-term framework and are clearly outlined in the updated policy framework paper for 1991/92-1993/94, as Malawi will require continued support from the World Bank and other donors.

As already indicated, Malawi has met the test of a strong track record in program implementation, although not without problems. It will be recalled that the stage for the successful completion of the three-year program was set by an earlier stabilization effort that was also preceded by a shadow program. In all these initiatives, the authorities made a determined effort to implement the measures agreed upon. Under the third annual arrangement, for example, the authorities have been able to follow through the measures recommended by the Fund, as clearly shown in Tables 2a and 2b in the staff report.

In order to avoid possible derailment of the program through unforeseen external shocks, different scenarios have been developed. At the same time, contingency measures have also been specified to allow the authorities to respond promptly. Already, the staff has correctly observed that in the current fiscal program, revenue performance during the first quarter of 1991/92 has been lower than anticipated in the budget. This outcome is linked to weaknesses in surtax administration and an increasing use of bonded warehouses by importers to avoid immediate payment of duty and surtax. Accordingly, action has been taken to improve surtax administration. All goods in bond which had been kept for over a period of one year are now liable for duty and surtax. Following the expansion of the surtax to include services, the credit system has been modified to ensure additionality in revenue. As a result of these measures, the authorities have indicated that revenue receipts in the second quarter have improved considerably, with collections now running at about MK 6 million above the program average. The authorities have emphasized their willingness to implement additional measures, if necessary.

In conclusion, Malawi deserves further support of the Fund through the fourth-year arrangement under the ESAF in order to underpin the substantial progress achieved thus far. As already pointed out, since the guidelines elaborated during the review of SAF/ESAF operations have been broadly satisfied, I would urge Directors to support the proposed decision.

Mr. Wright made the following statement:

Let me say at the outset that I welcome this fourth-year arrangement, the first of its kind to come to the Board. I have no doubt that Malawi qualifies for an additional ESAF arrangement, while the reduced level of access seems to be appropriate. Malawi's track record of adjustment has generally been good, and the adjustment undertaken so far seems to have played an important part in mitigating the effects of the crisis in the Middle East. Nevertheless, there is still some way to go in the area of structural reforms, and, as Mr. Mwananshiku points out in his thoughtful statement, there remains a need to consolidate and extend the adjustment process. By the end of the fourth-year arrangement, Malawi should be in a stronger position to weather the shocks to which it remains vulnerable.

Once again, there is a good deal to commend in Malawi's performance under its ESAF program. Fiscal and monetary policies have generally been tight, the program of structural reforms has been maintained, and growth has been strong. Moreover, the adjustment effort has been sustained, despite a generally inhospitable environment of drought, transport disruptions, the indirect effects of the Middle East crisis, and an influx of refugees.

Some developments mentioned in the staff report were less encouraging. In the fiscal area, there was a considerable shortfall in domestic revenues which helped fuel a sharp surge in monetary growth. The authorities should take careful note of the staff's comments on the need to strengthen tax administration and limit the use of export incentives, a point reinforced by the flat revenue projections for the years ahead. It was not clear from the staff paper whether the tax wedge on petroleum products, which was compressed by the incomplete pass-through of last year's oil price increase, has yet been restored. Perhaps the staff could reassure me on this point.

Delays in grant flows also contributed to the weaker revenue performance. Such delays are not new, and I must say that I am not convinced that they were entirely beyond the authorities' control. For example, the paper refers to delays in reaching agreements with the World Bank, which suggests a reluctance to implement structural reforms in certain sectors as rapidly as the Bank would wish.

Current expenditures seem to be under firm control. The authorities should focus increasingly on the composition of public spending. To date, macroeconomic stabilization in Malawi has had only a modest impact on the incomes of the majority of the population. There needs to be a clearer focus on the related objectives of poverty reduction and growth. In particular, resources need to be freed for investment in physical and human capital. I hope that the authorities will heed very carefully the World Bank's advice in this area.

In the monetary sector, I applaud the removal of direct controls and the maintenance of positive real interest rates. While the issue of Bank of Malawi bills was a welcome innovation, their yield has not so far been market related and auctions have been too limited in scale and penetration. I share the staff's desire for more rapid progress in this area and hope that the authorities will not hesitate to ask for technical assistance to develop techniques of indirect monetary control.

The adoption of a fixed exchange rate seems to have helped reduce inflation, though that battle is still far from over. Adjustments in the peg have become smaller and less frequent, which should reinforce its credibility. The background paper on recent economic developments for the 1990 Article IV consultation made clear that the deterioration in competitiveness suggested by the staff's real exchange rate index is more apparent than real. Nonetheless, I would be interested to know more about the study of external competitiveness, which constitutes a performance criterion under the new arrangement.

Chart 1 in EBS/91/153 shows a very encouraging pattern over the past two years, with an improvement in relative price performance offsetting a nominal appreciation to produce broad stability in the real exchange rate. But I would be interested to know how this picture might be altered, if Brazil were excluded from the comparatios.

The major unfinished item on the agenda of structural reform is promoting effective competition and the private sector. Malawi's economy remains characterized by a high degree of concentration and monopoly power. There are several ways in which this task should be tackled.

First, the momentum of public enterprise reform should be maintained by tackling the remaining problem cases, notably Malawi railways--where I am pleased to say that the United Kingdom is providing assistance--and the Post Office Savings Bank. The emphasis then needs to shift to divesting the profitable parastatals, preferably in ways which stimulate competition; I wonder whether the staff could tell us how far this process is likely to go in shrinking the parastatal sector.

Second, I hope that the review of trade taxes will lead to an early and substantial reform of the structure of tariffs, aimed at lower and more uniform rates. Third, the private sector cannot be expected to flourish without a fully transparent legal framework and accountable public institutions; I was surprised that more was not made of this in the staff report.

Finally, more needs to be done to improve the relative position of the agricultural smallholder. This is perhaps the key to broad-based growth and poverty alleviation. Now that restrictions have been lifted on the production of high-value crops, such as burley tobacco, smallholders require proper price incentives and improved marketing channels, in addition to the measures described in the staff report. I am well aware that this will require taking on vested interests, but the authorities cannot afford to adopt an equivocal stance. I was pleased to see from the policy framework paper that they have committed themselves to a phased elimination of the fertilizer subsidy.

However, I was struck by the rather heavy dependence on tobacco production over the medium term. The response to import liberalization has generally exceeded expectations, but there is little evidence of export diversification. While I note that the outlook in the world markets for tea and coffee in particular is not propitious, can the staff reassure me that impediments to the production of agricultural products other than tobacco are being fully addressed? This is clearly essential if production is not to become exceedingly concentrated.

Looking lastly at the external prospects, the debt-service position has improved markedly and, provided that the authorities retain the confidence of the donor community, external viability looks fairly secure.

The paper makes very clear how sensitive Malawi's prospects are to the security situation in the region, and in particular to the restoration of transport links to its main markets. The closure of the Tete route through Mozambique, which carried up to 60 percent of the country's foreign trade, increased the c.i.f. margin to 41.5 percent. I see that the program assumes an early reopening of this route and the opening of a northern corridor through Tanzania, which together will reduce the c.i.f margin to 35 percent. I was unclear, however, what basis the staff had for assuming that the c.i.f. margin would fall further to 29 percent by 1997. Even the staff's supposedly pessimistic scenario assumes a c.i.f. margin of 30 percent. It would have been useful to illustrate the consequences of the margin stabilizing at 35 percent. Perhaps the staff could comment on that.

With these remarks, I can support the draft decision and wish the authorities well in their endeavors.

Mr. Dognin made the following statement:

We would like to commend the authorities for their good track record of policy implementation under the first three-year ESAF arrangement. The successfully implemented stabilization process allowed for a certain stability of the nominal exchange rate and contributed to re-establishing confidence in the Malawi economy. However, recent slippage in revenues could undermine both the domestic savings effort and external competitiveness. Therefore, the adjustment process should be strengthened even though a great part of the economy's fragility is due to its landlocked situation and external transportation problems.

Against this background, we share the thrust of the staff's report on the need to consolidate and extend the adjustment and reform effort in Malawi.

To comment on some specific issues, first, with respect to macroeconomic policies, it is indeed essential to maintain the tax collection effort and phase out tax exemptions in order to ease the budget and prevent any consequential inflationary pressure from resurging, as occurred in early 1991. We particularly welcome the quick response of the authorities to the continuing weak revenue performance in the first quarter of 1991. The revenue-enhancing measures adopted in August clearly demonstrate the authorities' commitment to pursue the stabilization process. On the expenditure side, it is worth noting that the successful restructuring of the main parastatals and their strengthened financial performance will allow for more public sector savings in line with the authorities' intention to pursue rigorous demand management. In this regard, we encourage the authorities not to relax wage policy.

Turning now to monetary and credit policy, it is indeed essential to maintain the present restrained monetary stance. The shift in credit from the public to the private sector, while maintaining positive real interest rates, should continue to guide the authorities' monetary policy with a view to achieving growth, inflation, and balance of payments targets. The ongoing process for switching to indirect mechanisms of policy monitoring is welcome, and we endorse the staff's recommendations with regard to the need for accelerating the diversification of financial instruments in order to enhance financial intermediation and facilitate the shift to indirect monetary control.

Concerning structural reforms, we commend the authorities for having implemented the restructuring of the parastatal sector, mainly the rehabilitation of the Agricultural Development and Marketing Corporation (ADMARC). The authorities should now strive to maintain the momentum of the divestiture program of ADMARC. Given the constant drain of Malawi Railways on the Central Government's budget and its importance in the transportation sector, we welcome the authorities' intention to formulate a comprehensive action plan to restructure this company by March 1992.

We would also like to underline and support the emphasis in the policy framework paper on reforms designed to increase output and productivity in the smallholder agricultural sector. Such a policy is indeed a priority to alleviate widespread poverty and also subdue inflationary pressures that arise with every crop shortage, especially in the maize sector.

Turning to the external sector, we endorse the staff's assessment of Malawi's increased vulnerability and the need to consolidate and extend the adjustment and reform effort. As a matter of fact, the import liberalization program and the additional transportation costs arising from the closing of the Tete route have made the external position fragile. Meanwhile, the diversification of the economy that should stem from the ongoing structural reforms and stabilization process has not yet materialized. Therefore, it is clear that the return to external viability has been temporarily delayed. The medium-term outlook, as rightly pointed out by the staff, remains highly contingent upon the resolution of the transportation difficulties.

Against this background, we endorse the authorities' intention to rely on demand management policies to pursue their nominal fixed exchange rate strategy that has proved so far to be successful in maintaining the external competitiveness of the economy.

To conclude, despite adverse exogenous factors, Malawi has demonstrated its commitment to strengthen the adjustment and reform effort. Given a strong past record of policy implementation, we are confident that Malawi will remain on track to external viability, a favorable outcome that could indeed be achieved earlier in a more favorable regional situation.

With this consideration in mind, we deem a fourth-year arrangement under the ESAF to be appropriate in the case of Malawi. We therefore support the proposed decision and wish the authorities every success in their future endeavors.

Mr. Galan made the following statement:

During the past three years under an ESAF arrangement, Malawi has achieved remarkable progress toward both macroeconomic stability and structural reform. The inflation rate has decreased substantially, GDP has grown at a high rate, while the nominal exchange rate has been maintained. The Malawi authorities also deserve to be commended for the substantial progress made in the process of structural adjustment, and for a strong record of policy implementation. The opening of the economy makes it more vulnerable to external shocks, which requires the continuation of the adjustment efforts and the consolidation of their structural reforms.

We are very pleased to note that imports are now free of restrictions and that a liberal policy of foreign exchange approval has been implemented. We welcome the remarkable progress on the structural reform of public enterprises, which has resulted in an improvement in profitability. However, intensified efforts should be made in the case of Malawi's Railways; in order to reduce its significant losses, the authorities' intention to develop an action plan by March 1992 aimed at alleviating its financial difficulties is a much-needed step in the strengthening of public finances.

We welcome the progress made in the structural reform of the financial sector and the decision of the authorities to maintain positive real interest rates. The introduction of auctions by the Reserve Bank of Malawi of treasury bills and an enhanced role for the discount rate will contribute to a better control of monetary aggregates, particularly in view of the higher than desirable monetary expansion observed in response to a weakening fiscal position. We endorse the staff opinion that, notwithstanding the significant policy achievements under the three annual arrangements, macroeconomic structural adjustment policies need to be strengthened and carried forward. In this regard, I would like to focus on the fiscal policy stance, export diversification, and monetary control.

With regard to fiscal policy, I will concentrate on wage developments, the vulnerability of the tax system to external shocks, and government savings. First, although we are aware of the importance of competitive wages in the public sector, wage adjustment must be a part of a comprehensive program aimed at increasing productivity, not only by abolishing unneeded positions but also by developing training programs.

Second, the tax system is still too vulnerable to external shocks, calling for a further broadening of the internal tax base and elimination of the remaining tax exemptions, in the context of structural tax reform. We welcome the authorities' commitment to carry out the final phase of the tax reform program.

Another source of concern is that little improvement in government savings is shown in the fiscal current account. Given Malawi's low per capita income, the achievement of positive government savings is important, because of the urgent need to increase investment, both in human capital and in physical infrastructure.

The less than promising response of nontraditional exports is also a matter of serious concern. In this regard, it is important that the authorities make further progress in improving institutional arrangements for exports.

We welcome the authorities' intention to widen the use of fiscal and investment incentives within the margins allowed by revenue targets. Careful monitoring of the exchange rate should also be maintained, in order to avoid losses in external competitiveness. Appropriate fiscal and monetary policies must support the basic exchange rate strategy.

We welcome the measures taken in order to enhance monetary control. However, the situation observed in June 1991 must not be allowed to reoccur in the future. In this regard, although we recognize the temporary need to absorb liquidity by means of increasing reserve requirements, the use of more market-oriented instruments should be intensified. In this respect, we would appreciate comment from the staff on the possibility of issuing treasury bills, instead.

Finally, we are very pleased to note that Malawi's economy has attained the strong conditions needed to manage balanced growth with external viability. We commend the timely manner in which Malawi has always met its debt service obligations, and we hope that the projections for financing from the Fund not being needed after the expiration of the current program will become a reality We also urge the Malawian authorities to strengthen their efforts to eliminate poverty and to extend the benefits of the success of the program to the most needy.

With these remarks, we support the proposed decision and wish the Malawi authorities well.

The staff representative from the African Department said that the tax on petroleum currently approximated 30 percent. As a result of the most recent increase of 5 percent in petroleum prices as of August 31, payment to the Petroleum Stabilization Fund would be approximately 35 percent in ad valorem terms. The amount received, MK 12-15 million, was in line with the program assumption; indeed, the price increase had had to be made before the program came to the Board.

On the study of external competitiveness, it had seemed useful for the work to be done--with some assistance--by the authorities themselves, rather than by outsiders, the staff representative explained. There were several components to the study: first, to inventory the relevant data on unit labor and other costs in the export sector; second, on that basis, to look at recent trends in unit labor costs and prices in the key export sectors relative to those of major trading partners; and third, to look, as Mr. Wright mentioned, at the various permutations of the real effective exchange rate, taking into account both relative consumer prices and unit labor costs. One element to consider was the appropriateness of Malawi's existing basket, in the light of the structural reforms that had taken place, to see whether or not adaptations might be warranted, and, if so, what the implications would be for the nominal exchange rate. As far as Brazil's inclusion in the comparator was concerned, the rapid price increase alongside fairly rapid movement in Brazil's exchange rate broadly speaking canceled each other out.

Structural developments and policies in the area of public sector management were dealt with somewhat more fully in the policy framework paper, the staff representative noted. It was an area of operation in which, of course, the World Bank was closely involved and was providing credit.

As for whether there were any structural or other impediments to the growth of nontraditional output and exports, the staff representative went on, a certain amount of attention had been diverted away from some of the initiatives that had been taken, merely by the virtue of the strength of the tobacco market. The midterm review had taken place three months before the tobacco auction, and the market had proved to be much stronger than foreseen. Moreover, one objective of the structural reform being supported by the World Bank had been to open up tobacco production to smallholders, whose output had been increasing very rapidly. For the year ahead, the projection was not only for a sizable increase of more than 20 percent in the tobacco price, but also an increase of 10 to 12 percent in volume as well.

There still were structural impediments to be removed as part of the process of export diversification in Malawi, the staff representative added. It was not simply a question of financial incentives. The necessary measures would largely affect the agricultural sector, and the smallholder sector in particular. In addition to technical assistance to increase the use of fertilizers, legislative impediments to new investment activity in Malawi would have to be removed. That was why the World Bank was supporting, under a new loan, a number of efforts to deal with such issues as land leasing arrangements, zoning requirements, and many other traditional legal impediments to investment. In some cases in the past, investment applications had languished for as long as four years. The objective of the new loan was to open up the investment process and create a class of entrepreneurs, starting at the smallholder level. Only through that process would genuine export diversification occur.

Until major problems were encountered with transportation difficulties, the c.i.f margin had been running at about 29-30 percent, the staff representative explained. In the scenarios for medium-term growth and development and the balance of payments implications, it had to be borne in mind that the c.i.f margin had a major impact which would, however, be most difficult to compute. The restructuring of Malawi Railways should have a beneficial affect on the c.i.f. margin in the future. A major transportation study by consultants, which would shortly be in the hands of the authorities, set out the broad thrust of the reform program, which the staff hoped the authorities would immediately build into an action plan. If action was taken by 1993-94, the economic subsidy to the railroads would be about 1.5 percent of GDP--roughly the same amount that was being spent on primary health care, or half as much as was spent on education. That was why the formulation of a restructuring plan for Malawi Railways had been brought into the program as a benchmark.

The pressure to increase high-quality recurrent expenditure in Malawi was considerable, the staff representative observed. Guided by the external donors and with their support, the authorities had actually adopted quantitative targets for increasing expenditure in parts of agriculture, primary and secondary education, and primary health care and health prevention. Looking at the weight of those expenditures, together with that of interest payments, in recurrent expenditures, the possibility of cutbacks was limited. The aim was to ensure the success of the measures that had already been taken to strengthen the yield of the revenue system by approximately 6-10 percent of GNP. In a sense, the public sector was enhancing the private sector's own savings effort by taking the equivalent of about 2 percent of GDP of the counterpart from imports to retire its own obligations with the central bank. The private sector thus had greater access to credit, which in some sense might also enhance its capacity to save in the future.

In developing a more market-oriented package of monetary instruments, the staff representative noted, the Reserve Bank of Malawi was currently benefiting from considerable technical assistance. For a long time, the idea had been to have a market-based interest rate mechanism based on the auction of treasury bills. However, there was a great need to develop a demand for those instruments outside the Reserve Bank of Malawi. The staff had talked to the authorities about shifting in the future toward treasury instruments and increasing the various maturity ranges available to achieve a more desirable package of instruments.

Mr. Esdar stated that the authorities were to be commended for the substantial progress achieved under the ESAF-supported program. Malawi's success demonstrated that despite an unfavorable external environment, strict implementation of, and decisive adherence to, an adjustment program could restore balance of payments viability and sustainable growth. However, in order to maintain the momentum of the reform process, it was important to continue to implement prudent economic and structural policies. In that regard, he welcomed the willingness of the authorities to cooperate further with the Fund, and he fully agreed with the analysis and policy recommendations outlined in the staff paper. In particular, given the still high inflation rate, he fully endorsed the need for restrained monetary policy and extended reform in the financial sector.

Having said that, he had only two additional remarks, Mr. Esdar said. First, he welcomed Malawi's exchange rate policy as it demonstrated the intention of the authorities to reduce inflation by means of an adequate domestic policy. However, he was somewhat confused to note in the staff paper that Malawi's currency had appreciated in nominal effective terms in spite of the nominal exchange rate anchor. That posed the question whether the basket of currencies to which the Malawi kwacha was pegged was the appropriate anchor to safeguard Malawi's competitiveness. Perhaps the staff could explain the criteria that guided the selection of currencies for the basket.

Second, some doubts remained about whether Malawi was an appropriate candidate for a fourth-year arrangement under the ESAF, Mr. Esdar noted. According to the Chairman's summing up of the recent review of the ESAF, fourth-year arrangements should be approved only on an "exceptional basis." He was surprised to see that the first possible case was already "the exception." In addition, he had not found a convincing argument for the extended use of Fund resources on the grounds that it was crucial for a successful continuation of the program. The medium-term scenario illustrated that Malawi would not depend on exceptional financing in the coming years. Furthermore, given the level of external reserves of SDR 115 million in 1991 and SDR 130 million in 1992, the amount of the requested arrangement--SDR 11 million--did not seem to be a critical component for the buildup of reserves.

He would have expected those questions to be discussed in more detail in the staff paper, Mr. Esdar commented. However, having said that, and given that the Fund's exposure would decline over the program period, he could in the end support the proposed decision.

Mr. Tanase said that he supported the proposed decision on the grounds of the already introduced policy measures and taking into account the future need for adjustment.

The budget deficit, excluding grants, had declined from 6.8 percent of GDP in 1989/90 to 5.6 percent in 1990/91, Mr. Tanase noted, but it was projected to increase to 6 percent in the current fiscal year. Over the next two fiscal years, the overall budget deficit would continue to decline, but at a very slow pace. He recalled that many Executive Directors, including his chair, had asked on previous occasions for the introduction of strict controls on expenditures, especially current expenditures. Like other speakers, he believed that that request was still valid, if a major improvement of the fiscal position was to be achieved.

More closely connected with the problem of the overall deficit, he wished to raise the problem of the loss-making enterprises, Mr. Tanase commented. The most striking example was Malawi Railways, which in 1990/91 had experienced its third successive year of losses. The Government was aware of the situation and was trying to increase the efficiency and to reduce the costs of that parastatal company. He fully agreed with those efforts, but he wondered whether some tariff adjustment could not be envisaged. He understood from the policy framework paper that by March 1992, a restructuring plan would be developed for that company. His impression was that the financial situation of Malawi Railways required faster action.

Finally, he had been struck by the staff's computation of the level of gross official reserves in terms of months of nonmaize imports, Mr. Tanase said. The standard practice in staff papers was to refer to months of total imports. The methodology used by the staff in Malawi's case could be misleading, because it gave a rosy impression. He would appreciate any comments the staff might have on that problem.

Mr. Ishikura made the following statement:

> We are pleased to see the substantial progress made so far in both macroeconomic and structural adjustment during the three years of the ESAF arrangement. We strongly commend the authorities' adjustment efforts, which made this successful achievement possible.
>
> Moreover, the authorities' intention to continue the economic adjustments is also commendable. As to the requested fourth annual arrangement under the ESAF, we can go along with the proposed decision; however, like Mr. Esdar, we cannot help having some doubts about the need for the additional use of the ESAF.

First of all, in view of the favorable balance of payments outlook referred to on page 19 of the staff report, the financing need does not seem so serious as to warrant use of ESAF resources. Even without this fourth-year arrangement, if appropriate policies are continued, it seems that the balance of payments situation will be sustainable and, in the medium term, approach the target of foreign exchange reserves at a level equivalent to four months of imports.

Even if Malawi needs further support from the Fund, I wonder whether the financing need could not be met from general resources. We recognize Malawi's need for concessional terms for borrowing in view of the low per capita income. However, the provision for a fourth-year arrangement should not be applied too easily; Malawi has already benefitted from the limited available concessional resources.

Second, we are still hesitant to grant a fourth-year arrangement in general that is not related to the Middle East crisis or some exceptional, adverse exogenous factor. In this case, the expected financing needs have emerged mainly as a result of the liberalization of imports and the payments system as well as the closing of the main route for foreign trade. While the latter can be thought of as an exceptional exogenous factor, that part of the additional financing need that has come from the import and payments liberalization should be compensated to the greatest possible extent by appropriate demand-management and incomes policies, not by relying on the use of additional ESAF resources.

We recall that the proposal for fourth-year ESAF arrangements was considered and approved in the context of the Fund's response to the Middle East crisis. While such arrangements are not necessarily limited to the countries adversely affected by the crisis, in our view at least, a fourth-year arrangement should be approved only in exceptional cases where the additional financing needs are due to exogenous factors beyond government control.

With these remarks, we will go along with the proposed decision in this case, but, at the same time, we strongly hope that the staff will maintain a strict stance on the use of the limited ESAF resources.

Mr. Fernando considered that the authorities of Malawi were very much to be commended for the sustained implementation, with Fund support, of a program of stabilization and reform. Even if one could always argue for a faster pace, the progress in structural reform was particularly noteworthy. The steps taken to improve the finances of public enterprises were not merely important support for budgetary reform and for enhancing domestic savings, but augured well for an effective program of privatization. The agenda remained long, especially as important aspects of the financial sector and infrastructure support--transport in particular--required continuing emphasis. Therefore, it was appropriate that a fourth-year arrangement under the ESAF be approved. He wished to note that Malawi had embarked on an enhanced structural adjustment arrangement without the benefit that some others in a comparable situation had had in terms of setting the stage for strong actions through SAF-type arrangements.

That said, he had some concerns in the macroeconomic area, Mr. Fernando continued. Although the overall budgetary deficit for 1990/91 was well within the program parameters, it had been achieved in, if he might use the word, a disorderly manner through qualitatively inferior measures. A shortfall in revenue had been offset by a cut in development outlays. For a country like Malawi that had large unmet needs for infrastructure, the authorities could ill afford that type of ad hoc action, which resembled "concerted adjustment." At the current stage of policy implementation, and given the imperatives of a strong fiscal policy in the light of the fixed exchange rate policy, he would have expected the authorities to have in store contingency actions to safeguard revenues, such as one-time discretionary measures. The staff had just confirmed that there was no potential for cuts in current expenditures, and he wondered whether staff could comment on the scope for contingent actions on the revenue side. The ripple effect of the change in financing had also contributed to monetary expansion, through the Government's transactions with the banking sector, and had thus slowed progress in reducing inflation.

His second comment concerned the setback to the target for gross official reserves, a critical element of an enhanced structural adjustment program, Mr. Fernando stated. The strain on payments arising from the incentives to stockbuild imports in the wake of import liberalization testified to the hidden pitfalls in policy implementation. However, he wished to inquire whether the desire for stockbuilding also reflected a lack of confidence in the sustainability of the fixed exchange rate, exacerbated by incentives to hold imports in customs bond warehouses. While the importance of a steady exchange rate policy for cutting back inflation was obvious, what were the guidelines and policy tools that could be employed to determine how far to go in defending the rate?

Finally, Mr. Fernando inquired whether the authorities intended to update the policy framework paper annually after the enhanced structural adjustment arrangement concluded in 1992.

Mrs. Hansen made the following statement:

We commend Malawi's relatively good performance under its ESAF program to date. In view of Malawi's track record, the important structural reforms under way, the vulnerability of its external accounts, and the modest level of additional access proposed, we can support its request for a fourth-year program.

The success of Malawi's adjustment effort depends on a strong fiscal program, both to promote a climate of low inflation and to avoid crowding out private sector credit. We note that Malawi slightly overperformed on the fiscal target under the third ESAF program, notwithstanding the shortfalls in surtax revenue. We welcome the indications in Mr. Mwananshiku's statement and the staff report that the authorities are taking steps to improve performance in this area. However, we are concerned to see the large shortfall in development expenditure compared with what was budgeted, and would appreciate some clarification from the staff on the reasons why this occurred and the grounds on which a higher level of development expenditure is expected to be achieved in the coming program period.

On the monetary side, we regret that the weak fiscal performance in the first quarter resulted in a significant increase in credit to the public sector, crowding out programmed private sector credit. This, in our view, underscores the importance of stronger fiscal performance.

We support Malawi's pragmatic approach to exchange rate management. It goes without saying, however, that maintaining low inflation, and hence appropriately restrictive financial policies, is the key to the success of such a policy. In this connection, we support the development of a monthly composite index of consumer prices, as well as the inclusion of a performance criterion on this point, although we confess to some surprise that this was not already accomplished within the first three years of the ESAF program. With regard to other external policies, we have some reservations about the authorities' intention to use fiscal incentives in order to promote export diversification. Perhaps the staff would comment on how these incentives will be targeted and how extensive they are expected to be. We would prefer to see the authorities concentrate on removing structural impediments to export diversification, rather than use fiscal incentives.

Looking ahead to the program for next year, we welcome the emphasis on further structural reform and growth, especially in view of Malawi's low per capita income. In the structural area, we particularly support steps to improve the performance of state enterprises and privatize some of ADMARC's holdings. We agree that the restructuring of Malawi Railways and the Postal Savings Bank deserves the highest priority. We welcome recent financial sector reform, but we agree with the staff that the pace should be increased. In this connection, we believe that competition from foreign banks would be very helpful in accelerating financial sector development. We would also strongly encourage steps to clarify investment procedures and codify recent liberalizations so as to encourage private capital inflows.

With respect to the fiscal program for next year, we support the emphasis on social expenditure. However, caution will have to be exercised in other areas of expenditure. We hope the authorities will be particularly cautious on wage policy, especially since the degree of wage stability achieved so far has reportedly helped Malawi maintain external competitiveness.

Finally, we welcome the attention paid to environmental issues in the policy framework paper and encourage the authorities to follow through on their stated intention of developing an Environmental Action Plan.

Mr. Towe said that his chair was pleased to lend its support to the proposed decision. Nevertheless, while Malawi's track record during its three-year enhanced structural adjustment arrangement had been highly commendable, it was unfortunate that performance in the third year had been weaker than programmed and that a number of the benchmarks for the latter half of the year had not been met. It was disturbing to note that those weaknesses had apparently spilled over into the first quarter of the current fiscal year and contributed to a significant acceleration of the money supply growth. His chair therefore urged the authorities to make every effort to bring their ESAF-supported program to a successful conclusion.

As he broadly shared the staff's appraisal and the comments of previous speakers, he would simply raise a number of questions, Mr. Towe said. First, the staff appraisal seemed to suggest that there might be a need to reassess the performance criteria on net domestic assets for end-December, in the light of government expenditure patterns. Perhaps the staff could elaborate further on that point.

Second, the staff report referred to the Government's desire to widen its use of export allowances and investment incentives as a means of promoting export growth and diversification, Mr. Towe noted. He asked the staff to indicate whether its view was that emphasis on tax incentives would be effective or appropriate, given the relatively narrow tax base, the need to finance important development projects, and the recent tax reform. He shared Mrs. Hansen's concerns in that regard.

Third, the benchmark in the third-year program requiring formulation of a plan for domestic sugar pricing and allocation had been completed successfully, resulting in a substantial increase in domestic sugar prices, Mr. Towe continued. Moreover, the staff report and the authorities' letter of intent referred to continued efforts to promote Malawi's export potential. He asked the staff to indicate the extent to which incentives for smuggling had been eliminated, and what mechanisms had been put in place to effect future price increases that may be necessary.

Mr. Fridriksson made the following statement:

In the Board discussions on the enhanced structural adjustment facility we have indicated our willingness to accept fourth-year arrangements in certain cases. Malawi is a good first candidate for such an arrangement. Its program has been generally successful and the record of cooperation with the Fund is good. Access under the proposed arrangement appears to be appropriate.

As shown in the paper, Malawi's external situation continues to be relatively weak, due in part to the liberalization of the economy, and it is important to consolidate the achievements under the ESAF program so far. This requires a continued implementation of restrictive financial policies and further progress in the parastatal sector, particularly in strengthening the position of Malawi Railways, as well as further attempts to diversify the export sector.

The balance of payments continues to be vulnerable to outside disturbances, but I am satisfied that the baseline scenario is a realistic one. According to that scenario, further Fund support will not be needed after the program period, and there are no plans to request further debt reschedulings. As noted, Malawi has always met its debt service obligations to the Fund.

In the monetary policy area, I would like to ask the staff to comment on the depth of the financial market and the effectiveness of the Reserve Bank of Malawi's bill operations. The staff might also elaborate on why the purchase of an aircraft by Air Malawi in 1991 is left out of the balance of payments statistics.

Malawi has made important progress under its ESAF arrangements, but careful policy design and implementation will be equally important in the post-ESAF period. I support the proposed decision.

Mr. Ismael made the following statement:

We are pleased to read from the staff report and Mr. Mwananshiku's statement of the considerable progress achieved by Malawi under the ESAF-supported programs of adjustment. Indeed, over the past three years, the economic and financial performance has improved significantly and important structural measures have been implemented. These have enabled the country to make important gains in output, to reduce inflation, and to almost halve the fiscal deficit. We are greatly encouraged by these achievements, which are also indicative of the good track record of policy implementation by the Malawian authorities, who deserve our full commendation.

However, notwithstanding these significant achievements, the economy remains vulnerable to shocks, and macroeconomic and structural adjustment policies need to be strengthened. In particular, the external accounts appear to have weakened as a result of the liberalization of imports and of other current payments as well as the uncertainty concerning external transportation. Moreover, the structural reforms under way in the other sectors of the economy, in particular in the fiscal, financial and parastatal sectors, need to be reinforced. Continued assistance from the international community would help Malawi to deepen these reforms and achieve a higher level of economic growth in the context of a stronger balance of payments position.

In view of these facts, we fully support the request of Malawi for a fourth-year arrangement under the ESAF, which also meets the conditions under the guidelines adopted during the last review of operations under the SAF and ESAF.

The program of adjustment envisaged under the fourth-year arrangement is a strong and comprehensive one. We agree with the objectives and the policy measures envisaged. As we are also in agreement with the staff appraisal, I shall confine my brief comments to the fiscal sector.

We note that the measures implemented have enabled expenditure to be contained so that despite a shortfall in revenue, the overall deficit was reduced more than programmed in 1990/91. We agree that measures are needed to improve revenue performance. In this context, additional efforts appear to be required to improve tax administration and strengthen the revenue base, and at the same time to eliminate the surtax exemptions. On the expenditure side, while the present stance must be maintained, the urgent social needs must be given consideration. In this context, can the staff elaborate on the measures envisaged to assist the more vulnerable group of the population? We also agree that wage compression in the civil service needs to be relaxed to improve its efficiency and to attract the qualified personnel required. Overall, we welcome the fact that the present policies will allow for a sizable net repayment by the Government to the banking system and allow for a transfer of resources to the private sector. In conclusion, we support the proposed decision.

The staff representative from the African Department said that with respect to the appropriateness of a fourth-year arrangement under the ESAF for Malawi, it should be noted that the country had a very weak capacity to service debt on commercial or near-commercial terms. For that reason, there was a provision in the arrangement that strictly controlled the uptake of any debt on nonconcessional terms. The other two points that had been discussed at the time of the Board's review of the ESAF would seem to have been met: policy performance had been strong, and the efforts were being supported by considerable concessional assistance from other sources. The increment in reserves during 1991/92 of $15-$16 million was being made possible by the fourth-year arrangement.

The fiscal deficit of 6 percent of GDP before grants characterized the path that had been selected for Malawi as being consistent with the availability of external financing on appropriate terms for expenditures under the public sector investment program which, the staff representative explained, the donors and the World Bank had agreed were of high priority and high quality. In other words, it was a sustainable expenditure/revenue/financing configuration. The figure for the 1991/92 fiscal deficit in the previous policy framework paper had been 5 percent of GDP. It was quite possible that the fiscal deficit would be smaller than 6 percent of GDP, which was viewed by the staff and the authorities as the upper limit--not a target--and one that seemed consistent with other parameters as far as financing was concerned. On the sustainability of the deficit, it should be noted that in looking beyond the aggregate deficit to the character of the external financing, the scenario was not one that ran up against a long stream of sizable balance of payments support or import support. It reflected more and more a shift toward project financing, which, toward the end of the medium-term period, was a normal supplement to domestic savings from foreign savings on high-quality projects. That seemed appropriate for a country with a per capita income of $180 a year. The pace of decline in the fiscal deficit was a reflection of the availability of resources to Malawi and the demand for expenditure in support of the restructuring and transformation of the economy. It was a time path that had actually been set forth in the first arrangement, so that in some sense the authorities were continuing along a well-established track.

On the measure of reserves in relation to nonmaize imports, the staff representative explained that most maize imports were funded abroad from grants and were simply passed on to the refugees. The transactions appeared in Malawi's balance of payments but were not an inherent part of the balance of payments structure over the longer run. All transfers to the refugees, whether from domestic production or imports, were considered to be external transactions, but the inclusion of maize imports overstated the weight of imports in Malawi's economy. As far as the aircraft purchase was concerned, in an economy as small as Malawi's, such a large, single transaction--which incidentally was financed on concessional terms consistent with the program--resulted in a sharp move in the external current account position in one period. Therefore, it might in fact be better to identify the specific transaction.

Concern had been expressed about the way in which the authorities had responded to the shortfall in revenue in the previous fiscal year, accompanied by a simultaneous and significant shortfall from projected import support, the staff representative noted. In fact, a cut in extrabudgetary expenditures had been programmed into the budget as a safety margin, which was, he believed, a rather orderly way to proceed. It would be recalled that the credit ceiling at the end of that fiscal year had been breached because the Government had purchased sizable a amounts of maize--at a cost of MK 68 million, or an amount equal to about 1.5 percent of GDP--to sell to foreign aid agencies for the refugees. Owing to some uncertainty as to whether or not the Government would have to purchase maize, MK 29 million had been included as a safety factor in the budget for extrabudgetary expenditure. Fortunately, the maize purchase had not been necessary. Thus, the reduction in expenditure was not on account of development expenditure, which, however, had been overestimated in the budget. The capacity to absorb resources and carry out development projects frequently did not meet expectations. Development expenditures in Malawi in 1990/91 were more than 10 percent higher than in 1989/90, and it would be misleading to suggest that the authorities had consciously cut back on development expenditure. There had been a fortuitous overstatement of expenditure and an extrabudgetary allocation that was not needed. Also, the greater part of the shortfall in the fiscal program had been in the import counterpart, rather than in the revenue shortfall.

There were several possible reasons for the stockbuilding that had taken place in conjunction with the import liberalization, the staff representative remarked. In some sense, it might have had an element of speculative behavior, relating to how firm the exchange rate policy or the realism of the exchange rate would be. Any indication that credit policy might be slack, or that real interest rates might be negative, was another possibility. The question of confidence was highly subjective and was probably less a matter of the exchange rate than of the availability of foreign exchange to finance imports. It might take some time to convince the economic agents of the irreversibility of the import liberalization. In addition, as noted in the staff paper, it was possible to avoid the payment of fairly significant taxes for some period as long as imports remained in a bonded warehouse. If the taxes had been applied up front, that kind of stockbuilding might not have taken place. The authorities were taking strong action to remedy the situation. They had recently reduced to one year the period during which goods could be held in a bonded warehouse without being subject to tax. There was no longer provision for extending the period by six months, and the one-year period itself would be reduced to six months when Parliament opened in October.

It was not so much a matter of why Malawi had not had a monthly price index as the need for a new household expenditure survey, the staff representative explained. The authorities felt that moving from the quarterly system to a monthly system, without updating and making the household survey much more comprehensive, was not the answer. It was taking them some time, with the assistance of the UNDP and others, to complete that process, which was being supported through the program, and the new monthly index would be a much improved indicator.

How to raise additional revenue was always a matter of concern, the staff representative said. The tax reform process, which was supported by the World Bank directly with technical assistance, was designed initially to be revenue neutral. While there had been a reduction in rates, Malawi's corporate income tax was very high, at 45 percent, and personal income tax rates were also high. Bank staff, and he himself, would not be anxious to resolve what was perhaps a short-term liquidity problem by increasing those tax rates. The fact that the authorities had increased the number of tax auditors, from 5 to 15, was already a major strengthening. Other action that would require parliamentary approval was being taken at that time, including a significant increase in the surtax on the services sector. Broadly speaking, the parties that had been working together--the Fund, the Bank, and the major donors--felt very comfortable with a tax system that combined further reductions of rates and rationalization of the system, on the one hand, with a broadening of the tax base, but generally keeping the level of revenue to GDP at a ratio of about 20 percent, which would be the medium-term outcome.

On the question of possible further measures to stimulate nontraditional exports, and how far to extend fiscal incentives, the staff representative stated, the fundamental question was one of the competing demand for resources. If Malawi should take other action in addition to the institutional and legislative changes that he had already alluded to, priority should be given to reducing the level of import protection, which was high in many areas, and create a dynamic traded goods sector. It was not only tariff duties that were high, but the fact that some taxes did not apply to domestically produced import substitutes; in some cases, the level of protection might be well over 100 or 200 percent. In the next stage of the World Bank loan, the liberalization process and the reduction of protection was being directly supported. A major study done in 1989 had been updated, with specific guidelines in the area, and its implementation was the major step to be taken before any major fiscal incentives were offered.

The staff had been in constant touch with the authorities with respect to the ceiling on net domestic assets, which had been running above the parameters of the program in the early months and would probably continue to do so for September, the staff representative explained. Additional resources would become available in October, including a major release of import support funds from the United Kingdom, and the authorities had confirmed that the December ceiling was viable. If the pace of disbursement of import support accelerated over and beyond the forecast, the ceiling would automatically be reduced.

There was no automatic formula for adjusting sugar prices, the staff representative noted. It had been agreed during the previous year that a new sugar production mill would be opened in the medium term, with the result that capacity would be increased by about 30 percent. For its part, the Government had agreed in principle, subject to continuing discussions with the company that owned the sugar mills, to ensure on an informal basis that the domestic sugar price was sufficient, in light of international prices and domestic costs, to give an adequate rate of return and to support the new investment incentives.

Mrs. Hansen remarked that perhaps an actual increase of development expenditure over the previous year of less than 10 percent might be normal for a country like Malawi. But if so, the projection in the program for the coming year of a 25 percent increase in development spending posed the question whether implementation would improve greatly or whether it was again a matter of overestimation.

The staff representative from the African Department commented that there was of course some linkage between the level of expenditure and the receipt of the external assistance to support it; not all of the counterpart of import support was received by the Reserve Bank, and certainly not all of it was available for recurrent expenditure. Another significant delay in receipt of import support, insofar as more of the counterpart went to the development budget than to the recurrent budget, might have an impact on the pace of development expenditure, which, however, had been approved by the World Bank staff. At the same time, the previous pattern of the budgets had shown a tendency toward overstatement.

Mrs. Hansen asked to what extent the problem was one of implementation on the part of the Malawians, rather than of estimation and the ebb and flow of development assistance.

The staff representative from the World Bank said that the discrepancy in development expenditure between the 1990-91 program and the actual outcome was partially due to a delay in implementation. The projected increase for 1991-92 was in part due to a catchup in that delay, and also to a general reallocation of development expenditures from low-priority areas to priority social sectors, which had been agreed upon jointly by the Bank, the Fund, and the Government.

The staff representative from the Exchange and Trade Relations Department, referring to the justification for a fourth-year arrangement, commented that from the two usual points of view--that of adjustment and that of financing--the discussion suggested the need for further structural reform and for a good macropolicy underpinning of that structural reform, especially to meet the inflation targets which had not been observed. The critical areas in which the Fund expected to be involved in terms of policy advice concerned the financial sector and taxation. If the reform in those areas was not completed, the baseline scenario would not materialize, the balance of payments vulnerability would be greater, and even the short-term financing need would be much larger.

The dilemma was that with the strengthening of the adjustment effort, financing needs were reduced, the staff representative added. In the case of Malawi, it was clear that if there was no supplementary adjustment, the financing need would be larger. By the same token, because some of the financing need was offset by adjustment, and because the donors were playing such a lead role, the Fund's share in the financing was smaller; but that should not be taken to mean that it was not needed, nor that a smaller amount of financing was not important. In Malawi, the small amount of financing was coupled with appropriate policy advice and an adjustment effort that was crucial to establishing a more solid longer-term situation.

As to whether the amount of financing that was being provided could not have been provided by the Fund from its general resources, the staff representative from the Exchange and Trade Relations Department added, the aim was to create an underlying baseline scenario that would lay a solid foundation and reduce the vulnerability of the economy; in the process, the declining trend in Malawi's debt-service ratio would be solidified in the future. To have shifted to use of general resources before the medium-term improvement was realized would have been somewhat premature. Also, the calculation of the financing need included not only current account financing requirements, but also what was considered to be a safe margin for reserves. The reserve financing need could not be ignored, just because it was small. In sum, the staff had tried to arrive at a careful balance between the effectiveness of the Fund's role on both the adjustment and the financing side, especially on the former, which was crucial to the medium term.

Mr. Esdar recalled that it had been concluded as part of the review of the enhanced structural adjustment facility that such fourth-year financing should be exceptional. He asked in what way Malawi was an exceptional case, compared with other ESAF-eligible countries.

The staff representative from the Exchange and Trade Relations Department responded that the case of Malawi was exceptional in the sense that, first, the past record of adjustment and of achieving the stated objectives had been good. Second, a signal had been given in the level of access that the need for Fund financing was going to fall.

Mr. Esdar commented that he hoped that that did not mean that good performance and reduced access were to be exceptional, too. That would be a strange interpretation of the guidelines.

The staff representative from the Exchange and Trade Relations Department considered that Malawi's record, compared with that of other countries, stood out as being very strong. One of the points mentioned in the guidelines was the past record. Second, the decline in access was very sharp, and that was also consistent with the guidelines.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/134 (9/27/91) and EBM/91/135 (9/30/91).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 91/7 and 91/8 are approved.

5. EXECUTIVE BOARD TRAVEL

Travel by Advisors to Executive Directors as set forth in EBAP/91/224, Supplement 3 (9/26/91) and EBAP/91/239 (9/26/91) is approved.

APPROVED: April 1, 1992

LEO VAN HOUTVEN
Secretary

ANNEX
ATTENDANCE
FOR ITEM 1

INTERNATIONAL MONETARY FUND

Minutes of Executive Session

9:30 a.m., September 30, 1991

A. Kafka, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	
G. K. Arora	
	Chen M., Temporary
C. S. Clark	
T. C. Dawson	
	J. Prader
E. A. Evans	
R. Filosa	
M. Finaish	
	I. Fridriksson
H. Fukui	N. Tabata
B. Goos	
J. E. Ismael	
A. Kafka	
J.-P. Landau	
A. Mirakhor	
L. B. Monyake	
D. Peretz	
G. A. Posthumus	
C. V. Santos	
A. Torres	A. G. Zoccali

J. W. Lang, Jr., Secretary